

Selection and Implementation of Marital and Generation-Skipping Transfer Tax Formulas

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This article addresses the actual funding process under the various marital and generation-skipping transfer tax formulas. The pros and cons of the various formulas are discussed and then illustrated numerically in the accompanying exhibits.

Trusts have historically been created under the provisions of an estate plan or lifetime gift to maximize the tax benefit of both the applicable exclusion amount (estate tax exemption amount)¹ and the generation-skipping transfer (GST) tax exemption. (For 2014, each taxpayer can transfer \$5,340,000 to individuals who are more than one generational level below the taxpayer without paying an additional GST tax at the highest federal estate tax rate.)² Marital formulas are employed to maximize the use of each spouse's applicable exclusion amount by creating marital and nonmarital shares as discussed below. Various GST formulas similarly have a goal of segregating the GST exempt portion of the decedent's estate or lifetime gift (assets not subject to GST tax, referred to as the GST exempt share) from the non-GST exempt portion (assets subject to the GST tax, referred to as the non-GST exempt share) to reduce the impact of GST tax. This article is intended to illustrate the impact of the various formulas on the funding process.

The drafting attorney and all professional advisors working with the administration of an estate need to understand the various methods of funding marital gifts despite the current debate as to the future utility of the credit shelter trust (the nonmarital share) under the new world of estate tax portability (the transfer of a decedent's unused applicable exclusion amount to a surviving spouse)³ and larger applicable exclusion amounts. The largest estates (those with a combined net worth of greater than twice the applicable exclusion amount) will continue to regularly use marital formulas. Furthermore, because portability cannot be used to trans-

fer a decedent's unused GST exemption to the surviving spouse's estate, GST formulas are as important as ever.

This article does not delve into alternatives to the traditional marital formulas, such as the intentional use of portability—specifically the deceased spousal unused exclusion (or DSUE amount, as it is commonly referred to) via significant lifetime gifting after the death of the first spouse. It also does not address the nontax reasons for trusts created through marital formulas, such as (1) protection of a decedent's children from dissipation of assets to a surviving spouse's descendants or subsequent spouse and (2) creditor protection for trust beneficiaries.

Marital Funding Formulas

Marital formulas (1) use the decedent's applicable exclusion amount by creating a credit shelter trust, frequently referred to as a bypass trust or family trust (referred to in this article as the Family Trust), and (2) use the unlimited marital deduction for the excess over the amount passing to the Family Trust. The marital share can be either an outright gift to the surviving spouse or in the form of a qualifying marital trust, such as (1) a QTIP (qualified terminable interest property) trust,⁴ which allows the decedent to control the disposition of the trust assets at the death of the surviving spouse; or (2) a general power of appointment marital trust, which allows the surviving spouse to direct the disposition of the trust assets at his or her subsequent death⁵ (referred to for the sake of simplicity as the Marital Trust). This standard approach results in no estate tax for the estate of the first spouse to die and delays

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the payment of estate tax on the value of the Marital Trust until the subsequent death of the surviving spouse.

There are only two basic types of formulas used for funding marital and non-marital distributions under an estate plan: (1) the pecuniary funding formula (which defines either the marital or the nonmarital share as a fixed dollar amount); and (2) the fractional funding formula (which uses a fraction to determine the marital and nonmarital shares). The remainder of the estate after fulfilling the pecuniary gift is used to fund the other share, whether marital or nonmarital.

For example, for an estate with (1) a date of death value in 2014 of \$6 million; (2) date of funding value of \$7 million; (3) an estate plan with a pecuniary marital funding formula; (4) no prior lifetime gifts; (5) administrative expenses deducted on the estate tax return (discussed in detail below); and (6) true worth funding (discussed below), the Marital Trust is calculated to have a value of \$660,000 (\$6 million date of death value less \$5,340,000 applicable exclusion amount), and the resulting amount passing to the Family Trust is \$6,340,000. All appreciation on the value of the estate assets between the date of death and the date of funding is used to fund the Family Trust, which is not taxed at the subsequent death of the surviving spouse. Correspondingly, however, if the same estate declined in value to \$5 million on the date of funding, \$660,000 would still be allocated to the Marital Trust, but only \$4,340,000 (\$5 million less \$660,000) would be available to fund the Family Trust.

There are advantages and disadvantages to each type of funding. Use of a standard funding methodology may result in more certainty for the attorney in the estate administration phase. Many times, however, another type of funding formula may produce arguably better results for a particular client's situation. The various methodologies are discussed below, and the funding details of specific marital formulas are set out in Exhibits A through D to numerically illustrate the impact of the formulas.

Marital Pecuniary Formula

The marital pecuniary formula provides for the least amount necessary to result in zero estate tax at the first death to pass to the Marital Trust and the remainder to the Family Trust. Once the amount of the marital pecuniary bequest is known, the personal representative or trustee allocates assets equal to this amount to the marital share.

