Alternative Approaches to Subtrust Funding in a Declining Economy

By David E. Libman

David Libman explains the structure and function of a subtrust plan within a joint revocable living trust and tax saving strategies that can be implemented through the use of these entities.

Introduction

Estate planning offers a means to plan for two certainties (death and taxes), and the near universality of marriage. One of the most common tools in the estate planner's toolbox is a joint revocable living trust. Uniquely, joint revocable living trusts help to avoid probate and reduce estate administration costs. They also can make it easier to pass property to a decedent's spouse and children. Joint revocable living trusts are now so common that numerous do it yourself books and courses tout their benefits and accessibility.

Contrary to some urban legends, joint revocable living trusts do not necessarily avoid income or estate taxes to the grantor. Indeed, the grantor of a joint revocable living trust is taxable on its income throughout the grantor's life.[1] Moreover, in a community property state, community property that funds a joint revocable living trust retains its community property character.[2] Hence, on the first spouse's death, his gross estate includes his community share of the joint revocable living trust property, which could be subject to estate taxes.[3]

To reduce these potential estate taxes down to zero at the first death, joint revocable living trusts often establish an "A, B, C subtrust plan. The A, B, C subtrust plan contemplates that on the first spouse's death, property in the joint revocable trust will distribute to three subtrusts: trust A (the survivor's trust), trust B (the credit shelter trust), and trust C (the marital deduction trust). The basic structure looks like this:

The survivor's trust receives the surviving spouse's share of community assets. The credit shelter trust (a.k.a. bypass trust) receives assets protected by the decedent's remaining applicable estate tax exclusion amount.[4] Through 2008, the exclusion amount was \$2M; in 2009, it rises to \$3.5M; and in 2010, the estate tax will, if the law does not change, be repealed for a year. [5] The decedent's available applicable exclusion amount is reduced during life by up to \$1M to account for gifts he made out of his estate.[6]

The marital deduction trust receives the portion of the decedent's property that did not fund the credit shelter trust. The marital deduction trust avoids estate taxes via the Code Sec. 2056 marital deduction, but it can be less desirable than the credit shelter trust because the assets it holds could be subject to estate tax upon the surviving spouse's death.

Until recently, the economy was chugging along nicely, and many estate planners crafted estate plans based on reasonable assumptions that assets would appreciate in value over time. Such planning in subtrust funding can reap significant benefits for the decedent's estate and its beneficiaries. For example, a pecuniary (specific dollar amount) formula that bequests property in kind (*i.e.*, valued at the specific dollar amount) into a credit shelter trust immediately after the decedent's death could (1) allow the assets distributed to avoid substantial capital gains; and (2) then appreciate free from estate taxation.

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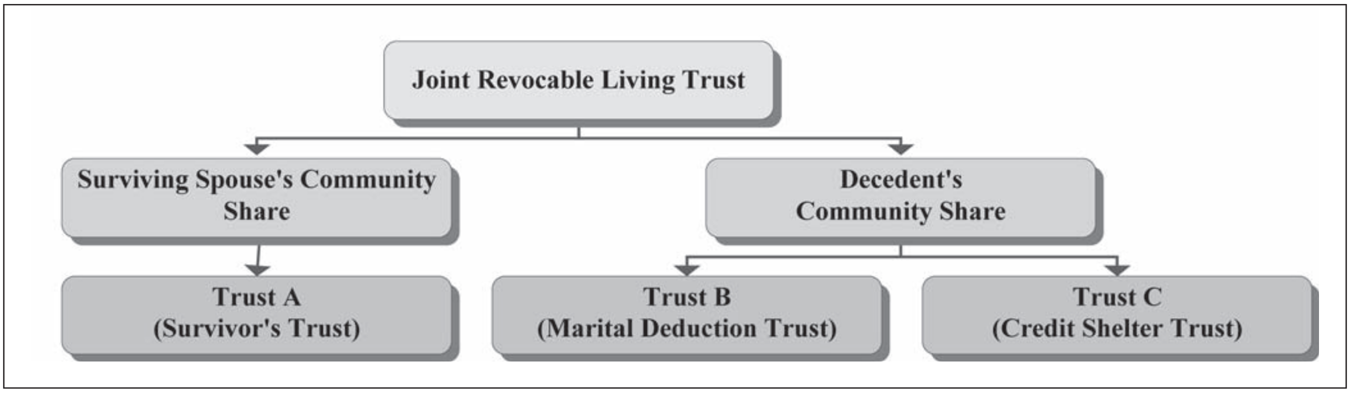
Figure 1.



