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Making Spousal Estate Tax Exemptions Transferable

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Under the Internal Revenue Code of 1986, taxpayers are permitted a federal gift tax exemption and an estate tax exemption. Although technically not exemptions but more in the nature of exemption "equivalents" that entitle taxpayers to a credit, each is more easily understood as an exemption. The gift tax exemption, as so understood, is $1 million for each taxpayer and is not scheduled to increase. The estate tax exemption, as also so understood, is $1 million for 2005 and is scheduled to become $2 million in 2006, 2007, and 2008 and reach $3.5 million in 2009. There will be no estate tax for individuals dying in 2010. Beginning in 2011, the estate tax exemption drops to the gift tax exemption level of $1 million.

Tax Exemptions of Married Persons

As indicated, each individual has his or her own gift and estate tax exemption. It is not portable: one taxpayer cannot transfer his or her unused exemption to another. Even though the Code can be understood as treating married couples as one economic unit for certain transfer-tax purposes, as per the one-economic-unit theory, a surviving spouse's estate may not use the other spouse's unused exemption. Nonetheless, in the case of lifetime gifts, a couple may share, at least to a limited degree, exemptions by "gift splitting" under Code § 2513, which permits one spouse to consent to be treated as though he or she made one-half of the gifts made by the other spouse (except for gifts made to or for the other spouse). When this section is operative, one consequence is that it permits the spouse making the gift to apply the other spouse's exemption. For example, a wife gives $2 million to her child. Her husband, whether or not he is the father of the child, may consent under Code § 2513 to be treated as though he made half of the gift for federal gift tax purposes. If the election is made, he will report the half attributed to him on his own gift tax return and will use any remaining portion of his gift tax exemption. (In addition, if the gift could be subject to generation-skipping transfer tax, such as a gift to a grandchild, the gift-splitting spouse—the husband in the foregoing example—is also treated as the transferor for generation-skipping transfer tax purposes. That may have the effect of permitting the spouse who made the transfer also to use the GST exemption of the other spouse.)

As suggested, sharing of unused exemptions by spouses for estate tax purposes is not permitted, although such portability has been long proposed. As a result, and to avoid wasting the exemption, so-called credit shelter trusts are commonly used. Such trusts are structured to use exactly the federal estate tax exemption of the spouse dying; they typically provide benefits for the surviving spouse but are structured so as not to be included in the gross estate for federal estate tax purposes of the surviving spouse. These trusts entail financial and psychological costs, such as the cost of drafting and administering the trust and the loss of control over the trusts' assets by the surviving spouse. A portable exemption, under which the surviving spouse would be permitted to enjoy his or her spouse's unused exemption, would obviate the need for credit shelter trusts entirely (although a trust might be used for creditor protection and other reasons). If, for example, under current law, one spouse died and bequeathed the entire estate to the other spouse, the exemption would be wasted. If the Code permitted portable exemptions, however, the surviving

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spouse's exemption would be increased by the unused exemption of the other spouse. An interesting issue if such portability were allowed is whether only the estate tax exemption of the surviving spouse would be increased or also the gift tax exemption of that spouse.

Although Congress has thus far refused to address the issue, the IRS has begun issuing private letter rulings and national office technical advice memorandums (which under Code § 6110(k)(3) may not be cited or used as precedent) that diminish the planning problems some taxpayers face because of the nonportable nature of the exemption. The principal focus of the rulings appears to be the case in which a spouse dies with insufficient assets to use his or her estate tax exemption in full—a situation that becomes more common as the exemption increases. In such a case, the unused exemption is wasted, of course, even though the surviving spouse may have wealth that is greater than his or her exemption. With proper planning, the waste of the exemption could be avoided by having the wealthier spouse make a gift to the less wealthy spouse. This could be accomplished either by an outright gift or by creating a qualified terminable interest property or QTIP trust described in Code § 2523(f) for the benefit of the less wealthy spouse. This kind of planning, however, may encounter objections from clients who are unwilling to relinquish control over assets to their spouses.

PLR Strategy: Creating a General Power in the Deceased Spouse

In the rulings, the IRS has approved a plan that permits clients who have such control concerns to avoid wasting the exemption at the death of the less wealthy spouse. See, e.g., PLR 200403094 (single grantor revocable trust) and PLRs 200210051, 200101021 (joint grantor trust). Under the plan, the wealthier spouse creates a revocable trust that grants the other spouse a testamentary general power of appointment over sufficient assets such that there will be no waste of the exemption in the less wealthy spouse's estate. And because the wealthier spouse is able to revoke the trust at any time, the plan does not entail any surrender of control. To illustrate, assume the less wealthy spouse died in 2005 with $500,000 in assets and had a testamentary general power of appointment over $1 million in assets under the other spouse's revocable trust. The gross estate, under the rulings, would be $1.5 million. In other words, even though the general power could have been revoked by the other spouse, it is nonetheless a general power within the meaning of Code § 2041, and the gross estate is, therefore, $1.5 million.