The value of the marital share does not change between the date of death and the date of distribution. Accordingly, either appreciation or depreciation in the post-death values of the estate will be allocated to the Family Trust. In addition, in the context of a special use valuation (the use of the actual value of certain farm and business property rather than its highest and best use value),⁶ date of distribution values are apparently still used despite the special use valuation reduction for estate purposes, creating the potential to fund the Family Trust with even more assets.⁷

Pecuniary funding typically creates gains and/or losses for income tax purposes.⁸ Furthermore, pursuant to the Hubert regulations,⁹ which are beyond the scope of this article, if the typical expenses of administration (expenses that are incurred only due to the death of the decedent, such as legal and accounting fees), commonly referred to as transmission expenses (referred to in this article as either transmission expenses or administrative expenses), are taken on the federal estate tax return (Form 706) rather than on

the federal income tax return for the estate (Form 1041), these expenses do not reduce the amount allocated to the Family Trust. This is illustrated in Exhibit A.

Under the specific facts set forth in Exhibit A for an estate valued at \$8,461,000 in 2014, \$5,340,000 is allocated to the Family Trust for purposes of the Form 706 if expenses are deducted on the Form 706, but only \$5,265,000 is allocated to the Family Trust for purposes of funding if the transmission expenses are deducted on the Form 1041. The decision to deduct the administrative expenses on the Form 706 must be weighed against the income tax savings in deducting such expenses on the Form 1041. The impact of deductibility of transmission expenses on the funding process is discussed below, under "Reporting of Administrative Expenses."

Credit Shelter Pecuniary Formula

In contrast, a credit shelter pecuniary formula, also known as a reverse pecuniary formula, determines a pecuniary amount for the Family Trust by defining the Family Trust share as the maximum amount that can be allocated to the Family Trust without generating any estate tax. The residuary is allocated to the Marital Trust. This formula locks in the value of the Family Trust, and any appreciation or depreciation in the value of the estate assets passes to the Marital Trust.

Exhibit B reflects the funding mechanism for the same estate under a credit shelter pecuniary formula, again illustrating the difference in the amount passing to the Family Trust for purposes of the Form 706, depending on whether administrative expenses are taken on the Form 706 or on the Form 1041. Specifically, as is the case for the marital pecuniary formula, \$5,340,000 is allocated to the Family Trust for purposes of the Form 706 if expenses are deducted on the Form 706, but only \$5,265,000 is allocated to the Family Trust for purposes of funding if expenses are deducted on the Form 1041. The impact of deductibility of transmission expenses on the funding process is discussed below, under "Reporting of Administrative Expenses."

The income tax ramifications are similar to those of the marital pecuniary formula, except that they apply to the Family Trust. Logically, the smaller the pecuniary gift for a particular decedent's estate, the better for income tax purposes. Accordingly, when the marital share will be larger than the nonmarital share, the credit shelter pecuniary formula reduces the income tax burden on funding the marital and nonmarital shares.

Fractional Marital Formula Funding

The second basic type of formula used for marital funding is the fractional share formula. The fractional share formula is expressed as a fraction equal to the value of the assets being transferred to the Marital Trust, where the numerator is equal to the amount of the marital deduction sought, and the denominator is the value of the total assets available for funding. A properly drafted formula defines the numerator as the amount of marital deduction available less the value of assets passing to the surviving spouse outside the will or trust that qualify for the marital deduction.

Under this method, the denominator is the date of death value of assets available for funding determined either before or after payment of the residuary expenses such as debts, expenses, and taxes charged against the nonmarital share (the gross estate or the net estate). The other factor in computing the fraction is whether

administrative expenses are taken on the Form 706 or the Form 1041.

Exhibit C illustrates the computation of the Marital Trust and Family Trust values based on the gross or net estate approach and based on the deduction of transmission expenses on either the Form 706 or the Form 1041. For instance, under the same fact pattern, the numerator of the fraction is \$1,915,000 if expenses are deducted on the Form 706 and is \$1,990,000 if expenses are deducted on the Form 1041. The denominator is \$7,375,000 under the gross estate approach and \$7,255,000 under the net estate approach. Again, the Family Trust amount remains at \$5,340,000 if transmission expenses are deducted on the Form 706, but changes to \$5,265,000 if transmission expenses are deducted on the Form 1041. The impact of deductibility of transmission expenses on the funding process is discussed below, under “Reporting of Administrative Expenses.”

The funding of the fractional formula, however, is complex, and the personal representative or trustee should review the will or revocable trust carefully to make sure the fraction is computed accurately. Much like the state tax apportionment issues addressed by the Colorado Supreme Court in *Estate of Klarner*,¹⁰ confusion can arise if the estate plan terms are not express and clear as to the computation of the denominator of the fraction.¹¹

It is preferable to fund pursuant to a fractional formula as of one date to avoid multiple recalculations of the fraction and revaluation of the assets to be distributed. If disproportionate distributions are nevertheless made, it is unclear how to recalculate the fraction and, thus, the most conservative approach is to treat the amount that should have been distributed to the other share as an interest-bearing obligation of the estate.

For income tax purposes, fractional share funding has the advantage of not generating gains and/or losses on funding. It also results in fairly equivalent treatment of all beneficiaries, because increases and decreases in asset values as of the date of funding are allocated proportionately between the marital and nonmarital shares. Accordingly, it is viewed by some as more equitably apportioning the income tax consequences among the beneficiaries.