Unfortunately, lately, previously "reasonable" assumptions that assets will appreciate seem less and less reasonable. This article proceeds with the assumption that, upon the first death, a qualified fiduciary will be able to make an educated assessment as to whether the existing asset base in the decedent's estate will have a probability of appreciating or depreciating. In that regard, this article focuses on ways to approach funding and administration of subtrusts if and when assets are expected to depreciate.

The Basics: Some Mechanics of the A, B, C Subtrust Plan

As of 2008, the current high long-term capital gain rate is 15 percent (or 28 percent for collectibles); the high income tax rate for individuals and estates is 35 percent; the high estate tax rate is 45 percent; and the generation skipping tax (GST) transfer rate is 45 percent.[7] Thus, all other things being equal, entirely avoiding any tax is preferred. But if that is not possible, it is nice to find a way to pay lower rates: *i.e.,* prefer capital gains rates to income tax rates, and avoid estate tax and GST rates if at all possible.

The credit shelter and marital deduction subtrusts in the A, B, C subtrust plan can often help the decedent to avoid any estate tax (and even the GST tax) upon his death. Good planning seeks to leave as little property as possible in the survivor's estate upon her death. Estate planners often set up marital deduction trusts that distribute all income to the surviving spouse, and on her death, all assets belong to the surviving children.

However, terminable interest property does not qualify for a marital deduction.[8] A terminable interest is a life estate, term of years, defeasible fee, or other interest terminating upon a lapse of time or contingency. Certain trusts are excepted from the terminable interest rule, so they can still allow for the marital deduction: a Code Sec. 2056(b)(5) general power of appointment trust; or a Code Sec. 2056(b)(7) qualified terminable interest property (QTIP) trust.

A Code Sec. 2056(b)(5) general power of appointment trust (1) entitles the surviving spouse to all or a specific portion of trust income for life; and (2) gives the surviving spouse a general power to appoint trust property to herself or her estate (but to no one else).[9] Some husbands fear that their surviving spouse could appoint trust property to her estate and pass it along to a new boyfriend or husband. Thus, estate planners and their clients often prefer a Code Sec. 2056(b)(7) QTIP trust.

A QTIP trust passes qualified terminable interest property from the decedent to the surviving spouse. QTIP property must have a "qualifying income interest for life," meaning that the surviving spouse must be entitled to all income from the property at least annually. Plus, no one may appoint "any part of the property to any person other than the surviving spouse" while the surviving spouse is alive.[10] With a QTIP trust, the surviving spouse has no general power of appointment.[11] Instead, the QTIP trust allows the first-to-die spouse to dictate disposition of the QTIP property after the surviving spouse's death. Yet oddly, the value of that QTIP property interest is included in the surviving spouse's gross estate, not the estate of the first to die.[12]

The QTIP trust also uniquely offers GST benefits via a reverse QTIP election. Transfers subject to the GST are taxed at the maximum federal estate tax rate, yet each person gets a GST exemption equal to the applicable exclusion amount (*i.e.,* $2M in 2008).[13] The Credit Shelter Trust often has beneficiaries and provisions that would cause GST transfers. Thus, it can be desirable to allocate the GST exemption to the Credit Shelter Trust.

A reverse QTIP election allows allocation of the decedent's GST exemption to the QTIP trust for GST purposes, even though the QTIP trust will be included in the surviving spouse's estate for estate tax purposes.[14] Because the GST exemption can only be allocated to an entire trust, a partial reverse QTIP election is not allowed.[15] Unless the entire QTIP trust will qualify for GST exemption without severance (which is unlikely), the solution is to set up two QTIP trusts: a GST exempt trust and a GST nonexempt trust.[16]

Subtrust Funding Clauses

Joint revocable living trusts or wills often distribute assets to credit shelter and marital deduction trusts via pecuniary or fractional share formula clauses. Pecuniary formulas route assets with an ascertainable dollar value into a particular trust (*e.g.,* the credit shelter trust), leaving the residue to the other trust (*e.g.,* the marital deduction trust).[17]

The value of a decedent's gross estate is generally stepped up or down to its fair market value as of the decedent's date of death.[18] Alternatively, pursuant to Code Sec. 2032, the decedent's gross estate can be valued as of an alternative date within six months after the decedent's date of death.[19] When a trust satisfies a pecuniary bequest to a subtrust with an in kind property distribution, it can recognize gain or loss based on the difference in valuation between the decedent's date of death (or alternate Code Sec. 2032 valuation date) and the date of distribution.[20]

> The A, B, C subtrust plan contemplates that on the first spouse's death, property in the joint revocable trust will distribute to three subtrusts: trust A (the survivor's trust), trust B (the credit shelter trust) and trust C (the marital deduction trust).

