A REPRINT FROM THE JOURNAL OF TAXATION, OCTOBER 1986

ESTATE TAX MARITAL DEDUCTION PLANNING FOR ALTERNATE VALUATION

Use of alternate valuation, though restricted to instances in which the gross estate declines, may still be used to advantage.

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Under Section 2032(a), the executor may elect to value the property included in an estate at its value as of six months after the decedent's death.[1] This is called alternate valuation.

Alternate Valuation

Alternate valuation was first enacted in 1935. Its purpose was to prevent undue hardship arising from a decline in value after the date of death, sometimes to the extent that the value of the estate was less than the amount of the estate tax.[2]

Since property passing from a decedent generally takes a new basis for income tax purposes equal to the estate tax value under Section 1014(a), executors elected alternate valuation in nontaxable estates to produce higher values.[3] Executors also elected alternate valuation if the income tax benefits of the higher basis outweighed the additional estate tax costs,[4] or if it enabled the estate to qualify for Sections 303 or 6166.[5] The only restriction (other than those governing the time, method and revocability of the election) was that alternate valuation could not be elected if the estate was too small for a return to be required.[6] Prior to 1977, estate tax returns were required for gross estates exceeding $60,000. This figure has increased each year since 1977, and is now $500,000 and is scheduled to increase to $600,000 in 1987.[7]

After the enactment of the unlimited marital deduction, effective for decedents dying after 1981, nontaxable estates became more common. Where the unlimited marital deduction was available, alternate valuation was used where the assets increased in value to obtain a higher basis for income tax purposes, without any estate tax cost.

Restriction on Alternate Valuation

As a result, Congress enacted Section 2032(c) to restrict the use of alternate valuation to estates in which its use would decrease both the gross estate and the estate tax. This change became effective for estates of decedents dying after 7/18/84.

Thus, alternate valuation is no longer available if it would increase the gross estate. However, there are several ways to overcome Section 2032(c) where alternate valuation would reduce the gross estate, but would not reduce the estate tax due to the unlimited marital deduction. The possible solutions include a partial QTIP election,[8] a qualified disclaimer by the surviving spouse[9] and appropriate drafting for the credit shelter in the will.[10] These solutions are discussed in greater detail below, following a discussion of the different ways of structuring the unlimited marital deduction and the credit shelter.

Three Types of Deduction

There are three ways to structure a typical estate plan utilizing the unlimited marital deduction and the credit shelter:

- A preresiduary marital and a credit shelter residuary
- A preresiduary credit and a residuary marital
- A fractional share

As used herein, a "preresiduary bequest" means a pecuniary formula bequest; a "marital bequest" means one which qualifies for the marital deduction (assuming a QTIP election is made if necessary); and a "nonmarital" or "credit shelter" bequest means one which does not so qualify.

In other words, in the context of the unlimited marital deduction, a preresiduary marital bequest is a marital bequest of a dollar amount equal to the smallest amount necessary in order for the estate to pay no Federal estate tax, with the residuary estate constituting the credit shelter. Similarly, a preresiduary credit shelter bequest is a credit shelter bequest of a dollar amount equal to the largest amount possible such that the estate will still pay no Federal estate tax, with the residuary estate constituting the marital bequest.[11] In either case, the amount of the preresiduary bequest is determined by a formula, and the satisfaction of the preresiduary bequest (whether it is a preresiduary marital or a preresiduary credit shelter bequest) with property other than money is treated as a sale or exchange by the estate for income tax purposes.

Consequences of Type of Marital Deduction

The consequences of each approach depend upon post-death changes in the values of the estate's assets. To illustrate this, suppose the date of death value of the net estate[12] of a decedent dying in 1986 is $2 million. As of the date of death, without regard to the credit for state death taxes or any other credits or adjustments, the

marital share of the estate would be $1.5 million and the nonmarital share of the estate would be $500,000. (The effect of the state death tax credit is considered in greater detail below.)

If the value of the net estate increases to $2.5 million following the date of death, the effects of this would be:[13]

Estate plan	Marital share	Nonmarital share
Preresiduary marital	$1,500,000	$1,000,000
Residuary marital	2,000,000	500,000
Fractional share	1,875,000	625,000

Thus, where the assets increase in value, the preresiduary marital best shelters the post-death appreciation from estate taxation in the surviving spouse's estate.

