MEMORANDUM

Barber Emerson, L.C.

ESTATE TAX MARITAL DEDUCTION

The federal estate tax is imposed on property owned by a person at the time of death. It is commonly referred to as a "tax-inclusive tax," as the tax is imposed upon the property itself, and only the property remaining after the tax is paid passes to the estate beneficiaries. The tax brackets begin at thirty-seven percent, rising to fifty percent for large estates. The entire estate is not, however, subject to tax, in that up to a certain amount can pass free from federal estate tax. In the Economic Growth and Tax Relief Reconciliation Act of 2001 ("**EGTRRA**"), Congress increased the amounts that can pass free from federal estate tax based on the following schedule:

	Estate Tax		Gift Tax		Generation Skipping Transfer Tax	
	Exemption	Maximum Rate	Exemption	Maximum Rate	Exemption	Maximum Rate
2002	$1,000,000	50%	$1,000,000	50%	$1,100,000	50%
2003	$1,000,000	49%	$1,000,000	49%	* $1,100,000	49%
2004	$1,500,000	48%	$1,000,000	48%	$1,500,000	48%
2005	$1,500,000	47%	$1,000,000	47%	$1,500,000	47%
2006	$2,000,000	46%	$1,000,000	46%	$2,000,000	46%
2007	$2,000,000	45%	$1,000,000	45%	$2,000,000	45%
2008	$2,000,000	45%	$1,000,000	45%	$2,000,000	45%
2009	$3,500,000	45%	$1,000,000	45%	$3,500,000	45%
2010	Repealed		$1,000,000	35%	Repealed	
2011	$1,000,000	55%	$1,000,000	55%	$1,000,000	55%

* 2003 GST exemption may increase by inflation index and, in 2011, the exemption probably will be the non-EGTRRA inflation-indexed exemption for 2011.

As the schedule shows, the estate tax exemption increases to $1,000,000.00 on January 1, 2002, and then increases in steps to $3,500,000.00 by 2009. Most of the exemption increases occur during the last few years of the phase-in period. As the exemption increases, the estate tax rate decreases from 55% to 50% on January 1, 2002, with further incremental decreases to 45% by 2007. EGTRRA repeals the estate tax in 2010, but revives it in 2011 at its 2001 exemptions and rates unless Congress votes to make repeal permanent. EGTRRA therefore gives us the prospect of estate tax repeal rather than repeal itself.

Each estate is also permitted to deduct the debts owed by the decedent at the time of his death and the costs of estate administration from the value of the estate before taxes are imposed. For married persons, a third deduction called the "marital deduction" is also permitted. This deduction allows all property passing to the surviving spouse, either outright or in certain trust arrangements, to pass free from federal estate tax. Generally, for a trust to qualify for the marital deduction and thus be exempt from federal estate tax, the surviving spouse must have almost complete control over the trust and its ultimate disposition. Moreover, a terminable interest does not qualify for the marital deduction. A terminable interest is one that ends at some specified time. For example, a husband might leave his wife the use of a residence, but specify that the residence shall pass to the husband's children at the spouse's death. The value of the residence is thus a terminable interest and does not qualify for the marital deduction.

Congress has, however, carved out an exception to the terminable interest rule for property left to a surviving spouse in trust that meets the so-called QTIP rules. QTIP stands for "Qualified Terminable Interest Property." Thus, even though the property is left in a terminable interest, if it qualifies under certain rules a marital deduction will be available with respect to that property. Thus, under the QTIP rules, a trust may qualify for the marital deduction, even though the survivor's rights to the trust are restricted and the interests are terminable upon the surviving spouse's death.

In order to qualify as a QTIP trust, the surviving spouse must receive all of the income, and there must be a distribution of that income at least once a year. No one else can be entitled to receive any of the trust property during the surviving spouse's lifetime. At the time of the surviving spouse's death, the trust property will pass to persons named in the trust agreement, rather than as designated by the surviving spouse. Thus, the ultimate disposition of property left in a QTIP trust is not subject to the surviving spouse's discretion, but instead will pass only to those persons named in the trust agreement. For example, under pre-QTIP marital deduction rules, the surviving spouse would have been free to designate the ultimate recipient of the marital deduction trust property, including a second spouse or non-relatives. Under the QTIP rules, at the surviving spouse's death, the trust property can pass to the children or issue of predeceased children, and the surviving spouse need not have the ability to cause the property to be distributed to anyone else. There is, therefore, assurance that the property will stay within the family, yet qualify for the marital deduction.