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If the less wealthy spouse exercises the power of appointment in favor of his or her estate and then directs in the will that it be placed in a credit shelter trust for the benefit of the wealthier spouse, the exemption is not wasted. It is, of course, critical that the surviving spouse not be viewed as the transferor of the assets passing into the credit shelter trust. For if that were the case, there would be two negative consequences: (1) the wealthier spouse could be viewed as having made a taxable gift to the other beneficiaries under the credit shelter trust at the death of the less wealthy spouse; and (2) the corpus of the trust could be included in the wealthier spouse's estate under Code § 2036 or § 2038, depending on the nature of the interests or powers conferred on the surviving spouse. Most critical, the rulings conclude that the wealthier spouse should not be viewed as the transferor. That may seem somewhat surprising. After all, one could easily imagine that the IRS would be inclined to invoke the step-transaction doctrine and thereby treat the wealthier spouse as the true transferor—or to argue, similarly, that, under state law, the wealthier spouse is considered the transferor for purposes of analyzing creditors' rights and that Code § 2036 or § 2038 should therefore apply at the wealthy spouse's death. See *Griffin v. United States*, 42 F. Supp. 2d 700 (W.D. Tex. 1998); *Estate of Cidulka v. Commissioner*, 71 T.C.M. (CCH) 255 (1996); *Heyen v. United States*, 945 F.2d 359, 363 (10th Cir. 1991); *Paolozzi v. Commissioner*, 23 T.C. 182 (1954); *Estate of Paxton v. Commissioner*, 86 T.C. 785 (1986). Presumably, because of a sensitivity to the difficulties that nonportability creates, the rulings do not take this approach.

The rulings take a taxpayer-friendly approach on another critical issue, the gift-tax marital deduction. For the plan to work, the wealthy spouse must not be viewed as having made a taxable gift to the less wealthy spouse. It is, of course, clear that no completed gift occurs as long as the trust remains revocable. Treas. Reg. § 25.2511–2(c) (second sentence). The rulings acknowledge as much. But the more controversial question is whether a taxable gift occurs at the death of the less wealthy spouse. The rulings conclude that the marital deduction applies and, therefore, no taxable gift is made. As such, a gift tax marital deduction is not permitted under Code § 2523(i) for a transfer to a spouse who is not a U.S. citizen, nor is an estate tax marital deduction permitted under such circumstances unless the transfer is in the form of a qualified domestic trust, described in Code § 2056(d). To be sure, the IRS might have taken a less taxpayer-friendly position. It could have denied the marital deduction on the ground that the gift does

not occur until the death of the less wealthy spouse, reasoning that the marital deduction contemplates a living donee. Cf. *Estate of Dave Gordon v. Commissioner*, 70 T.C. 404 (1978), acq. 1979–2 C.B. 1. Treas. Reg. §§ 20.2056(b)-2 ex. 8 and 20.2056(b)-4(e) support the position taken in the rulings by indicating that payments to the spouse's estate qualify for the marital deduction, but in each instance the spouse survived. In contrast, Code § 2056(b)(3)(A) permits a marital deduction when the bequest to a spouse will terminate as a result of the death of the "surviving" spouse in a common disaster. The IRS might also have taken the position in the case in which the less wealthy spouse allows the power to lapse that the marital deduction might possibly be denied on the ground that it constitutes a terminable (nondeductible) interest within the meaning of Code § 2523(b). But, here again, policy concerns about nonportability likely helped to drive the outcome.

One final issue implicated in the rulings is the question of income tax basis. Under Code § 1014, it would seem, at first blush, that the assets passing into the credit shelter trust should qualify for a change in basis. Code § 1014(e), however, provides that the section is inapplicable—no change in basis is permitted—when the asset is gifted to the decedent within one year of death and the asset then passes back to the donor at the death of the decedent. Relying on Code § 1014(e), the rulings conclude that the assets in the revocable trust will not qualify for a change in basis to the extent that the surviving spouse receives property from the decedent as a result of the exercise of the power (or its lapse). In concluding that Code § 1014(e) is triggered, the rulings take the view that the gift is made to the deceased spouse at the moment of death and, therefore, falls within the provision's one-year time frame. In effect, the rulings analogize to the gift-tax regulations. In other words, just as the gift does not occur for gift-tax purposes until the death of the less wealthy spouse because the wealthier spouse retains a revocation power, so, too, the gift is not deemed to occur for purposes of Code § 1014(e). That kind of analogy seems to be a sensible one and could certainly be adopted in regulations. At the present time, however, there is no regulation under the section.