Date of Values for Funding

A fairly representative pecuniary formula, whether a marital pecuniary or credit shelter pecuniary formula, funds the pecuniary share using the basis of the assets distributed, which is typically the federal estate tax value. The total fair market value of the assets distributed must, however, be “fairly representative” of the appreciation of all the estate assets available at the date of distribution. No gains or losses are recognized on funding here, but obviously date of distribution values need to be taken into account, asset by asset.¹²

A minimum worth marital pecuniary formula funds the Marital Trust, using the lesser of the federal estate tax values or the date of distribution values. Because depreciation cannot be allocated to the marital share, there is no requirement that appreciation or depreciation be shared ratably as in the case of the fairly representative approach. As a result, this method again provides the personal representative or trustee some flexibility to choose the assets that fund the minimum worth pecuniary bequest. No gains or losses are recognized on funding with this approach. However, this approach may not work for a credit shelter pecuniary formula due to the potential overfunding of the Family Trust. It also does not work for GST planning, as discussed below.

A true worth funding approach funds either the Marital Trust or the Family Trust pecuniary gift based on date of distribution values. As a result, all appreciation or depreciation on the remaining assets between the date of death and the date of funding flows into the non-pecuniary share. The true worth funding approach is reflected in Exhibits A through D.

For a fractional formula, depending on the terms of the estate plan, either the *pro rata* or pick and choose method of funding can be used. With the *pro rata* approach, a proportionate share of each and every asset is used to fund both the marital and nonmarital shares. The pick and choose approach allows the personal representative or trustee to select different assets to fund each share. With the pick and choose approach, assets must be valued as of the date of funding or on a fairly representative basis if federal estate tax values are used.

Reporting of Administrative Expenses

For a pecuniary formula, the deduction of transmission expenses on the Form 706 as opposed to the Form 1041 impacts the funding of both the Marital Trust and the Family Trust, because the Family Trust amount does not need to be reduced by the transmission expenses if such expenses are deducted on the estate tax return. This requires an analysis by the personal representative or trustee to determine whether it is more tax advantageous to take the income tax deduction or the estate tax return deduction to reduce future estate tax by allocating more to the Family Trust (because taking expenses on the Form 706 does not reduce the federal estate tax for the decedent’s estate).

For a fractional formula with either the gross estate or the net estate approach, assuming expenses are deducted consistently on either the Form 706 or the Form 1041, the same marital deduction is calculated for purposes of the Form 706 because the deduction is based on the value of the residuary estate as of the date of death. However, each approach has a different impact on the funding of the marital share. The deduction of expenses on the Form 706 or the Form 1041 does not impact the denominator, but does impact the numerator, as reflected in Exhibit C. As specifically illustrated in Exhibit D, administrative expenses affect the actual funding of the marital and nonmarital shares for all types of marital formulas.

Asset Allocation on Funding

Under all of the marital formulas, the actual funding of the shares may be made on either a *pro rata* basis or a pick and choose basis, as directed in the estate plan. With the *pro rata* funding approach, the marital and nonmarital shares each receive a *pro rata* share of each asset available. Some assets, however, are not easily subject to division. Other assets, such as life insurance on the life of the surviving spouse, should not be distributed to the Marital Trust.

Due to the obvious complications associated with the *pro rata* method of funding fractional shares, many planners draft documents authorizing a pick and choose funding method. Colorado law authorizes the pick and choose methodology for the residuary estate.¹³ The flexible nature of this method allows the personal representative or trustee to select assets that will be allocated to the marital share. This works well to ensure that appropriate assets are allocated to the surviving spouse. In addition, assets that are expected to highly appreciate can go into the Family Trust, where they escape estate tax at the surviving spouse’s death.

For all marital funding formulas, funding requirements, such as the Hubert regulations,¹⁴ must be complied with to result in no reduction in the value of the marital deduction for purposes of the Form 706. In addition, only assets qualifying for the marital deduction should be allocated to the marital share. As previously illustrated, the deduction of administrative expenses on the Form 706, as opposed to the deduction of expenses on the Form 1041, also impacts the funding of the marital and nonmarital shares because the marital share does not need to be reduced for transmission expenses paid by it if the expenses are taken on the estate tax return.¹⁵

Considerations in Selection of Marital Formula

As discussed above, there are many drafting choices to be made in selecting the estate plan formula provisions, and then, under either a fractional or pecuniary approach, the funding mechanism for the formula, such as the pick and choose approach as opposed to the *pro rata* approach or the true worth approach, as opposed to the fairly representative approach. The funding methodology can leverage the reduction of future estate tax if the personal representative or trustee has choices with respect to which assets to use for funding the different shares. For instance, one goal may be to fund the Family Trust with assets with the greatest appreciation potential.

The funding method may also have income tax consequences to the beneficiaries and/or the estate. The funding of a pecuniary share with income in respect of decedent (IRD) assets will accelerate recognition of income tax.¹⁶ Furthermore, if a pecuniary

bequest is satisfied with non-cash assets that have appreciated or depreciated between the date of death and the date of funding, gain or loss will be recognized by the estate on funding.¹⁷

Another consideration in determining which method of funding to use is that the gain on the funding of pecuniary bequests may be subject to the new 3.8% Medicare surtax¹⁸ or net investment income tax for purposes of both federal and state income tax. Thus, an estate in a combined 39.6% bracket, the highest marginal rate for 2014, which is reached at about \$12,000 of income for estates and trusts, will be subject to the new higher 20% capital gains rate, plus the 3.8% tax or 23.8%, a 58.667% increase over prior capital gains rates.