Estate administration can be a lengthy process. Thus, significant appreciation or depreciation can occur between death and distribution. Thereafter, the subtrust takes a basis in the property equal to its fair market value on the date of distribution.[21]

A fractional formula funds one subtrust with a fraction of property. The numerator is the desired value of the trust, and the denominator is the value of the residue of all assets from which that desired value will be carved. What is left passes to the residuary trust.[22] A distributing estate or trust will not recognize a gain or loss by funding a subtrust via a fractional share clause.[23]

Revenue Procedure 64-19. Before 1964, wills or trusts often used pecuniary funding clauses, giving the fiduciary discretion to select assets to fund subtrusts based on date of death values. Subtrust funding based on date of death values produced neither gain nor loss because there was no difference in value between the dates of death and distribution. Often, the fiduciary had the ability to place appreciating assets in one trust (*e.g.,* the Credit Shelter Trust), while depreciating assets funded the other (*e.g.,* the Marital Deduction Trust). Assets in the Credit Shelter Trust could appreciate free from estate tax, and assets in the Marital Deduction Trust could depreciate, thus reducing the surviving spouse's estate at death. Everyone was happy, except for the IRS.

In 1964, the IRS issued Revenue Procedure 64-19 to address when and whether it would allow the marital deduction in situations where a fiduciary had the foregoing type of discretion.[24] Revenue Procedure 64-19 disallows the marital deduction for pecuniary funding clauses that satisfy bequests of noncash assets with date of death values if the fiduciary has no clear limitation on how to allocate assets. However, Revenue Procedure 64-19 allows the marital deduction if applicable laws or the distributing instrument instruct the fiduciary to use what has become known as a "true worth" or "fairly representative" formula (provided the fiduciary has no discretion to choose either formula or a mixture of those formulas).[25]

A "true worth" formula requires the fiduciary to distribute assets to a subtrust with "an aggregate fair market value" on their date(s) of distribution at least equal to pecuniary bequest.[26] For example, a true worth marital deduction formula would fund a Marital Deduction Trust with assets with a value at least equal to the pecuniary amount as of the date of distribution, leaving the residue to the Credit Shelter Trust.[27] When a subtrust receives distributions via a true worth pecuniary formula, the distributing trust can recognize gains or losses on the difference in the assets' value between date of death and date of distribution.[28] The beneficiary trust's basis in the property received is its fair market value on the date of distribution.[29]

Nonetheless, any such loss recognition may require a Code Sec. 645 election. The problem occurs because Code Sec. 267 disallows loss recognition on distributions between related parties, including between a trustee and beneficiary.[30] A subtrust could be the beneficiary of the distributing trust, so Code Sec. 267 could disallow losses on a distribution to the subtrust. The solution to this hyper-technical problem may lie in Code Secs. 267(b)(13) and 645. According to Code Sec. 267(b)(13), recognition of losses from sales and exchanges between an "estate" and its beneficiary are disallowed, "except in the case of a sale or exchange in satisfaction of a pecuniary bequest … "[31] Code Sec. 645 allows a trustee to elect to treat a "qualified revocable trust" as part of the "estate."[32] A Code Sec. 645 election may allow recognition of a loss, because the distributing trust can now be deemed an "estate" that comes within the Code Sec. 267(b)(13) exception.[33]

> A reverse QTIP election allows allocation of the decedent's GST exemption to the QTIP trust for GST purposes, even though the QTIP trust will be included in the surviving spouse's estate for estate tax purposes.

A "fairly representative" formula requires the fiduciary to satisfy a pecuniary bequest with assets that fairly represent post death appreciation and depreciation of all property then available for distribution from the estate.[34] Fairly representative subtrust funding is not a sale or exchange and does not automatically result in the trust recognizing capital gain or loss.[35] As such, the property distributed keeps a carryover date of death value basis.[36]

Revenue Procedure 64-19 does not impact fractional share or certain other types of bequests. Fractional share bequests, in similar fashion to fairly representative bequests, cause distributed assets to share in the appreciation and depreciation of the assets available for distribution.[37] Fractional funding can create administrative hassles for fiduciaries. They end up having to apply a fractional formula to the assets available for distribution on a pro-rata basis.[38]

Moreover, funding with fractional share bequests yields tax results that are similar to the "fairly representative" clauses. Thus, they do not generate capital gain or loss for income tax purposes.[39] The recipient's basis in the property is its carryover date of death value.[40] Appreciation or depreciation in the decedent's gross estate typically results in either over-funding or under-funding of the respective marital deduction trust and credit shelter trust shares.[41] Hence, a fractional share bequest may not allow the credit shelter trust to be filled to capacity. That means it may not capture the benefits of post-death appreciation occurring between death and distribution.