If the conclusion that the gift occurs within the one-year time frame is correct, the question becomes how to compute basis. Although the more recent rulings give no guidance on this question, PLR 9321050 suggests that the determination be made by focusing on the actuarial value of the wealthy spouse's interest in the trust. In other words, if the wealthier spouse is given an income interest in the trust that has a value equal to, say, 40% of the value of the trust's assets, then 40% of the trust's assets should not be eligible for a change in basis under Code § 1014 (the remaining 60% would be eligible). This approach raises two questions: (1) how to determine which assets in the trust are eligible for a change in basis and (2) how to value the wealthy spouse's interest in the trust when it is discretionary. The first question may arise, for instance, when the revocable trust may have more assets than the amount over which the surviving spouse has the general power of appointment. It might be possible to specify the order in which the assets in the revocable trust will be used to satisfy the general power property if the power is exercised. But it seems likely that there is some question about which assets in the revocable trust are included in the gross estate of the deceased spouse on account of his or her general power. In reference to the second question, as a general rule, a truly discretionary interest may have no actuarial value. For example, the standard Code § 7520 income factor may not be used to value an income interest in property when the governing instrument permits trust corpus to be withdrawn for another person's benefit. Treas. Reg. § 20.7520-3(b)(2)(ii)(B)(2). However the calculation is made, it does seem that taxpayers will be able to enjoy some change in basis under the rulings—at least for the portion of the trust deemed to pass to the beneficiaries other than the surviving spouse.

Other Applications of the PLR Strategy

Inappropriate Assets Available to Fund the Credit Shelter Trust

There are two additional contexts in which the new rulings may be useful in planning. First, a spouse may have sufficient assets to use the exemption, but the assets may not be an ideal candidate for a credit shelter trust. For example, when a spouse has pension or IRA assets that could be used to apply the exemption but no other assets, or when the spouse may have insufficient assets other than qualified (pension) plan or IRA assets to use his or her exemption in full, the couple must decide whether to secure the estate tax advantage of making it payable to a credit shelter trust to avoid wasting the exemption. If the credit-shelter approach is used, there is an offsetting income-tax disadvantage: the deferral period for reporting the distributions will be shortened. See generally Natalie B. Choate, *Life and Death Planning for Retirement Benefits* (2003), at 14–26, 56–58, 144–53, for an excellent discussion of "fixed" versus "recalculated" life expectancy methods and income tax free spousal "rollovers." In addition, if they opt for the credit-shelter approach, the estate-tax outcome is sub-optimal: when dealing

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with pension-type assets, which generally will represent the right to income in respect of a decedent (IRD), the surviving spouse's estate tax can be reduced by making the benefit payable to the spouse, rather than to the trust. The right to IRD is not entitled to the change in basis under Code § 1014(a). See Code § 1014(c). Deferred compensation, such as interests in a qualified (pension) plan or individual retirement account (IRA), represent the right to IRD as a general rule. See *Hess v. United States*, 271 F.2d 104 (3d Cir. 1959). The advantage, in other words, that the credit shelter trust offers, when the trust is funded with the right to IRD, is eroded by the income tax on the distributions that the trust must bear. Whereas, if the benefit is made payable directly to the spouse, the income tax paid by the spouse reduces the amount eventually subject to estate tax at his or her death. If, however, the plan approved in the rulings is used, the couple can avoid wasting the exemption without suffering that erosion and without shortening the deferral period for income tax purposes.

> The strategy approved in the rulings permits the couple to use as much of the exemption of the first of them to die as is possible.

To illustrate, assume that a wife has $1.5 million in her IRA and no other assets and that the husband has $1.5 million in non-IRD assets. Ideally, these assets of the husband would be of the type entitled to the change in basis under Code § 1014(a). Assets other than the right to IRD also may be denied a change in basis under the section. E.g., Code § 1014(b)(5) and (d). If the wife were to die in 2005 survived by her husband, she could direct that her IRA pass into a credit shelter trust to avoid wasting her $1.5 million exemption. But this would, as indicated, shorten the deferral period. And, given the erosion resulting from the trust's income tax liability, it also would not be as estate-tax effective as making the benefit payable to her husband. If the approach approved in the rulings were adopted, however, an optimal outcome could be achieved: the wife would simply make her husband the beneficiary of the IRA, and he would transfer his assets to a revocable trust under which she was given a general power of appointment. Under this arrangement, the husband's non-IRD assets would be used to fund the credit shelter trust created at the wife's death, and the IRA would pass directly to the husband—thus producing no waste of the exemption, no shortening of the deferral period, and no erosion. But it should be noted that the advantage of using the surviving spouse's assets may be eroded if Code § 1014(e) applies to them, as suggested by the private letter rulings. Nevertheless, as explained, it seems that some change in basis under Code § 1014(a) should occur.

Insufficient Assets Available to Fund Both Exemptions

The second context in which the rulings could prove to be helpful is when the couple wants to take full advantage of their exemptions but does not have sufficient aggregate wealth to secure this outcome. For example, assume that a couple has an aggregate wealth of $2.5 million and that they want to use available exemptions fully because they believe that they will eventually have very substantial estates. In 2005, with an exemption of $1.5 million, the couple presumably would be advised to title $1.5 million of their assets in the name of the spouse with the shorter life expectancy. But, of course, the order of death typically is not easily forecast. And if the spouse with the longer life expectancy were to die immediately with an estate of $1 million, part of the exemption ($500,000) would be wasted. Under the rulings, that result can be avoided. If each spouse were to create a revocable trust that conferred a general power on the other, the entire $1.5 million exemption would be used irrespective of the order of their deaths. It may be that the couple together does not have enough combined wealth even to use one exemption fully. For example, the husband has $500,000 and the wife has $750,000, for combined wealth of $1.25 million, which is less than the available exemption for the years 2005 through 2009. Nevertheless, the strategy approved in the rulings permits the couple to use as much of the exemption of the first of them to die as is possible.