Although the surviving spouse's rights under a QTIP trust are limited, those limitations relate only to the ultimate disposition of the trust, and not to the rights of the surviving spouse to enjoy the benefits from the trust during his or her lifetime. Those benefits would include all of the income and a limited right to encroach upon the trust principal. The encroachment rights must, however, be subject to certain objective standards or the surviving spouse would be able to distribute all of the trust property to himself or herself.

Whether a QTIP trust or an outright transfer to the surviving spouse is selected, marital deduction estate planning uses the interplay between the marital deduction and the applicable exclusion amount to prevent tax on estate assets up to double the applicable exclusion amount ($2,000,000 for decedents dying in 2002). Thus, for example, the husband (assuming he is the first of the spouses to die and dies in 2002) might leave $1,000,000 to the children, and the balance of the estate to his wife. The $1,000,000 left to the children would equal the applicable exclusion amount, and would therefore not attract any estate tax. The balance passing to the surviving spouse would qualify for the marital deduction, either as an outright transfer, a transfer to a marital deduction trust, or a transfer into a QTIP trust. At the time of the surviving spouse's death, the $1,000,000 that passed to the children at the time of the husband's death would not be taxed in his wife's estate. Not only is it the $1,000,000 original value of the applicable exclusion amount that would not be taxed at the time of the wife's death, but any appreciation in that amount would also escape tax. Thus, if the $1,000,000 initial amount grows to $2,000,000 at the time of the wife's death, the full $2,000,000 escapes tax.

Instead of leaving the $1,000,000 to the children, a more common plan for spouses is to leave that amount in a trust for the surviving spouse's benefit during his or her lifetime, but over which he or she has only limited controls. Because of the limited controls over the trust, the trust's assets will not be taxed in the surviving spouse's estate at the time of his or her subsequent death. This $1,000,000, either left to the children or to a trust for the surviving spouse, is called a "by-pass trust" in that it bypasses the surviving spouse's estate, thus completely freeing $1,000,000 from the burden of federal estate taxation. Because the order of the spouses' deaths cannot be predicted, both spouses should have estates of approximately equal to the applicable exclusion amount in order for each to create a by-pass trust that will free the applicable exclusion amount from taxation at the time of the surviving spouse's death.

The separate by-pass trust arrangement described in the preceding two paragraphs may not always be appropriate, particularly if the spouses' combined assets are below $1,000,000, which is the amount that may be sheltered from estate tax in 2002. If, for example, the spouses' combined assets are $1,000,000 and little growth in the value of those assets is expected, there would be no reason to have a separate bypass trust because even if all of the $1,000,000 passed to the surviving spouse, his or her estate would still be less than the exemption and thus not attract estate tax at the time of his or her subsequent death. If, however, the spouses' combined assets are $1,500,000, marital deduction planning is necessary because if one spouse should die and all of the assets should pass to the survivor, and the survivor should thereafter die while the exemption is $1,000,000, the survivor's taxable estate would be $1,500,000, and would attract a federal estate tax.

In order to provide for the possibility that a by-pass trust might not be necessary, and still create the opportunity to use a by-pass trust if the survivor's estate would attract federal estate tax, planning flexibility should be considered. That flexibility can be achieved by creating a "stand-by by-pass trust" for each of the spouses. At the time of the first death, the survivor can decide whether the size of the spouses' combined estates and the phase-in level of the exemption necessitate using a by-pass trust in the estate of the first spouse to die. If, considering these factors, the surviving spouse decides that no federal estate tax can reasonably be expected at the time of the surviving spouse's death, all of the property of the first spouse could pass outright to the surviving spouse or to a marital deduction trust over which the surviving spouse would have complete control. If, however, the survivor determined that estate taxes were probable in his or her estate, either due to the size of the combined estates or the possibility that the survivor would not live until the exemption increases to an amount greater than the spouses' combined estates, the survivor can disclaim all or a portion of the property passing to him or to her from the deceased spouse. The property disclaimed would then pass into a by-pass trust, thus protecting that property from federal estate tax in the survivor's estate.

If, for example, at the time of the first death, the federal estate tax exemption were $1,500,000 and the spouses' total assets were also $1,500,000, there would be no reason to have a by-pass trust other than to anticipate possible growth of assets following the first death. If substantial growth in the assets was expected, the survivor could elect to disclaim a portion of the property passing directly to him or to her, thereby causing such property to pass into a by-pass trust, and thus be excluded from the survivor's federal estate tax base at the time of the survivor's death. If, on the other hand, little growth was expected, or if the survivor anticipated using a substantial portion of the trust property for his or her support, there would be no reason to disclaim and thereby fund the by-pass trust.