In addition, if a GST formula is a component of the estate plan, a fractional formula or pecuniary formula with a fairly representative funding approach will help fulfill the GST formula funding requirements. The specific GST formula requirements are discussed below.

GST Funding Formulas

GST formulas are typically used to create GST exempt trusts for the decedent's descendants in the maximum amount sheltered by the decedent's unused GST exemption, commonly referred to as the decedent's available GST exemption. If the decedent's personal representative properly allocates the available GST tax exemption to the trust, this technique can reduce the imposition of estate tax at the subsequent deaths of the decedent's descendants, as long as the assets remain in trust. The GST tax¹⁹ is com-

puted by multiplying the taxable distribution by the applicable rate, which is the highest federal estate tax rate in the year of the transfer,²⁰ times the “inclusion ratio.” The inclusion ratio is 1 minus the “applicable fraction.”²¹ The applicable fraction²² has a numerator equal to the amount of GST exemption allocated to the transfer, and the denominator is typically the value of the property transferred, possibly subject to some adjustments not addressed in this article.²³ For example, if \$500,000 of the GST exemption is allocated to a \$1 million transfer to trust, the inclusion ratio is 1 minus \$500,000/\$1 million, or 50%. Accordingly, the primary goal is to produce an inclusion ratio for the trust of zero (1 minus an applicable fraction of 1) to avoid the imposition of GST tax.

Both pecuniary and fractional formulas tied to the decedent’s available GST exemption can define an amount with which the GST exempt trust is to be funded. Remaining assets pass either outright or in trusts with inclusion ratios of one. A secondary goal is to maximize the GST exempt share.

GST Exempt Pecuniary Formula

A GST exempt pecuniary formula allocates a fixed dollar amount to the GST exempt share. The remaining assets are allocated to the non-GST exempt share. Although there are similarities to the funding of marital pecuniary formulas, additional requirements, such as the valuation rules²⁴ and the separate share rules,²⁵ discussed below, must be fulfilled to avoid an inclusion ratio greater than zero.

Residuary Pecuniary GST Formula

A residuary pecuniary GST formula allocates a fixed dollar amount to the non-GST exempt share, with the remaining assets allocated to the GST exempt share. A common illustration of this formula is tied to a marital pecuniary formula, with the remaining assets funding a Family Trust that is intended to be exempt from GST tax. Again, certain valuation and separate share rules need to be addressed to avoid an inclusion ratio greater than zero for the intended GST exempt share.²⁶

Fractional GST Formula

A GST fractional formula typically uses date of death values in calculating the fractional GST exempt share. With a fractional formula, no appreciation can be shifted specifically to the GST exempt share. Non-*pro rata* funding is permitted under both the separate share and the valuation rules discussed below.²⁷

No capital gain is recognized on funding the GST exempt and nonexempt shares, and the distribution of IRD assets does not result in acceleration of income recognition. There is no appropriate interest test (discussed below) for a fractional formula; however, the shares are generally entitled to a *pro rata* share of income.

Due to the mechanical similarity to fractional marital formulas (assuming all requirements of the relevant separate share and valuation rules are fulfilled), similar numerical illustrations of the various GST funding formulas are not provided in this article. Exhibit E, however, does reflect a sample fractional formula funding for a scenario in which assets are distributed in kind on a disproportionate basis on more than one date, with a pick and choose approach. This approach avoids recalculation of the fraction after a disproportionate distribution to only one share.

Valuation Rules

The key valuation issue for GST formulas involves the computation of the inclusion ratio. For all pecuniary GST formulas, if property fulfilling a pecuniary gift is valued at the federal estate tax value, it must be on a basis that is fairly representative of all appreciation and depreciation from the date of death.²⁸ Otherwise, the date of distribution value must be used for the denominator of the applicable fraction. For example, if a pecuniary GST exempt gift of \$500,000 from a \$2 million estate is not funded on a fairly representative basis, instead of an inclusion ratio of zero (1-\$500,000/\$500,000), the inclusion ratio, assuming the asset with a date of death value of \$500,000 has a value of \$750,000 as of the date of funding, is 33.334% (1-\$500,000/\$750,000). This prevents the personal representative or trustee from selecting assets with the most appreciation potential for the GST exempt share.

For residuary pecuniary GST formulas, the value of the residuary GST exempt share is calculated based on the estate tax value of the assets available to fund the GST exempt share and the non-GST exempt share only if the pecuniary share must be paid “appropriate interest.”²⁹ Appropriate interest is interest payable from the date of death to the date of payment at a rate equal to the statutory rate of interest under the law of the state governing administration of the estate or, if there is no such rate indicated under the applicable state law, 80% of the § 7520 rate, as long as such rate does not exceed the greater of the applicable state statutory rate of interest or 120% of the § 7520 rate.³⁰ The § 7520 rate is equal to 120% of the federal midterm rate in effect under Code § 1274(d)(1) for the month in which the valuation date occurs.³¹ The Colorado statutory rate of interest is currently 8%.³² If a pecuniary payment is not subject to appropriate interest it will, however, be treated as carrying appropriate interest if the payment is made or irrevocably set aside within fifteen months of death or the governing instrument or state law requires the personal representative or trustee to allocate a *pro rata* share of income earned to the pecuniary share.³³