A Conservative Approach to Adopting the PLR Strategy

In all of these cases, the rulings solve the problems of nonportability. The IRS obviously resolved all of the legal uncertainties in the rulings in favor of taxpayers to reach a salutary outcome in policy terms. And, although the IRS should be applauded for taking this policy-driven approach, taxpayers will continue to entertain doubts about relying on the rulings until published guidance is provided.

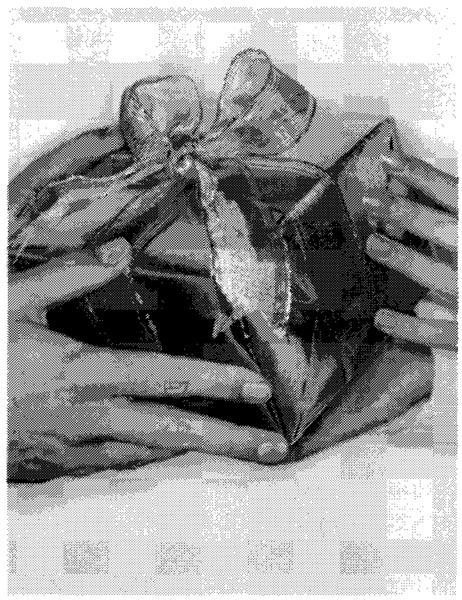
Given the nonbinding nature of private letter rulings and the difficulties practitioners face, as a consequence, it may be prudent to take a conservative approach in terms of drafting and planning to minimize the risk that the IRS would succeed were it to disavow the rulings. Practitioners who implement the approach approved in the rulings, perhaps, should consider adopting the three recommendations that follow.

First, the spouse who receives a general power should exercise it, rather than allowing it to lapse. Although the rulings do not require this, it would seem that the IRS could argue that a spouse who receives a power of appointment and

allows it to lapse has received a terminable interest that does not qualify for the gift-tax marital deduction. On the other hand, if the power is exercised, the terminable-interest argument would appear to be foreclosed. See Rev. Rul. 82–184, 1982–2 C.B. 215.

Second, the surviving spouse should be given a special power of appointment under the credit shelter trust that is created through the exercise of the other spouse's general power. The special power should be exercisable during life and at death. Under this structure, it would seem that the IRS could not argue that the surviving spouse has made a taxable gift of the remainder interest at the other spouse's death. For even if the IRS changes its position and takes the view that the surviving spouse is the transferor, no taxable-gift argument can be made successfully when the transferor has a special power that is immediately exercisable, because the gift of the remainder would be incomplete. Treas. Reg. § 25.2511–2(c). This is illustrated in *Goldstein v. Commissioner,* 37 T.C. 897 (1962), in which the court intimated that a taxable gift might occur if the time for exercising the special power is delayed.

Third, the grantor of the revocable trust should give the other spouse a mandatory income interest that qualifies the property over which the deceased spouse has the general power for QTIP treatment. The general power granted to the first spouse to die might cause the property to qualify for the marital deduction under Code § 2523(e) (a general power of appointment trust) rather than Code § 2523(f) (a QTIP trust). But for the trust to qualify under Code § 2523(e), the general power must be exercisable by the spouse alone and in all events. Treas. Reg. § 25.2523(e)–1(a)(4). Some condition could be built in: for example, the spouse can only exercise the power if he or she is under the age of 115 at the time of death. The built-in condition should prevent it from qualifying for the marital deduction under Code § 2523(e), so an election may be made to have it qualify under Code § 2523(f), in order that the trust will not be included in the surviving spouse's estate under Code § 2036 or § 2038. In addition, the credit shelter trust created for the benefit of the grantor through the exercise of the general power at the death of the first spouse should limit the trustee's discretion in terms of distributions to the grantor (an ascertainable standard relating to health, education, maintenance, and support should be