If the value of the net estate decreases to $1.6 million during the six months following the date of death, the effects of this (absent an alternate valuation election) would be:

Estate plan	Marital share	Nonmarital share
Preresiduary marital	$1,500,000	$100,000
Residuary marital	1,100,000	500,000
Fractional share	1,200,000	400,000

Thus, absent alternate valuation, where the net estate decreases in value, the preresiduary credit shelter and residuary marital approach is the best to minimize the surviving spouse's estate.

However, if alternate valuation were available, the marital and nonmarital shares would be based upon a net estate of $1.6 million and would be:[14]

Estate plan	Marital share	Nonmarital share
Preresiduary marital	$1,100,000	$500,000
Residuary marital	1,100,000	500,000
Fractional share	1,100,000	500,000

Thus, if alternate valuation were available, it would eliminate the estate tax disadvantages of the preresiduary marital in the surviving spouse's estate where the net estate declines, while preserving its advantages where the net estate increases.[15]

Making Alternate Valuation Available

Notwithstanding Section 2032(c), there are three ways to make alternate valuation available where the estate declines in value:

1. Limiting marital share. The preresiduary or fractional marital share can be limited to 99.95%[16] of the smallest amount which would result in no estate tax (or, alternatively, the credit shelter can be more than 100% of the largest amount which would result in no estate tax). This can be illustrated as follows (using a preresiduary marital bequest, and without regard to the credit for state death taxes which is discussed in greater detail below):

Value of net estate	Marital share	Nonmarital share	Estate tax
Remains at $2,000,000	$1,499,250[17]	$500,750	$278
Decreases to $1,600,000 without alternate valuation	1,499,250	100,750	278
Decreases to $1,600,000 with alternate valuation	1,099,445[18]	500,555	205

Since the alternate valuation would reduce both the gross estate and the estate tax, it may be elected where the net estate drops in value.

The advantage of this technique is that nothing needs to be done after death. As long as the net estate drops in value, alternate valuation will be available. However, the disadvantage is that it complicates the estate planning and will drafting in all cases, while the alternate valuation would only be utilized in a minority of estates.

2. Disclaimer by surviving spouse. The surviving spouse could disclaim 0.05% of the marital disposition. The result would then be the same as if the marital bequest were limited to 99.95% of the smallest amount which would result in no estate tax. However, in order to have a qualified disclaimer of a preresiduary marital bequest, the spouse may also have to disclaim certain rights and powers under the re-

[1] The optional valuation date is the date of disposition with respect to property distributed, sold, exchanged or otherwise disposed of within six months of death. Section 2032(a)(1); Reg. 20.2032-1(a). The six-month period was one year for decedents dying before 1971. For a discussion of dispositions for this purpose, see Wachtel, Alternate Valuation Date for Estates, 61 ABA J. 1136 (1975).

[2] H. Rep't No. 1337, 83d Cong., 2d Sess. 90 (1954).

[3] This was permitted by Reg. 20.2032-1(b)(1) and Rev. Rul. 55-333, 1955-1 CB 449.

[4] This was more common before 1977, when the estate tax rates were as low as 3% (before the effect of the 50% marital deduction).

[5] Section 303 allows exchange treatment for certain redemptions of stock of closely held corporations where the value of the stock exceeds 35% of the adjusted gross estate. Similarly, Section 6166 allows installment payment of the portion of the estate tax attributable to a closely held business whose value exceeds 35% of the adjusted gross estate, with interest on a limited portion of the deferred portion of the estate tax generally at a special rate of 4%.

[6] Regs 1.1014-3(a) and 20.2032-1(b)(1); Rev. Rul. 56-60, 1956-1 CB 443; *contra*, Staff, Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 1121.

[7] The $500,000 and $600,000 figures are reduced by post-1976 taxable gifts and by the gift tax specific exemption used after 9/8/76. Section 6018(a)(4).

[8] The executor may elect to treat qualified terminable interest property as passing to the surviving spouse under Section 2056(b)(7). The spouse must have an income interest for life, and no person other than the spouse can appoint the property to anyone other than the spouse. Fractional or percentile QTIP elections are permitted under Reg. 20.2056-1(b).

[9] In general, under Section 2518 a qualified disclaimer must be made in writing within nine months after the decedent's death and before the beneficiary accepts any of the benefits of the property disclaimed.

[10] The credit shelter refers to a bequest not qualifying for the marital deduction (or for which a QTIP election is not made). It is designed to take advantage of the unified credit under Section 2010. The unified credit is $155,800 for 1986, and will be $192,800 beginning in 1987. Disregarding other credits, taxable gifts, and any gift tax specific exemption used after 9/8/76, it operates to shelter $500,000 in 1986 ($600,000 beginning in 1987) from estate tax.