Although the use of the disclaimer arrangement creates substantial flexibility and prevents the existence of an inflexible by-pass trust, as described in this memorandum, great care must be taken to review the total estate at the time of the first death to determine if a disclaimer should be used. Moreover, because a disclaimer must be executed within nine months following the date of death of the first spouse to die, attention must be given to the timing of the disclaimer. In order that this attention will not be overlooked, we generally attach a notice sheet to the original trust agreement stating that at the time of the first death, an analysis should be made as to whether a disclaimer should be executed within nine months from the date of the first death.

If the surviving spouse exercises the disclaimer, as to either all or a part of the property that would otherwise pass outright to him or to her, the disclaimed property will be held and administered under a disclaimer trust, which serves the same purpose as the by-pass trust; that is, to prevent any of the trust property from being taxed at the time of the survivor's death. Whether the by-pass trust is established by disclaimer or by the will or revocable trust of the first spouse to die, the surviving spouse generally is entitled to all of the net income from the trust and such amounts of principal as are necessary for the surviving spouse's support in his or her accustomed manner of living, or for his or her medical, dental, hospital, or nursing expenses, and expenses of invalidism. Because the surviving spouse generally is the trustee of the by-pass trust, if he or she were given total discretion to make distributions to himself or herself, the by-pass trust would then be included in his or her estate at the time of his or her death. The right to make principal distributions only for the surviving spouse's support in his or her accustomed manner of living, or for his or her medical, dental, hospital, or nursing expenses, and expenses of invalidism, is what is referred to as a power that is limited by an ascertainable standard. Such a limited power prevents the by-pass trust from being included in the surviving spouse's estate. The surviving spouse should generally avoid using principal from the by-pass trust, since any distributions from the by-pass trust to the surviving spouse would ultimately be taxed in his or her estate. Consequently, the surviving spouse's separate property should be his or her first source of support, and the by-pass trust should be the second source of support. We recommend that withdrawals of principal from the by-pass trust be made only if the survivor truly needs additional funds for his or her support.

The stand-by by-pass trust may be particularly effective when qualified plan assets are a large part of the total estate. Qualified plan assets include IRAs, 401(k) plans, 403(b) plans, and similar arrangements. If, for example, the value of both spouses' total assets is $2,000,000 and qualified plan assets constitute $1,500,000 of that total, only $500,000 will remain to fill up the by-pass trust on the death of either of the spouses. Because only $500,000 of assets are outside of qualified plans, the $1,000,000 by-pass trust could not be filled up at the time of the first death, even if all of the non-qualified plan assets were owned by the first spouse to die. If the by-pass trust is to be filled up, therefore, a portion of the qualified plan assets must be used. The simplest way to use qualified plans to fill up the by-pass trust would involve naming the revocable trust as beneficiary and permitting the trustee to allocate plan assets between the by-pass trust and the marital trust to the extent necessary to fill up the by-pass trust. This simplicity, however, extracts a price. The price is inflexibility. We believe that in most instances the surviving spouse should have the flexibility to determine whether it is in his or her best interest to use qualified plan assets to fund the by-pass trust. Several factors will weigh heavily in the surviving spouse's decision.

Among those factors are the following: the income tax benefits of deferral that can be obtained through a roll-over arrangement vs. the possible estate tax savings by using qualified plans to fund the by-pass trust; the size of the surviving spouse's estate; the tax laws at the time of the death of the first spouse to die, and; the requirement that distributions to a trust, even if payout is measured over the surviving spouse beneficiary's lifetime, must begin within the year following the date of death of the deceased spouse, whereas IRA distributions from a roll-over are not required to be made until the surviving spouse reaches age 70 ½. The disclaimer arrangement using the stand-by by-pass trust allows the surviving spouse to weigh these factors at the time of the first death and make an informed decision as to whether qualified plan assets should be paid directly to the surviving spouse as the primary beneficiary, or to the by-pass trust as the secondary beneficiary. If a trust is to be named as a secondary beneficiary of qualified plans in order to facilitate a possible disclaimer, however, several rigid requirements imposed by the Internal Revenue Service must be followed.

We believe that the information in this memorandum will provide a general overview of the estate tax marital deduction and several important tax deferral planning techniques. No single plan is right for everyone, and generalizations are precarious. Consequently, each client's financial and family situation must carefully be analyzed to establish the most effective tax plan consistent with the client's wishes for the disposition of his or her assets.