used). If this suggestion is implemented, it would seem that the IRS would be precluded from including the trust in the estate of the surviving spouse (the grantor of the revocable trust) on a creditors' rights theory. See *Paolozzi,* 23 T.C. at 182; *Paxton,* 86 T.C. at 785. In other words, even if, under state law, creditors of a transferor can reach trust assets when the trustee has discretion to make distributions to the transferor and even if the grantor would be viewed as the transferor of the credit shelter trust—on the rationale that the exercise of the general power by the other spouse should be ignored as a prearranged step designed to give the transferor access to the trust's assets—inclusion in the grantor's estate would nonetheless appear to be precluded. For, under the QTIP regulations, once the QTIP beneficiary has died, neither Code § 2036 nor § 2038 can apply at the death of the spouse who created it even if he or she has a beneficial interest in the trust or a power over it. See Treas. Reg. § 25.2523(f)–1(f) ex. 11. And while Code § 2041 might interact with a creditors' rights theory under state law to produce inclusion in the surviving spouse's estate, the use of an ascertainable standard should eliminate this possibility. In summary, neither Code § 2036 nor § 2038 can apply even if the surviving spouse is treated as having created the credit shelter trust because it will have been treated as a QTIP trust for the spouse dying first. That is so even if the so-called creditors' rights theory of *Paolozzi,* 23 T.C. at 182, and similar precedent is invoked—those cases cause Code §§ 2036 and/or 2038 to apply—because the QTIP regulation cited above forecloses the application of those sections. Moreover, a power exercisable only under an ascertainable standard described in Code § 2041 forecloses the power from being a general power of appointment. Hence, the credit shelter trust should not be included in the gross estate for federal estate tax purposes of the surviving spouse, despite the interests and powers the survivor will hold over the trust. Thus, even if the IRS were to abandon its taxpayer-friendly approach and invoke a creditor's rights theory, documents drafted in the manner suggested would likely produce a favorable outcome.

Some Additional Practical Points

The surviving spouse should file a gift tax return and any applicable state gift tax return, disclosing the gift to the other spouse and claiming QTIP marital-deduction treatment. Assuming adequate disclosure under Code § 6501(c)(9), the statute of limitations for the IRS to challenge the allowance of the marital deduction will expire in three years when there is not a greater than 25% omission from the return. See Code § 6501(e)(2). That means that, if no timely and successful challenge to

the allowance of the marital deduction is made by the IRS, the credit shelter trust should be excluded from the surviving spouse's estate.

Conclusion

The recent rulings produce a taxpayer-friendly outcome in many cases in which the nonportable nature of the estate-tax exemptions makes planning and drafting difficult. But, until published guidance is issued on some of the complicated issues that the rulings resolve in favor of taxpayers, practitioners may find it prudent to draft conservatively and, therefore, implement some of the suggestions made in this article.

Implementing the Strategy

To implement the strategy approved in the rulings, each spouse creates a revocable trust or the couple creates a joint revocable trust. The trusts or trust must be funded with a sufficient amount of property before either spouse dies to ensure that the spouse who dies first has a general power of appointment (causing estate tax inclusion under Code § 2041) over an adequate level of property such that his or her exemption will be used optimally. For example, if each spouse has $1 million titled in his or her name and they have an additional $500,000 in assets, the $500,000 sum could be placed in the revocable trust so the first to die will have an estate for federal estate tax purposes of $1.5 million. Of course, the key is the amount of the taxable estate of the spouse dying first, not the gross estate. Also, values in the trust will vary over time and the federal estate tax exemption is scheduled to increase over the years. Hence, it probably is preferable for the spouses to transfer substantially more to the revocable trust than the minimum expected to be needed to avoid wasting the exemption in the estate of the first spouse to die.

The provision that would be added to the revocable trust might be similar to the following, which is sample language derived from Wealth Transfer Planning[sm], a computer software system of which Mr. Blattmachr and Michael L. Graham are co-authors and that is published by InterActive Legal Systems (www.ilsdocs.com), which has granted its permission for the language to be reproduced here.

> **Grant of General Power of Appointment.** If the Grantor's husband/wife predeceases the Grantor, then upon the death of the Grantor's husband/wife if the Grantor's husband/wife is then under the age of 115 years, the trustees acting hereunder shall transfer the lesser of (a) all property held hereunder at the time of the death of the Grantor's husband/wife or (b) a {SUM\FRACTIONAL SHARE} of all property then held hereunder, which shall be the amount, if any, by which (i) the Unused Applicable Exclusion Amount of the Grantor's husband/wife exceeds (ii) the value of the taxable estate of the Grantor's husband/wife (determined by excluding the value of property subject to this general power of appointment) to such one or more persons (including the estate of the Grantor's husband/wife) on such terms as the Grantor's husband/wife may appoint by a Will specifically referring to this power of appointment. (If the lesser of "(a)" and "(b)" is "(b)" and if the trustees hold property that would represent the right to income in respect of a decedent within the meaning of Code Sec. 691 at the death of the Grantor's husband/wife, then the power of appointment hereby granted to the Grantor's husband/wife shall be applied first to property that does not represent the right to income in respect of decedent and shall be exercisable with respect to property that does represent the right to income in respect of a decedent only to the extent necessary to permit the Grantor's husband/wife to be able to exercise the power in full to the extent of the lesser of "(a)" and "(b)".) The "Unused Applicable Exclusion Amount of the Grantor's husband/wife" means the largest taxable estate the Grantor's husband/wife could have at the time of his/her death without incurring any Federal estate tax. To the extent this power of appointment is not effectually exercised by the Grantor's husband/wife, the property subject to the power shall be paid over to the Executor under the Will [*change to "personal representative of the estate" if appropriate*] of the Grantor's husband/wife to become part of his/her estate. If the Grantor's husband/wife (or the Executor of the Will of the Grantor's husband/wife) disclaims the general power of appointment granted under this paragraph, that power shall be expunged as of the date of death of the Grantor's husband/wife and treated as though never granted.