For residuary pecuniary GST formulas that do not require the payment of appropriate interest on the pecuniary share, only the present value of the pecuniary payment calculated based on the § 7520 rate is subtracted from the value of the remaining assets in calculating the value of the denominator rather than the federal estate tax value.³⁴ In addition, as is the case for GST exempt pecuniary formulas, the denominator of the applicable fraction residual share after fulfilling the pecuniary share with in-kind assets must be the date of distribution value of the assets remaining after funding the pecuniary share if there is also no fairly representative funding requirement.³⁵

For pecuniary GST formulas, either date of distribution values or federal estate values on a fairly representative basis can be used to fund the pecuniary share.³⁶ This prevents the personal representative or trustee from shifting appreciation to the GST exempt share. If the pecuniary share is funded in kind at federal estate tax values and the fairly representative requirement is not mandated in the controlling document, the denominator of the applicable fraction will be the date of distribution value of the property used to satisfy the gift, resulting in a greater than zero inclusion ratio.³⁷

For fractional GST formulas, the inclusion ratio is calculated based on federal estate tax values. This also prevents shifting of appreciation favorable to the GST exempt share. Both the GST exempt share and the non-GST exempt share in estate appreciation or depreciation.

Separate Share Rules

Substantially separate and independent shares for different beneficiaries are treated as separate trusts for both income tax and GST tax purposes.³⁸ Separate shares exist for income tax purposes if distributions from the shares are made as if separate trusts had been created.³⁹ For GST tax purposes, a pecuniary payment will be treated as separate as of the date of death: (1) if appropriate interest must be paid under the terms of the governing document; and (2) if the pecuniary payment is made on a basis other than date of distribution values, it must be paid on a fairly representative basis.⁴⁰ For the situation in which a single trust, such as a revocable trust, consists of separate and independent shares for different beneficiaries, each share is treated as a separate trust for GST purposes, imposing the requirements of the separate share rules for both pecuniary GST formulas and residual pecuniary GST formulas.⁴¹

The separate share rules discussed below are more stringent than the valuation rules for pecuniary GST formulas and, if met, satisfy the valuation rules, as well. Furthermore, due to possible confusion as to which rules apply to a given situation, as well as the duplication of several of the valuation and separate share rules, the most conservative drafting approach is one that complies with both rules. One technique to avoid the valuation rules discussed below is for a revocable trust to make the § 645 election to combine the trust and estate for income tax purposes. Because only trusts are subject to the separate share rules, the treatment of the trust as a part of the estate avoids application of the separate share rules.

The separate share rules for all pecuniary GST formulas require the payment of appropriate interest on the pecuniary share.⁴² Furthermore, if the funding is not made with date of distribution values, the pecuniary share must be funded in a manner that fairly reflects net appreciation or depreciation in the value of the assets from the date of death to the date of funding.⁴³

Although the minimum worth funding approach works for the pecuniary marital formula, it is penalized under both the separate share and valuation rules, because it can result in disproportionate appreciation in the GST exempt share. If minimum worth funding is provided for in the relevant document, the penalty is the requirement of the use of date of distribution values in calculating the inclusion ratio. Accordingly, minimum worth funding should not be used in the context of GST formulas.

Considerations in Selection of GST Formula

If the separate share rules discussed above do not apply, a pecuniary GST formula used to fund the GST exempt share is maximized when assets decrease in value between date of death and date of distribution. Correspondingly, with a residuary pecuniary GST formula that is funded with date of distribution values, the residual GST exempt share is maximized when assets increase in value before funding to sufficiently exceed the payment of interest or income paid on the pecuniary share. This must, however, be weighed against the capital gains tax on funding the pecuniary share, as well as the possibility of the estate assets declining rather than appreciating in value between the date of death and the date of funding. Furthermore, every attempt should be made to comply

with the valuation and separate share rules when drafting documents with GST formulas.

Conclusion

Despite the current debate as to alternative funding approaches with portability of exemption and significantly larger applicable exclusion amounts, existing and future formula gifts need to be carefully analyzed, in both the planning and the estate administration phases. Income tax consequences and non-tax trust funding reasons also continue to be critically important, as does GST planning.