Revenue Procedure 64-19 does not apply, nor does it prevent a marital deduction for bequests (1) of cash; (2) of specific assets; (3) for which the fiduciary has no discretion to select which assets will be distributed in kind; or (4) for assets to be distributed in kind, but valued as of their date of distribution.[42] Of the foregoing, cash distributions do not result in the realization of gain or loss by the trust, but they do carry out distributable net income that the trust can deduct, and which the beneficiaries would realize.[43] Specific asset bequests do not realize gain or loss for the distributing trust.[44]

On the other hand, specific assets distributed in kind without fiduciary discretion might receive sales treatment, depending on whether they were distributed based on date of death or date of distribution values. Moreover, distributions of assets to be selected in kind and valued as of their date of distribution can generate gains or losses for the distributing trust, with the subtrusts taking a basis in those assets equal to their fair market value as of the date of distribution.[45]

Subtrust Funding Suggestions When Assets Are Depreciating

If a pecuniary bequest of assets in kind could fund the credit shelter trust with depreciating assets, consider postponing funding. When assets are appreciating, pecuniary in kind distributions based on date of distribution values can result in capital gains to the distributing trust. One may fund the smaller of the credit shelter or marital deduction trust with the pecuniary bequest as soon as possible to try to reduce capital gains. A smaller pecuniary bequest yields fewer capital gains. Plus, a brief period between death and distribution should minimize the appreciation.[46]

On the other hand, when assets are declining in value, one may postpone pecuniary distributions, especially to the Credit Shelter Trust, to allow the estate to realize greater capital losses when the credit shelter trust actually funds. Perhaps more importantly, this may allow for additional assets in the credit shelter trust given their lower date of distribution values. If the economy improves after funding, and assets in the credit shelter trust start appreciating, more value escapes the estate tax. A pecuniary funding clause giving the fiduciary discretion over timing of funding and selection of assets may therefore make sense (so long as that funding is based on date of distribution values).

When a pecuniary bequest of assets in kind could fund the marital deduction trust with depreciating assets, consider prompt funding. The residue of such a formula falls to the credit shelter trust. If assets are depreciating, funding promptly would be preferable. A delay in funding the marital deduction trust while assets depreciate means that when funding eventually takes place, additional assets will be needed to satisfy the pecuniary bequest. The residue falling to the credit shelter trust will be correspondingly smaller. That means fewer assets have the potential to escape the estate tax.

In a declining market, fractional share formulas may become more desirable. Funding a credit shelter trust with a pecuniary bequest often makes sense, insuring maximum funding of the credit shelter trust. With larger estates, fractional shares can be less attractive, quite apart from their administrative hassles. However, when assets are depreciating, fractional share clauses may become more attractive.

With fractional share funding, there are no capital gains. The fractionalized assets once distributed retain their carryover date of death value.[47] In a depreciating market, if a fiduciary utilizes a "pick and choose" fractional formula, he can use his discretion to pick and choose assets for each subtrust.[48] Such a "pick and choose" fractional formula requires revaluation of all assets available for distribution each time a distribution occurs. Accordingly, each distribution naturally equalizes any appreciation and depreciation occurring up to that point in time and, thus, helps reduce the risk of having an unbalanced distribution of appreciating or depreciating assets to one or another of the subtrusts.[49]

Nevertheless, a pecuniary true worth formula can offer "pick and choose" flexibility for the distributing fiduciary.[50] Hence, unless there is a concern that a fiduciary will not be able to gauge which assets should go to which trust (in which case the naturally equalizing effect of a "pick and choose" fractional formula might be desirable) a pecuniary true worth formula may still be the preferred formula choice.

When a credit shelter trust is under-funded because of depreciating assets, consider using a disclaimer or a partial QTIP election to fully fund it. A credit shelter trust can be under-funded when fractional share formulas are used. Under-funding can also occur if the credit shelter trust receives the residuary share after the marital deduction trust receives a pecuniary bequest. In either case, a surviving spouse can make a qualified disclaimer of certain assets that funded the marital deduction trust in order to fully fund the credit shelter trust.

For the disclaimer to be effective, the will or trust must have appropriate language directing disclaimed interests to the credit shelter trust. The disclaimer must be irrevocable, unqualified, and made in writing within nine months of the survivor's receipt of the interest. [51] Furthermore, the surviving spouse cannot have accepted any benefits of the interests disclaimed, and cannot direct where those interests will go.[52]

A disclaimer approach provides tremendous flexibility to fund the credit shelter trust with whatever amount the surviving spouse is willing to disclaim. Of course, a disclaimer depends on the surviving spouse's willingness to make the disclaimer.[53] Where the surviving spouse may not be so willing, the decedent may want to include language in the joint revocable living trust giving the fiduciary the ability to make a partial QTIP election.