The language for a joint revocable trust (that is, one created by both spouses) might be similar to the following:

> **Grant of General Power of Appointment.** Upon the death of the First Decedent [*many practitioners, in drafting "joint" revocable trusts, refer to the husband and wife as "Trustors" as they both create the trust. Others refer to the "husband and wife," the "Settlors," the "Grantors" or some other term. The term in this provision should be modified in accordance with the "naming" convention for the husband and wife used in the joint revocable trust*], the trustee acting hereunder shall transfer upon the death of the First Decedent, if the First Decedent is then under the age of 115 years, the lesser of (a) all property held hereunder at the time of the death of the First Decedent consisting of the Surviving Spouse's separate property and the Surviving Spouse's one-half interest in community property [*remove the reference to "community*

property" if appropriate] or (b) a {SUM\FRACTIONAL SHARE} of the Surviving Spouse's separate property and the Surviving Spouse's one-half interest in community property then held hereunder equal to the amount, if any, by which (i) the First Decedent's Applicable Exclusion Amount exceeds (ii) the value of the First Decedent's taxable estate (determined by excluding the value of property subject to this power) to such one or more persons (including First Decedent's estate) on such terms as the First Decedent may appoint by a Will specifically referring to this power of appointment. (If the lesser of "(a)" and "(b)" is "(b)" and if the trustees hold property that would represent the right to income in respect of a decedent within the meaning of Code Sec. 691 at the death of the First Decedent, then the power of appointment hereby granted to the First Decedent shall be applied first to property that does not represent the right to income in respect of decedent and shall be exercisable with respect to property that does represent the right to income in respect of a decedent only to the extent necessary to permit the First Decedent to be able to exercise the power in full to the extent of the lesser of "(a)" and "(b)".) The First Decedent's "Unused Applicable Exclusion Amount" means the largest taxable estate the First Decedent could have at the time of the First Decedent's death without incurring any Federal estate tax. To the extent this power of appointment is not effectually exercised by the First Decedent, the property subject to the power shall be paid over to the Executor under the Will of the First Decedent to become part of his or her estate. If the First Decedent (or the Executor of the Will of the First Decedent) disclaims the general power of appointment granted under this paragraph, that power shall be expunged as of the date of death of the First Decedent and treated as though never granted.

As mentioned above, it seems preferable for the spouse dying first to exercise the general power of appointment. Here is a sample of how the exercise might be described in that spouse's will:

> **Exercise of Power of Appointment.** Under [*describe trust agreement*], I may hold a power to appoint certain property held thereunder at the time of my death. I hereby exercise that power and direct that all property subject to that power of appointment be added to my estate to become a part thereof. ■

Keeping Current
Probate

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Keeping Current—Probate offers a look at selected recent cases, rulings and regulations, literature, and legislation. The editors of *Probate & Property* welcome suggestions and contributions from readers.

CASES

ABATEMENT: Trust language controls. The marital trust created from the decedent's revocable lifetime trust directed that the trustees pay the trust's pro rata share of estate tax in the surviving spouse's estate and then directed that stock in a closely held company and one-quarter of other assets be distributed to decedent's nieces and nephews with the remaining three-quarters to the decedent's brother-in-law. The court in *In re Rinaldo Revocable Trust*, 696 N.W.2d 41 (Iowa 2005), held that federal law does not apply to abatement and whether or not the gift of closely held stock is similar to a specific bequest is irrelevant because language requiring the trust to pay its pro rata share requires that all assets in the trust abate ratably.

CHARITABLE GIFTS: Property given in trust lost its trust character after trustees expended it for charitable purpose. The testator's will devised a portion of the residue in trust for the benefit of a hospital to be spent as directed by a committee of persons named in the will to create a memorial to the testator's family. The committee expended the trust property to build a chapel on the hospital grounds completed in 1956. In 2003, the hospital decided to raze the chapel to expand its facilities. The court determined that (1) the expenditure of the trust property to build the chapel terminated the testamentary trust, (2) the will did not create a successor trust with the hospital as trustee, and (3) the will did not create a condition subsequent. *St. Mary's Medical Center, Inc. v. McCarthy*, 829 N.E.2d 1068 (Ind. Ct. App. 2005).

DEPENDENT RELATIVE REVOCATION: Doctrine not applicable if subsequent will expressly revokes prior will. The decedent was the donee of a power of appointment the exercise of which required the fulfillment of certain conditions. After executing two wills that exercised the power in accordance with the required conditions, the decedent executed a new will expressly revoking all prior wills and purporting to exercise the power but which failed to fulfill the conditions. The court held that the property subject to the power passed to the default taker because the doctrine of dependent relative revocation cannot apply if the revocation is made by a completely valid will with an express revocation clause. *Rosoff v. Harding*, 901 So. 2d 1006 (Fla. Dist. Ct. App. 2005). Compare *Wehrheim v. Golden Pond Assisted Living Facility*, 905 So. 2d 1002 (Fla. Dist. Ct. App. 2005) (if the revocation clause is not invalidated by undue influence, dependent relative revocation is not applicable).