Notes

1. IRC § 2010(c)(2).
2. IRC §§ 2631(a) and 2641(b).
3. IRC § 2010(c)(4).
4. IRC § 2056(b)(7).
5. IRC § 2056(b)(5).
6. IRC § 2032A(a)(1).
7. *E.g.*, IRS PLR 83-14-005 (Dec. 14, 1982); IRS PLR 81-34-001 (Sept. 22, 1982).
8. Treas. Reg. § 1.661(a)-2(f).
9. Treas. Reg. § 20.2056(b)-4(d).
10. *In re Estate of Klarner*, 113 P.3d 150 (Colo. 2005).
11. *Id.* at 158.
12. Rev. Proc. 64-19, 1964-1 CB 682.
13. CRS § 15-12-906(2)(c).
14. Treas. Reg. § 20.2056(b)-4(d).
15. Treas. Reg. § 20.2056(b)-4(d)(2).
16. Treas. Reg. § 1.1014-4(a)(3); IRC § 691(a)(2). *See* CCA 200644020 (Nov. 3, 2006), www.irs.gov/pub/irs-wd/0644020.pdf.
17. Treas. Reg. § 1.661(a)-2(f).
18. IRC § 1411(a)(2).
19. IRC § 2602.
20. IRC § 2641(b).
21. IRC § 2642(a)(1).
22. IRC § 2642(a)(2).
23. IRC § 2642(a)(2)(B).
24. Treas. Reg. § 26.2642-2.
25. Treas. Reg. § 26.2654-1.
26. Treas. Reg. § 26.2642-2; Treas. Reg. § 26.2654-1.
27. Treas. Reg. § 26.2654-1(b)(1)(ii)(C)(1).
28. Rev. Proc. 64-19, 1964-1 CB 682.
29. Treas. Reg. § 26.2642-2(b)(3)(i).
30. Treas. Reg. § 26.2642-2(b)(4)(i).
31. IRC § 7520 (a)(2).
32. CRS §§ 5-12-102 (2) and -904.
33. Treas. Reg. § 26.2642-2(b)(4)(ii).
34. Treas. Reg. § 26.2642-2(b)(3)(i).
35. Treas. Reg. § 26.2642-2(b)(3)(ii).
36. Treas. Reg. § 26.2642-2(b)(2)(i).
37. Treas. Reg. § 26.2642-2(b)(2)(ii).
38. Treas. Reg. § 26.2654-1(a)(1)(i).
39. Treas. Reg. § 1.663(c)-3(a).
40. Treas. Reg. § 26.2654-1(a)(1)(i).
41. Treas. Reg. § 26.2654-1(a)(i) and (ii).
42. Treas. Reg. § 26.2654-1(a)(1)(ii)(A).
43. Treas. Reg. § 26.2654-1(a)(1)(ii)(B).



Exhibit A

True Worth Pecuniary Marital Formula Funding Scenarios as Reflected on Estate Tax Return

Assumptions

Tom and Anne are husband and wife.
 Tom is first to die in 2014.
 The applicable exclusion amount for 2014 is \$5,340,000.

Tom's Estate:

Assets

Real Estate	\$5,490,000
Stocks and Bonds	1,235,000
Cash and Notes Receivable	475,000
Joint Tenancy (JT) Property (held with Anne)	565,000
Miscellaneous Other Property	175,000
IRAs (Anne is the beneficiary)	<u>521,000</u>
Tom's Gross Estate	<u>\$8,461,000</u>

Expenses & Debts

Funeral Expenses	\$ 10,000
Administration Expenses	75,000
Debts	<u>35,000</u>
Total Expenses and Debts	<u>\$ 120,000</u>

	Pecuniary Marital Bequest Expenses Deducted on Form 706	Pecuniary Marital Bequest Expenses Deducted on Form 1041
Gross Estate	\$8,461,000	\$8,461,000
JT Property	(565,000)	(565,000)
Applicable Exclusion Amount	(5,340,000)	(5,340,000)
IRAs	(521,000)	(521,000)
Funeral Expenses	(10,000)	(10,000)
Administration Expenses	(75,000)	—
Debts	(35,000)	(35,000)
Pecuniary Amount Passing to the Marital Trust Share Based on Date of Death (DOD) Values	\$ 1,915,000	\$ 1,990,000
Residual Amount Passing to the Family Trust Based on DOD Values	\$ 5,340,000	\$ 5,340,000
Less: Administration Expenses Deducted on Form 1041	—	(75,000)
Net Amount That Will Ultimately Fund the Family Trust Share	\$ 5,340,000	\$ 5,265,000

Items to Consider:

By electing not to take the expenses on the 706, the amount that will ultimately fund the Family Trust will not be the full \$5,340,000, because the expenses will have to be paid with assets that are held in the Family Trust.

Because the pecuniary formula is a true worth formula, the executor is entitled to pick and choose the assets that will be used to fund the pecuniary bequest to the Marital Trust share. The assets must be valued at their date of distribution value. Gain or loss on funding will have to be recognized by the estate for the appreciation/depreciation in value of assets that will ultimately be used to fund the Marital Trust share.

Because gain on funding of a pecuniary bequest may be recognized, it is advised to use a pecuniary formula to fund the smaller of the Marital or Family Bequest.

In determining whether to deduct the administration expenses on the 706 vs. the 1041, the executor should run the numbers to see what yields the most favorable tax result. The inclusion of the Marital Trust share in the surviving spouse's estate should also be taken into consideration in making this determination.

Exhibit B

True Worth Pecuniary Credit Shelter Formula Funding Scenarios as Reflected on Estate Tax Return

Assumptions

Tom and Anne are husband and wife.
 Tom is first to die in 2014.
 The applicable exclusion amount for 2014 is \$5,340,000.