Specifically, if an A, B, C subtrust plan funds a QTIP marital deduction trust, the fiduciary (not the surviving spouse) can be given discretion to elect QTIP status for only a partial portion of the decedent's estate.[54] This offers the fiduciary the ability to craft the size of the marital deduction QTIP trust, thus enlarging the credit shelter trust. Unlike with a disclaimer, the partial QTIP election can be made later than nine months after the decedent's death. One can obtain a six-month extension beyond that nine-month deadline to file the estate tax return.[55]

Still, a partial QTIP election has its drawbacks. For example, when an executor makes a partial QTIP election, the regulations require that the "partial election must be made with respect to a fractional or percentage share of the property [available for QTIP treatment] so that the elective portion reflects its proportionate share of the increase or decrease in value of the entire property … "[56] Unlike a disclaimer, a partial QTIP election cannot have the effect of shifting certain appreciating assets to one subtrust, while shifting other depreciating assets to another.[57]

When receiving partnership property that has decreased in value below its inside basis, if possible, avoid a Code Sec. 754 election. When a decedent passes a partnership interest to a beneficiary, the beneficiary generally takes that decedent's inside basis in the partnership interest.[58] With assets that have appreciated, this can be bad for the beneficiary, who, on the later disposition of partnership assets, will have to realize the same gain the decedent partner would have realized (even though the beneficiary essentially entered the game in the fourth quarter).

On the other hand, the Code allows for a Code Sec. 754 election, which steps up or down the beneficiary's inside basis in that partnership interest to the value of his outside basis.[59] This means the beneficiary only realizes his actual gain or loss (as opposed to the decedent's actual gain or loss) on a disposition of partnership property.[60]

When assets are appreciating and a partnership interest passes from a decedent to a beneficiary (including a beneficiary subtrust), a Code Sec. 754 election makes sense. It adjusts the beneficiary's inside basis in partnership property upwards, and thus minimizes capital gains and income to that beneficiary. Conversely, when assets are depreciating, a Code Sec. 754 election is less appealing for assets with a built-in loss (*i.e.,* that have a higher inside basis than their actual fair market value). By not making a Code Sec. 754 election when assets depreciate, a subtrust beneficiary may reap the benefits of deducting built-in losses on the transfer of partnership property.[61]

This strategy has only limited potential. After all, if a partnership's inside basis in property exceeds that property's fair market value by more than $250,000 immediately after the transfer then the partnership has a "substantial built-in loss" with respect to that property.[62] Code Sec. 754's basis adjustment is mandatory (not an election) for "substantial built-in loss" property. This mandatory adjustment decreases an inflated adjusted basis in the partnership property to the value of the transferee's proportionate partnership interest.[63] Therefore, the benefits of avoiding the Code Sec. 754 election with depreciating assets can only be realized to the extent the property does not have a "substantial built-in loss."[64]

When trying to avoid a step down in basis at death to preserve loss, consider a pre-death transfer of depreciated assets. Because an estate receives depreciated property from the decedent at its date of death fair market value, whatever built-in loss the decedent might have had in that property can go permanently unrecognized.[65] One strategy to avoid this step down in basis is for the client to gift or sell property out of his estate before death.[66] Such a pre-death strategy requires careful planning and luck.

Moreover, in a community property state, it may be unclear whether a gift from one spouse is separate property or still 50/50 community property.[67] The couple should probably do a transmutation agreement to the effect that any remaining community interest the donor has in the gift to the donee spouse shall be considered the donee spouse's separate property.[68]

With gifts between nonspouses, if the gifted property's basis exceeds its fair market value, "then for the purpose of determining loss, the basis shall be [the property's] fair market value."[69] Therefore, a gift to a nonspousal donee is only effective in avoiding a step-down in basis (and a permanent nonrecognition of loss) if the donee thereafter holds the property until its basis exceeds the basis that the donor had in the property at the time of the transfer.[70]

Moreover, for any pre-death gift that occurs within three years of the decedent's death, Code Sec. 2035 may draw that gifted asset back into the decedent's estate.[71] Specifically, Code Sec. 2035 draws property back into the decedent's estate if it (but for the gift) would have been included in the decedent's estate under Code Sec. 2036 (regarding transfers with a retained life estate), Code Sec. 2037 (regarding certain reversionary interests retained by the transferor), Code Sec. 2038 (regarding certain revocable transfers), and Code Sec. 2042 (regarding proceeds of life insurance). Otherwise, Code Sec. 2035 does not apply to outright gifts that do not trigger any of the foregoing four statutes.[72] Furthermore, an asset sold in a nonfraudulent sale before death will not be drawn back into the decedent's estate under Code Sec. 2035.