DIVERSIFICATION: Language allowing retention of stock of corporate trustee does not negate duty to diversify. The decedent's inter vivos trust allowed the trustee to retain property added to the trust, including shares of a corporate trustee. After the decedent's death, the corporate trustee sold other assets to raise necessary cash, increasing the concentration in its own stock to 86%. The stock declined greatly in value during the two-year period between death and the final distribution of the trust. The court in *Wood v. U.S. Bank, N.A.*, 828 N.E.2d 1072 (Ohio Ct. App. 2005), held that the permission to retain stock of the corporate trustee overrode the duty of loyalty but that express language is necessary to override the duty to diversify as expressed in Ohio's version of the Uniform Prudent Investor Act, which codified the common law of diversification. A retrial was necessary to determine if the statutory "special circumstances" excusing a lack of diversification were present.

FAMILY LIMITED PARTNERSHIPS: Fifth Circuit upholds *Strangi II*. The decedent transferred assets to a FLP in exchange for a 99% limited partnership interest. In *Strangi v. Commissioner*, 417 F.3d 468 (5th Cir. 2005), the court stated: "[W]e hold that the Tax Court did not clearly err in finding that Strangi's transfer of assets to [the family limited partnership] lacked a substantial non-tax pur-

pose. Accordingly, the 'bona fide sale' exception to § 2036(a) is not triggered, and the transferred assets are properly included within the taxable estate. We therefore affirm the estate tax deficiency assessed against the Estate."

FIDUCIARY RESPONSIBILITY: Trustee liable for negligently providing information. A bank advised its client to make present interest annual exclusion gifts to an irrevocable trust to reduce estate taxes. An attorney selected by the client drafted the trust, but the trust but did not include a *Crummey* power. Three years after the creation of the trust, a trust officer told the drafting attorney about the problem, but nothing was done. The bank continued to advise the client to contribute to the trust. In *Hatleberg v. Norwest Bank Wisconsin*, 700 N.W.2d 15 (Wis. 2005), the court held that the bank was liable for the increased estate taxes because the bank negligently provided information by advising the client to make gifts to a trust it knew to be deficient.

INCIDENTAL BENEFICIARIES: Organizations with similar purposes to charitable trust do not have standing. An animal welfare organization presented its accounting as the trustee of a charitable trust for its exclusive benefit and petitioned for permission to pledge the trust property as collateral for a line of credit. Other animal welfare organizations opposed the petition, asserting that they had an interest in the trustee beneficiary continuing to provide services they would otherwise have to provide. The court in *In re Public Benev. Trust of Crume*, 829 N.E.2d 1039 (Ind. Ct. App. 2005), held that the objectants were not persons having an interest in the trust and thus did not have standing. The court also determined that the doctrines of equitable deviation and cy pres did not apply.

NONPROBATE PROPERTY: Writing sufficient to restore beneficiary. Local law allows the owner of a nonprobate asset to pass the asset under the owner's will and to override the change made in the will by a writing naming the original or a new beneficiary. In *In re Estate of Cordero*, 113 P.3d 16 (Wash. Ct. App. 2005), the testator executed a will changing the beneficiary of an investment account from the joint tenant he had placed on the account to his estate. Two years later, he and the former joint tenant met with his broker, and the testator signed an instrument setting forth the reasons for changing the investments in the account and stating that the former joint tenant planned to retain the new investment if the testator died during the next five years. The court determined that this document was sufficient to restore the joint tenancy with right of survivorship.

TAX APPORTIONMENT: State tax apportioned against QTIP under federal provision. In *In re Estate of Klarner*, 113 P.3d 150 (Colo. 2005), the court held as a matter of first impression that the apportionment of estate tax due Colorado under its "pick-up" tax because of the taxation of a QTIP trust in the surviving spouse's estate is governed by Code § 2207A and not by the Colorado tax apportionment statute. Overriding statutory apportionment therefore requires an indication of specific intent to alter the statutory rule.

TRUST INVESTMENTS: Trustee has no fiduciary duty to remainder beneficiaries to produce growth equal to or greater than rate of inflation. The decedent created a testamentary trust with mandatory income to son, discretion to invade principal for son if "absolutely necessary" to provide essential support, and the remainder to the son's descendants. The son and a bank were co-trustees. At the son's insistence, the trust property was invested in tax-exempt property. After the son's death, the remainder beneficiaries sued alleging breach of duty by the bank. In *SunTrust Bank v. Merritt*, 612 S.E.2d 818 (Ga. Ct. App. 2005), the court held that the gift of all the income to the son means that the bank did not breach any duty by allowing son to maximize the income and that there is no duty to invest to keep pace with inflation.