[11] For a more detailed discussion of the different types of marital bequests, see Covey, *Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions* (U.S. Trust Company of New York, 1984); Lewis, *The Marital Deduction* (PLI, 1984).

[12] For purposes of this article the term "net estate" means the gross estate, less all deductions allowed for estate tax purposes other than the marital deduction.

[13] The illustrations in this article do not take into account the interest or income payable on the preresiduary bequest, the income allocable to the fractional share or the capital gains tax incurred upon the funding of the preresiduary marital or preresiduary credit shelter bequest with appreciated property.

[14] This does not take into account changes in the net estate after the alternate valuation date.

[15] William D. Zabel, Lecturer, Association of the Bar of the City of New York, 1/27/82. See also Covey, *supra* note 11, at 131-33.

[16] The use of the figure 99.95% is arbitrary. Any percentage close to 100% could be used. However, if the percentage selected is too close to 100%, it might not result in a lower tax if the value of the net estate declined by only a small amount, in which case alternate valuation would not be available.

siduary credit shelter disposition.[19]

3. QTIP election. If the marital disposition is in QTIP form, the executor could make the QTIP election as to only 99.95% of it. Again, the result would be as if the marital disposition were limited to 99.95% of the smallest amount which would result in no tax due.

Thus, with proper estate planning or post-mortem planning, the preresiduary marital and residuary credit shelter approach preserves the opportunity to use alternate valuation if the net estate declines, so as to minimize the surviving spouse's estate, while keeping the post-death appreciation out of the surviving spouse's estate if the net estate increases in value.

Additional Considerations

Of course, the disadvantage of using alternate valuation to reduce the value of the estate for estate tax purposes is that it will also serve to reduce the basis of the assets for income tax purposes.

There may also be other considerations in particular situations.[20] For example, in small estates, a hybrid formula might be used to avoid incurring capital gains upon the funding of a pecuniary marital or credit shelter.[21] However, in large estates, the capital gains tax burden of the pecuniary marital is generally outweighed by the estate tax savings in the surviving spouse's estate.[22]

Credit for State Death Taxes

Finally, the effects of state death taxes must also be considered. Since the unified credit is taken into account before the credit for state death taxes,[23] it is generally not possible to pay any Federal estate tax without paying at least $11,212 ($15,497 beginning in 1987) in state death taxes. This can be shown as follows (for 1986):[24]

	Without Section 2011 credit	With Section 2011 credit
Taxable estate	$500,000	$530,305
Federal estate tax before credits	155,800	167,013
Unified credit	(155,800)	(155,800)
Credit for state death taxes	-0-	(11,212)
Net Federal estate tax	-0-	$ 1

For 1987 and succeeding years, the figures are:

	Without Section 2011 Credit	With Section 2011 Credit
Taxable estate	$600,000	$642,426
Federal estate tax before credits	192,800	208,498
Unified credit	(192,800)	(192,800)
Credit for state death taxes	-0-	(15,497)
Net Federal estate tax	-0-	$ 1

While the state estate and inheritance tax laws vary from state to state, it is possible to group them into three broad categories. The techniques for dealing with each category are discussed below:

Category 1 — Florida. In some states, such as Florida, the state estate tax is equal to the Federal credit for state death taxes. Thus, in a Florida estate, $500,000 can be sheltered in 1986 (or $600,000 beginning in 1987) with no Federal or state tax. However, as set forth above, if no Federal estate tax is paid, alternate valuation will not be available.

On the other hand, by using the state death tax credit, it is possible to shelter $530,303 in 1986 with no Federal estate tax, or $530,305 with $1 of Federal estate tax. (These figures would be $642,424 and $642,426 beginning in 1987.) If the state death tax credit is used, alternate valuation will be available. However, this will result in a state death tax of $11,212 (or 37% of the additional amount sheltered, which would otherwise not have to be paid.

In large Florida estates where it is reasonably certain that the surviving spouse's estate will eventually be subject to estate tax, it may be desirable to take advantage of the state death tax credit. However, it would not be desirable to do so in smaller Florida estates where it is not certain that the spouse's estate will be subject to estate tax.

Category 2 — New York. In some states, such as New York, the state estate tax law generally follows Federal law, except that the state tax is more than the amount of the Federal credit. Thus, in a New York estate, there is a relatively small state tax cost involved in utilizing the credit for state death taxes.[25] This can be illustrated for a New York estate [26] for 1986 as follows:

	Without Section 2011 credit	With Section 2011 credit
Taxable estate	$500,000	$530,305
Federal estate tax before credits	155,800	167,013
Unified credit	(155,800)	(155,800)
Credit for state death taxes	-0-	(11,212)
Net Federal estate tax	-0-	$ 1
New York estate tax	19,500	21,318
Total estate taxes	$19,500	$21,319

Thus, at an additional tax cost of $1,819 (or about 6%), an additional $30,305 can be sheltered. Consequently, in large New York estates, the credit shelter provision would generally take advantage of Section 2011, thereby preserving the opportunity to use alternate valuation.