If estate tax will be due on the first-to-die spouse's estate, consider electing Code Sec. 2032's alternate valuation date to reduce estate tax. Code Sec. 2032 allows an election to value estate assets as of (1) the date six months after the decedent's date of death; or (2) the earlier date of distribution, sale, exchange, or disposition (if either of those transactions occurred within six months of the date of death).[73] Most A, B, C subtrust plans seek to reduce estate tax to zero on the death of the first spouse. Code Sec. 2032(c) only allows the alternate valuation date election if the election will decrease both the value of the decedent's gross estate, and the sum of the estate tax imposed.[74] Hence, Code Sec. 2032's alternate valuation date is not generally an option on the first death.[75]

When Code Sec. 2032 is a desirable option, a fiduciary might consider selling property before the six-month alternate valuation date to ensure that certain property ends up in certain beneficiaries' hands.[76] Such a sale will cut the estate's losses on property that is expected to continue declining in value. The sale would not, however, reduce estate tax on that depreciating property (which would presumably be worth less if it continued to decline in value up to the six-month alternate valuation date).

A post-death sale before the alternate valuation date can also make sense when it is expected that property will decline and then appreciate in value during the six-month period following the decedent's death. For example, if a fiduciary felt strongly that property would be at its lowest value as of three months after the date of death, then distributing that property at its lowest value date would ultimately reduce the amount of estate tax due after the alternate valuation date election.

If enacted, the portable applicable exclusion could simplify subtrust planning. Congress has previously considered enacting a portable exclusion, which would allow the surviving spouse to increase her applicable exclusion amount by whatever amount the first-to-die spouse left unused. In June 2006, the House approved HR 5638, including a portable exclusion provision that could be invoked by an irrevocable election by the executor of the first-to-die.[77] Unfortunately, other than placing HR 5638 on the Senate legislative calendar, the Senate never took any real action on HR 5638, and it appears to be legislatively dead, although that could change in the new Congress.[78]

If enacted, a portable exclusion could avoid the problem of wasting the first-to-die spouse's applicable exclusion amount by funding the Credit Shelter Trust with assets destined to further decline in value before the surviving spouse's death. In a slumping economy, the value of the first-to-die spouse's applicable exclusion could be preserved and added to the surviving spouse's applicable exclusion amount.

Of course, a portable exclusion would not increase in value between the first and second death. Therefore, a portable exclusion would prevent estate tax free asset appreciation in a Credit Shelter Trust after the first death.

Conclusion

No one solution or strategy provides a universal panacea for subtrust funding and administration in a declining market. The approaches and strategies suggested here may help to make the best of the difficult scenarios presented by a declining economy. With any luck, a robust economy will return soon.

Endnotes

1 Code Sec. 676(a); Reg. §1.676(a)-1. Throughout the remainder of this article, unless otherwise indicated, all references to a "Code Sec." or "§," are to the Internal Revenue Code of 1986 (the "Code"), as amended and in effect as of the writing of this article. Similarly, references to a "§" may also refer to the applicable Treasury Regulations in effect as of the date of this article.

2 *See, e.g.,* Cal. Fam. Code §761(a) (explaining that with revocable trusts, "community property that is transferred in trust remains community property during the marriage…")

3 *See* Code Secs. 2038(a) & 2036. For convenience, and based on typical life expectancies, this article generally uses "his" and "her" based on the assumption that the husband will likely die first.

4 *See* Code Sec. 2010(a) & (c).

5 *Id.*

6 *Id.*; see also Sebastian v. Grassi, Jr., *Choosing the Appropriate Marital Deduction Funding Formula,* 33 Estate Planning 27 (August 2008).

7 Code Secs. 1(a)-(e) & (h), 2001(c), & 2641(b); Rev. Proc. 2008-54, I.R.B. 2008-54 (Aug. 29, 2008).

8 Code Sec. 2056(b)(1).

9 Code Sec. 2056(b); *see also Reg.* §20.2056(b)-5(j).

10 Code Sec. 2056(b)(7)(B)(ii); Reg. §20.2056(b)-7(d) & (e)(2).

11 Code Sec. 2056(b)(7)(B)(ii)(II); *see also* Reg. §20.2056(b)-5(g).

12 Code Sec. 2044(b)(1)(A).

13 *See* Code Secs. 2641(b), 2001(c), 2631(c), & 2010(c).

14 Code Secs. 2652(a)(3) & 2044; Kathryn G. Henkel, ESTATE PLANNING AND WEALTH PRESERVATION, at Chap. 5, ¶ 5.05[6][a] (2008).