WILLS: Constructive death of ex-spouse does not fulfill condition precedent of death. Local law provides that on divorce, all provisions in a will in favor of the testator's former spouse are read as if the former spouse had predeceased the testator. The testator died after divorce without altering his will, which gave the residue to his then spouse or, if they died simultaneously or if the spouse did not survive by thirty days, to his spouse's daughter. The testator's ex-spouse survived him by more than 30 days. The court held that the statute voids the gift to the ex-spouse but does not effect the other provisions of the will. Thus, the condition on the gift to the stepdaughter did not occur, and there being no further gift over, the testator died intestate. *In re Estate of Nash*, 164 S.W.3d 856 (Tex. App. 2005).

WILLS: "No residue of a residue" rule affirmed. Three of the eighteen residuary beneficiaries predeceased the testator, leaving no issue surviving the testator, so that the anti-lapse statute did not apply. The court held that the common law rule applied and thus the lapsed residuary gifts passed via intestacy. The court refused to imply survivorship language into the gift as is done in many states to avoid intestacy. *In re Estate of McFarland*, 167 S.W.3d 299 (Tenn. 2005).

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Divorce and Trusts. By using Colorado law as an example, Marc A. Chorney explains *Interests in Trusts as Property in Dissolution of Marriage: Identification and Valuation*, 40 Real Prop. Prob. & Tr. J. 1 (2005).

Family Limited Partnerships. Louis S. Harrison and John M. Janiga conclude that there are substantive economic justifications for FLPs in *The Interplay of*

Behavioral Economics and Portfolio Management with the Current Examination of Family Partnerships by the Courts, 40 Real Prop. Prob. & Tr. J. 117 (2005).

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Wisconsin's Inheritance Tax. Jack Stark tracks both political and constitutional history in *A History of the Wisconsin Inheritance Tax*, 88 Marq. L. Rev. 947 (2005).

LEGISLATION

California authorizes a trustee, unless prohibited by the governing instrument, to convert a trust into a unitrust, under specified procedures. 2005 Cal. Legis. Serv. 100.

Florida adopts the Florida Uniform Disclaimer of Property Interests Act. This Act is modeled after the Uniform Disclaimer of Property Interests Act but contains substantial enhancements to many sections of the UDPIA. 2005 Fla. Sess. Law Serv. 2005–108.

Hawaii authorizes trusts for the care of pet animals. 2005 Haw. Sess. Laws 160.

Maine creates a streamlined procedure to review acts of an agent if the principal resides in a long-term care facility. 2005 Me. Legis. Serv. 283.

Maine validates durable powers of attorney executed in compliance with the laws of other states. 2005 Me. Legis. Serv. 284.

New Hampshire makes technical corrections to its version of the Uniform Trust Code. 2005 N.H. Laws 270.

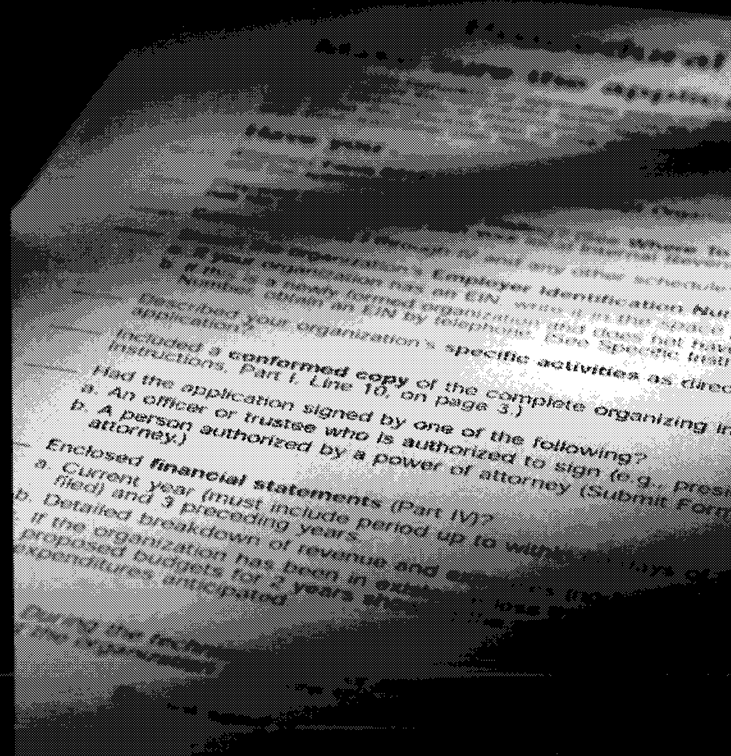
North Carolina enacts a modified version of the Uniform Trust Code. The effective date is January 1, 2006. 2005 N.C. Sess. Laws 192.

Oregon restricts the ability of a person who physically or financially abuses a decedent to inherit and to be a beneficiary under a will and under many non-probate arrangements. The disqualification exists even if there is no nexus between the abuse and the decedent's death or the dispositive instrument. 2005 Or. Laws 270 & 535.

Oregon enacts the Uniform Trust Code. The effective date is January 1, 2006. 2005 Or. Laws 348.

Oregon excludes "special marital property" from its inheritance tax. 2005 Or. Laws 124.

Texas adds many Uniform Trust Code concepts into the Texas Trust Code. 2005 Tex. Sess. Law Serv. 148. ■

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