Tom's Estate:

Assets

Real Estate	\$5,490,000
Stocks and Bonds	1,235,000
Cash and Notes Receivable	475,000
JT Property (held with Anne)	565,000
Miscellaneous Other Property	175,000
IRAs (Anne is the beneficiary)	<u>521,000</u>
Tom's Gross Estate	<u>\$8,461,000</u>

Expenses & Debts

Funeral Expenses	\$ 10,000
Administration Expenses	75,000
Debts	<u>35,000</u>
Total Expenses and Debts	<u>\$ 120,000</u>

	Pecuniary Family Bequest Expenses Deducted on Form 706	Pecuniary Family Bequest Expenses Deducted on Form 1041
Gross Estate	\$8,461,000	\$8,461,000
JT Property	(565,000)	(565,000)
IRAs	(521,000)	(521,000)
Funeral Expenses	(10,000)	(10,000)
Administration Expenses	(75,000)	—
Debts	<u>(35,000)</u>	<u>(35,000)</u>
	\$7,255,000	\$7,330,000
Pecuniary Bequest to the Family Trust Share (Applicable Exclusion Amount)	\$5,340,000	\$5,340,000
Less: Administration Expenses Deducted on Form 1041	—	(75,000)
Net Amount That Will Ultimately Fund the Family Trust Share	\$5,340,000	\$5,265,000
Residual Amount Passing to the Marital Trust Share	\$1,915,000	\$1,990,000

Items to Consider:

By electing not to take the expenses on the 706, the amount that will ultimately fund the Family Trust will not be the full \$5,340,000, because the expenses will have to be paid with assets that are held in the Family Trust.

Because the pecuniary formula is a true worth formula, the executor is entitled to pick and choose the assets that will be used to fund the pecuniary bequest to the Family Trust share. The assets must be valued at their date of distribution value. Gain or loss on funding will have to be recognized by the estate for the appreciation/depreciation in value of assets that will ultimately be used to fund the Family Trust share.

Because gain on funding of a pecuniary bequest may be recognized, it is advised to use a pecuniary formula to fund the smaller of the Marital or Family Bequest.

In determining whether to deduct the administration expenses on the 706 vs. the 1041, the executor should run the numbers to see what yields the most favorable tax result. The inclusion of the Marital Trust share in the surviving spouse's estate should also be taken into consideration in making this determination.



Exhibit C

Fractional Formula Funding Scenarios as Reflected on Estate Tax Return

Assumptions

Tom and Anne are husband and wife.
 Tom is first to die in 2014.
 The applicable exclusion amount for 2014 is \$5,340,000.

Tom's Estate:

Assets	
Real Estate	\$5,490,000
Stocks and Bonds	1,235,000
Cash and Notes Receivable	475,000
JT Property (held with Anne)	565,000
Miscellaneous Other Property	175,000
IRAs (Anne is the beneficiary)	<u>521,000</u>
Tom's Gross Estate	<u>\$8,461,000</u>
Expenses & Debts	
Funeral Expenses	\$ 10,000
Administration Expenses	75,000
Debts	<u>35,000</u>
Total Expenses and Debts	<u>\$ 120,000</u>

	Fractional Formula Based on Gross Estate and Expenses are Deducted on the Form 706	Fractional Formula Based on Gross Estate and Expenses are Deducted on the Form 1041	Fractional Formula Based on Net Estate and Expenses are Deducted on the Form 706	Fractional Formula Based on Net Estate and Expenses are Deducted on the Form 1041
Numerator				
Gross Estate	\$ 8,461,000	\$ 8,461,000	\$ 8,461,000	\$ 8,461,000
JT Property	(565,000)	(565,000)	(565,000)	(565,000)
Applicable Exclusion Amount	(5,340,000)	(5,340,000)	(5,340,000)	(5,340,000)
IRAs	(521,000)	(521,000)	(521,000)	(521,000)
Funeral Expenses	(10,000)	(10,000)	(10,000)	(10,000)
Administration Expenses	(75,000)	-	(75,000)	-
Debts	<u>(35,000)</u>	<u>(35,000)</u>	<u>(35,000)</u>	<u>(35,000)</u>
Marital Trust Share Based on DOD Values				
Numerator A	1,915,000	1,990,000	1,915,000	1,990,000
Denominator				
Gross Estate	\$ 8,461,000	\$ 8,461,000	\$ 8,461,000	\$ 8,461,000
JT Property	(565,000)	(565,000)	(565,000)	(565,000)
IRAs	(521,000)	(521,000)	(521,000)	(521,000)
Funeral Expenses	-	-	(10,000)	(10,000)
Administration Expenses	-	-	(75,000)	(75,000)
Debts	-	-	<u>(35,000)</u>	<u>(35,000)</u>
Denominator B	7,375,000	7,375,000	7,255,000	7,255,000
Passing to Marital Trust Share A/B	25.97%	26.98%	26.40%	27.43%
Passing to Family Trust (100% minus Marital Trust %)	*	*	73.60%	72.57%
Property Available to Fund the Family and Marital Trust Shares				
	\$ 7,375,000	\$ 7,375,000	\$ 7,255,000	\$ 7,255,000
Total Dollar Amount to the Marital Trust Share	\$ 1,915,000	\$ 1,990,000	\$ 1,915,000	\$ 1,990,000
Total Dollar Amount to the Family Trust Share	\$ 5,460,000	\$ 5,385,000	\$ 5,340,000	\$ 5,265,000
Less: Debts and Expenses	<u>(120,000)</u>	<u>(120,000)</u>	<u>-</u>	<u>-</u>
Net Amount to the Family Trust Share	\$ 5,340,000	\$ 5,265,000	\$ 5,340,000	\$ 5,265,000

Items to Consider:

There will be no gain or loss on funding using a fractional formula because both the Family and Marital Trusts will share equally in the appreciation and depreciation of the asset values between the date of death and date of funding.