15 Reg. §26.2632-1(a).

16 *See* Reg. §26.2654-1(b).

17 Boris I. Bittker, Elias Clark, & Grayson M.P. McCouch, FEDERAL ESTATE AND GIFT TAXATION, at 549 (9th ed. 2005).

18 Code Sec. 2031(a); Reg. §20.2031-1(b); *see* also Reg. §1014(a).

19 Code Sec. 2032.

20 *See* Marc M. Stern & Robert S. Tippett, *Income Taxation of Trusts in Fundamentals of Postmortem Trust Administration,* at 209, 241 and §11.50(CEB Program Handbook, April/May 2004); *see* also Reg. §1.1014-4(a)(3).

21 Reg. §1.1014-4(a)(3).

22 *See* James B. Bertles & Joel H. Yudenfreund, *Choosing a Formula Clause Based on Funding Effects*, 19 Est. Plan. 165, 170 (May/Jun. 1992).

23 Bertles & Yudenfreund, *Id.*, at 167 & 170-171.

24 Rev. Proc. 64-19, 1964-1 C.B. 682; David B. Gaw, *Subtrust Allocation and Funding on the Death of the First Spouse, in Fundamentals of Postmortem Trust Administration Program Handbook* 389, 433-434 § 14.30 (CEB Program Handbook, Apr./May 2004).

25 Rev. Proc. 64-19, 1964-1 C.B. 682; Rev. Rul. 90-3, 1990-4 I.R.B. 13, 1990-1 C.B. 174; *RIA Est. Planning & Analysis* § 44,838 n.22 (2008) (citing as authority a "Speech by Chief Counsel, 10/19/64").

26 Rev. Proc. 64-19, 1964-1 C.B. 682.

27 *See* Monica Dell'Osso & Frayda L. Bruton, 3 Cal. Transactions Forms--Est. Planning, *Ch. 15.* MARITAL DEDUCTION TRUSTS §15:46 (2007); William P. Streng & Mickey R. Davis, TAX PLANNING FOR RETIREMENT *, Pt. IV.* ESTATE PLANNING FOR RETIREES, *Ch. 12.* WILLS/ESTATE PLANNING FOR THE RETIREE ¶ 12.03[4][e] (2008)); Gaw, *supra* note 25, at 434 § 14.31.

28 Gaw, *supra* note 25, at 434-436 §§ 14.31 & 14.35.

29 Reg. §1.1014-4(a)(3).

30 Code Sec. 267(a) & (b)(6); Stern & Tippett, *supra* note 20, at 241 § 11.50.

31 Code Sec. 267(a) & (b)(13).

32 Code Secs., §§ 645(a) & 676.

33 Code Secs. 645(a) & 267(b)(13); Scott H. Mallin, *Strategies for Handling Difficult Fiduciary Income Tax Issues*, 25 Est. Plan. 410, 414 (Nov. 1998).

34 Rev. Proc. 64-19, 1964-1 C.B. 682; *RIA Est. Planning & Analysis* § 44,838 (2008).

35 Gaw, *supra* note 24, at 435-436 § 14.33.

36 *See* §§ 1014(a); *see also* Jeffrey N. Pennell, *Funding Marital Deduction Transfers*, C777 ALI-ABA 915, 931 (Nov. 16, 1992).

37 Rev. Proc. 64-19, 1964-1 C.B. 682.

38 Streng & Davis, *supra* note 27, at ¶ 12.03[4][f]; Varley H. Taylor, Jr., 6A VERNON'S OKLA. FORMS 2D, ESTATE PLANNING § 8.11(f); Bertles & Yudenfreund, *supra* note 22, at 170-171.

39 Bittker, Clark, & McCouch, *supra* note 17,

at 551; *see also* § 1.1014-4(a)(3); Bertles & Yudenfreund, *supra* note 22, at 171.

40 *See* Code Secs. 1014(a) & 643(e)(1) & Reg.§1.1014-4(a)(3).

41 Grassi, Jr., *supra* note 6, at 31-34.

42 Rev. Proc. 64-19, 1964-1 C.B. 682.

43 *See* Boris I. Bittker & Lawrence Lokken, FED. TAX'N INCOME, EST. & GIFTS ¶ 40.4.2 (2008); *see also* Bittker, Clark, & McCouch, *supra* note 17, at 550; Code Sec. 643(a) (defining distributable net income), Code Sec. 651 (re deduction for trusts distributing current income only), Code Sec. 661(re deduction for estates accumulating income or distributing corpus), & Code Sec. 662 (re including of amount in gross income of beneficiaries or estates and trusts accumulating income or distributing corpus); Bertles & Yudenfreund, *supra* note 22, at 166.

