Marital Deduction Trust

The Marital Deduction Trust protects the marital deduction on the first death. As a result of the Unlimited Marital Deduction, the tax benefits of this tax free deduction are lost if not protected in trust.

Qualifying for the Marital Deduction

The marital deduction may only be taken for transfers of property between spouses. Whether a couple is married or not is determined under state law. Some states recognize "common law" marriages where cohabitation has lasted a certain number of years, but other states do not recognize such relationships. For transfers at death, the marital deduction applies only to property included in the gross estate for federal estate tax purposes. This makes sense since only that property is potentially subject to tax at the decedent's death.

The marital deduction is generally available for federal estate tax purposes to estates of U.S. citizens, resident aliens, and nonresident aliens, where the surviving spouse is a U.S. citizen. Where the surviving spouse is not a U.S. citizen, the marital deduction is generally only available if the property is in a qualified domestic trust.

Only property that "passes" from the deceased spouse to the surviving spouse is eligible for the marital deduction. Property may "pass" in a variety of ways to meet this requirement:

- under the deceased spouse's will
- as life insurance death proceeds
- by right of survivorship in the case of property held by the spouses as tenants by the entirety or as joint tenants with rights of survivorship (but not as tenants in common)
- under a general power of appointment
- under state intestacy laws
- under the surviving spouse's election against the will (where the will leaves her less than the state law minimum
- under a dower or courtesy interest
- as a lifetime gift to the spouse that is pulled back into the deceased spouse's gross estate at death
- under a so-called estate trust
- under a qualified terminable interest property (Q-TIP) election by the executor

To qualify for the marital deduction, the property that passes to the surviving spouse (or the donee-spouse in the case of a lifetime gift) must not be a "terminable interest." That is, the spouse's interest in the property must not be subject to expiration due to the passage of time, the occurrence of some future event, or the failure of some future event to occur. If any of these things can happen, then he or she has a disqualified terminable interest.

What the spouses often want to avoid is piling all of the property into one spouse's estate where it will be taxed in a higher estate tax bracket than if it were split between the two estates. Also, the spouses may want their respective assets to pass to their own blood relations rather than to in-laws if they should die close in time to one another. The six-month survival clause accomplishes these objectives without the complications of determining whether death was simultaneous or resulted from a common cause.

Life Estate with Power of Appointment

Marital deduction trusts ("A" trusts) often utilize this exception to the terminable interest rule. The spouse is given a lifetime income from the trust with a general power to appoint the trust corpus.

Life Insurance Settlement Options

Similar rules apply to life insurance proceeds held under a settlement option. The proceeds can qualify for the marital deduction if:

- the proceeds are paid in installments or under the interest-only option to the spouse (but no one else) for life;
- the periodic payments are made annually or at more frequent intervals;
- the spouse has an unrestricted general power of appointment over the proceeds; and
- no one else has a power of appointment over the proceeds.

Terminable interest rule for Marital Deduction

Example: Mary leaves her Twin Fork vacation home to her husband, Fred, but only until her son from her first marriage reaches age 30, at which time this son will take title to the home. If the son should die before reaching 30, Fred gets to keep the property. Does Fred have a terminable interest in the home?

Yes. The vacation home would not qualify for the marital deduction in Mary's estate. Note that we do not wait to see if the son lives until age 30. The mere fact that Fred's interest could have terminated is enough to disqualify the interest.

Advantages of the Marital Deduction

- No estate tax liability is incurred on property qualifying for the marital deduction at the first spouse's death.
- The surviving spouse receives a stepped-up basis for income tax purposes on property qualifying for the marital deduction. Thus, if the property is subsequently sold, there will be less taxable gain.
- When the marital deduction is properly coordinated with other estate planning tools, combined estate tax liability in both spouses' estates can be minimized.

Disadvantages of the Marital Deduction

- If the first spouse to die takes full advantage of the marital deduction, all property remaining in the surviving spouse's estate at his or her subsequent death will be subject to the federal estate tax. If the surviving spouse's estate exceeds the applicable exclusion amount, this can result in a substantial estate tax liability at the second death.
- It is tempting to "over-utilize" the marital deduction at the first death. Remember, everyone has an applicable exclusion amount from the federal estate tax. So, instead of leaving this applicable exclusion amount outright to the spouse, where it will be taxed at the second death, why not put it in a trust that will provide an income to the surviving spouse but bypass the second estate at death? Then the survivor can use his or her own applicable exclusion amount to shelter other assets from tax at the second death. This is accomplished through the use of a "bypass trust."