In determining whether to deduct the administration expenses on the 706 vs. the 1041, the executor should run the numbers to see what yields the most favorable tax result. The inclusion of the Marital Share in the surviving spouse's estate should also be taken into consideration when making this determination.

*Total dollar amount to the Family Trust share equals the total property available to fund the two trusts less the amount that passes to the Marital Trust share.

Exhibit D

Summary of Funding Scenarios as of Date of Funding

Assumptions

Total Appreciated Value of Property Available to Fund at Date of Funding \$9,240,000
 Total Property Grossed up for Debts and Expenses* \$9,360,000

Method of Funding/Deduction of Administration Expenses	Marital Trust Share	Family Trust Share	Estate Recognizes Gain on Assets Funding the:
Pecuniary Marital Bequest Expenses Deducted on Form 706	\$1,915,000	\$7,325,000	Marital Trust
Pecuniary Marital Bequest Expenses Deducted on Form 1041	1,990,000	7,250,000	Marital Trust
Pecuniary Family Bequest Expenses Deducted on Form 706	3,900,000	5,340,000	Family Trust
Pecuniary Family Bequest Expenses Deducted on Form 1041	3,975,000	5,265,000	Family Trust
Fractional Formula Based on Gross Estate and Expenses are Deducted on Form 706*	2,430,427	6,809,573	N/A
Fractional Formula Based on Gross Estate and Expenses are Deducted on Form 1041*	2,525,614	6,714,386	N/A
Fractional Formula Based on Net Estate and Expenses are Deducted on Form 706	2,438,952	6,801,048	N/A
Fractional Formula Based on Net Estate and Expenses are Deducted on Form 1041	2,534,473	6,705,527	N/A

Assumptions

Total Depreciated Value of Property Available to Fund at Date of Funding \$6,240,000
 Total Property Grossed up for Debts and Expenses* \$6,360,000

Method of Funding/Deduction of Administration Expenses	Marital Trust Share	Family Trust Share	Estate Recognizes Loss on Assets Funding the:
Pecuniary Marital Bequest Expenses Deducted on Form 706	\$1,915,000	\$4,325,000	Marital Trust
Pecuniary Marital Bequest Expenses Deducted on Form 1041	1,990,000	4,250,000	Marital Trust
Pecuniary Family Bequest Expenses Deducted on Form 706	900,000	5,340,000	Family Trust
Pecuniary Family Bequest Expenses Deducted on Form 1041	975,000	5,265,000	Family Trust
Fractional Formula Based on Gross Estate and Expenses are Deducted on Form 706*	1,651,444	4,588,556	N/A
Fractional Formula Based on Gross Estate and Expenses are Deducted on Form 1041*	1,716,122	4,523,878	N/A
Fractional Formula Based on Net Estate and Expenses are Deducted on Form 706	1,647,085	4,592,915	N/A
Fractional Formula Based on Net Estate and Expenses are Deducted on Form 1041	1,711,592	4,528,408	N/A

*Gross Fractional Formula: Before applying the applicable Marital Trust fraction, you must gross up the value of the property available for funding by the debts, funeral expenses, and administration expenses that were paid from such property.



Exhibit E

Disproportionate GST Fractional Formula Funding Scenario

Assumptions

The applicable excusion amount for 2014 is \$5,340,000.

Tom was the second to die and died in 2014.

Date of Death Value of Residuary Estate	\$30,000,000
Expenses per Form 706	(600,000)
Personal Property Bequeathed	(500,000)
Gifts to Individuals	(1,300,000)
Charitable Gifts	(7,000,000)
Taxes	<u>(7,500,000)</u>
Tom's Residuary Estate After Specific and Charitable Gifts, Expenses, and Taxes	<u>\$13,100,000</u>

Determine Fraction as of Date of Death:

Numerator—available GST Exemption (none previously used)	5,340,000
Denominator—After Tax Residuary Estate	<u>13,100,000</u>
Fraction	<u>40.76%</u>

Using Date of Death Values:

Amount Due to GST Exempt Share	\$ 5,340,000
Amount Due to Non-GST Exempt Share	7,760,000

Amount Paid to GST Exempt Share—in Cash on Date One	3,000,000
% Paid Out	56.18%
Amount Due to Non-GST Exempt Share—with Interest Accrued to Date Two	4,375,899

Remaining Estate to Distribute (assuming appreciation of \$1 million)	11,100,000
Less Amount Due to Non-GST Exempt Share	(4,375,899)
Equals Amount Remaining to be Distributed on Date Two	6,724,101
Total of Remaining Estate to GST Exempt Share	2,740,969
Total of Remaining Estate to Non-GST Exempt Share	3,983,132

Total to GST Exempt Share	5,740,969
Total to Non-GST Exempt Share	<u>8,359,031</u>
Total Dollars Funding Trusts	<u>\$14,100,000</u>

Items to Consider:

Assumed an IRS AFR short-term rate of .5%.

Assumed estate value increased between date of death and final distribution date by \$1 million. ■