44 *Kenan v. C.I.R.*, 40 B.T.A. 824, 827 (1939).

45 Regs. §§ 1.661(a)-2(f) & 1.1014-4(a)(3); *see also* Henkel, *supra* note 14, at § 49.02[4][b][v].

46 *See* Jerry A. Kasner, Benton C. Strauss, & Michael S. Strauss, POST-MORTEM TAX PLAN., *Ch. 13.* PLANNING ESTATE AND TRUST DISTRIBUTIONS ¶ 13.04[8] - [10] (2008).

47 Reg. §1.1014-4(a)(3).

48 Plus, the fiduciary does not need to worry about Revenue Procedure 64-19, which expressly does not apply to factional share bequests. Proc. 64-19, 1964-1 C.B. 682.

49 Pennell, *supra* note 36, at 941.

50 *Id.* at 924.

51 Reg. §26.2518-2(a); Code Sec. 2518 (a) & (b).

52 Code Sec. 2518 (a) & (b).

53 *See* Grassi, Jr., *supra* note 6, at 34.

54 Code Sec. 2056(b)(7)(B)(v); Reg. §20.2056(b)-7(d)(3)(i); Kasner, Strauss, & Strauss, *supra* note 46, at ¶ 15.10.

55 Code Secs. 6075(a) & 6081 (a); Reg. §20.6081-1(a), (b), & (c).

56 Reg. §20.2056(b)-7(b)(2).

57 Kasner, Strauss, & Strauss, *supra* note 46, at ¶ 15.10.

58 Code Secs. 742, 743(a); Stephen A. Lind, Stephen Schwarz, Daniel J. Lathrope, & Joshua D. Rosenberg, FUNDAMENTALS OF BUSINESS ENTERPRISE TAX'N. 261 (3d ed. 2005).

59 *See generally* discussion of Code Sec. 743(a) and the Code Sec. 754 election at Lind, Schwarz, Lathrope, & Rosenberg, *supra* note 59, at 260-268.

60 *See id.*

61 *See* Lind, Schwarz, Lathrope, & Rosenberg, *supra* note 58, at 262.

62 Code Sec. 743(d)(1).

63 *See* Code Sec. 743(b)(2); *see also* Lind, Schwarz, Lathrope, & Rosenberg, *supra* note 58, at 262.

64 Code Sec. 743(b) & (d). Section 743's mandatory "substantial built-in loss" basis adjustment rule does not apply to certain electing investment partnerships or securitization partnerships. Code Sec. 743(e)(6) & (7).

65 *See* Robert A. Coplan, *Opportunities and Risks for Planners During a Recession,* 18 Est. Plan. 203, 208 (Jul./Aug. 1991); Code Sec. 1014(a).

66 Coplan, *infra* note 65, at 208; *see* also William Bassett, CAL. COMMUNITY PROP. LAW § 4:16 (2008 ed.); CAL. FAM. CODE § 852 (2008) (re transmutation agreements); *see also* §§ 1211, 1212, 1221, & 1222.

67 In California, property a spouse acquires by gift during marriage is that spouse's separate property. CAL. CONST. art. I, § 21; CAL. FAM. CODE § 770(a)(2) (2008).

68 *See* William Bassett, CAL. COMMUNITY PROP. LAW § 4:16 (2008 ed.); CAL. FAM. CODE § 852 (2008) (re transmutation agreements).

69 Code Sec. 1015(a).

70 Coplan, *supra* note 65, at 208.

71 Code Sec. 2035(a).

72 Code Sec. 2035(a)(2).

73 Code Sec. 2032(a).

74 Code Sec. 2032(c). Reg. §20.2032-1(b)(1) further explains that the "election may be made only if it will decrease both the value of the gross estate and the sum (reduced by allowable credits) of the estate tax and the generation-skipping transfer tax payable by reason of the decedent's death with respect to the property includible in the decedent's gross estate."

75 Sandra Price*, Estate Tax Returns, in Fundamentals of Postmortem Trust Administration Program Handbook* 253, 307 § 12.21 (CEB Program Handbook, Apr./May 2004).

76 Code Sec. 2032(a)(1).

77 *See* H.R. 5638 §§ 2(c)(2)(A) & 3(a)(2)(B), available online at www.govtrack.us/congress/billtext.xpd?bill=h109-5638 (last visited Feb. 8, 2008).

78 *See* Thomas Library of Congress Website, *Summary Regarding HR 5638*, http://thomas.loc.gov/cgi-bin/bdquery/z?d109:HR05638:@@@L&summ2=m& (last visited Feb. 8, 2008).