[17] A marital bequest of $1.5 million would result in no tax, and 99.95% of $1.5 million equals $1,499,250.

[18] A marital bequest of $1.1 million would result in no tax, and 99.95% of $1.1 million equals $1,099,445.

[19] See Regs. 25.2518-2(e)(2) and 25.2518-2(e)(5), Example (5). If a fractional share or residuary marital is used, and if the disclaimed property passes by intestacy, the spouse may also have to disclaim her intestate share.

[20] See, e.g., Lustgarten and Blattmachr, "The Choice Between Pecuniary and Fractional Marital Deduction Formula Provisions: The Ultimate Ambulatory Will," 32 U. So. Calif. Inst. on Federal Taxation, Ch. 13 (1980).

[21] A fractional share might also be used for this purpose, although fractional share estates tend to be extremely difficult to administer. See Cornfeld, "Marital Deduction: Planning and Drafting," 34 U. So. Calif. Inst. on Fed. Taxation ¶14.06 (1982); Cornfeld, "The Use and Abuse of the Unlimited Marital Deduction," 16 U. Miami Inst. on Estate Planning, ¶1704 (1982).

[22] See Cornfeld articles, *supra*. See also Mair: "Proper Utilization of the Unlimited Marital Deduction — Theory and Practice;" 41 N.Y.U. Inst. on Fed. Tax. $48.05 (1983); Gorman, Jr., *et al.*, "The Marital Deduction: Beyond the Basics," 35 U. So. Calif. Inst. on Fed. Tax. ¶1600.2 (1983).

[23] Section 2011(f). See Covey, *supra* note 11, at 134-35.

[24] This assumes that the state death taxes are at least equal to the Section 2011 credit for state death taxes. This is generally the case, except in Nevada (which does not impose a death tax) or for estates of U.S. citizens domiciled abroad having no property subject to death tax in any state. CCH Inheritance, Estate and Gift Tax Reporter, State Compilation, 70,391. This does not take into account the effect of post-1976 taxable gifts, reflected in the estate tax computation but not that of the state death tax credit.

[25] Covey, *supra* note 11, at 32-33, 134-35.

[26] N.Y. Tax Law, Section 952.

On the other hand, in small New York estates, where the Federal estate tax is not a concern, the planning might be geared toward deferring or avoiding the New York estate tax. Since New York follows the Federal unlimited marital deduction, but only has an effective credit shelter of $108,333 for New York estate tax purposes, it is possible to avoid both Federal and New York estate taxes in the first spouse's estate by limiting the use of the credit shelter to $108,333.

Category 3 — New Jersey and Pennsylvania. Some states, such as New Jersey and Pennsylvania, have complex inheritance taxes. The tax rates in these states vary depending upon the relationship between the beneficiary and the decedent, and there are exemptions for certain types of property, such as life insurance proceeds payable to a beneficiary, which are generally taxable for Federal estate tax purposes. States in this category generally also have estate taxes which serve as a backup to the inheritance tax, designed to ensure that the total state death tax is at least equal to the credit for state death taxes.

In a given New Jersey or Pennsylvania estate, if the state inheritance tax exceeds the credit for state death taxes, or if there is little or no additional state tax cost to using this credit, then the credit for state death taxes would generally be used so as to increase the amount that can be sheltered. However, if the state tax cost would be substantial (for example, due to the backup estate tax), then this credit would generally not be used.

The inheritance and estate taxes in this category are complex and vary from state to state. However, as a general drafting rule, the credit for state death taxes could be used where it does not result in any additional state death tax cost, but not where it would cause additional state death taxes to be paid.

This general rule can be refined by providing that the credit for state death taxes is to be used so long as it does not increase the death taxes payable in the testator's home state. The reason for limiting the test in this way is that an individual residing in a Category 3 state such as New Jersey might own property taxable in a Category 1 state (such as a winter home in Florida). Such an individual would generally want to take advantage of the state death tax credit if it did not increase the New Jersey death tax, even though this might cause a small Florida estate tax to be paid. Of course, this issue should be considered on a case by case basis wherever unusual situations are encountered. ★

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