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THE MARITAL *Deduction...*

The Internal Revenue Code provides estate and gift tax relief for certain transfers between spouses. Under the current law, assets passing to a decedent's spouse are generally not subject to estate taxes. Similarly, the donor spouse is generally allowed to make unlimited gifts to his or her spouse without incurring gift tax.

TERMINABLE INTEREST RULE

Gifts to a spouse that are not outright may require additional planning in order to qualify for the marital deduction. In order to qualify for the marital deduction, the spouse's interest cannot terminate based upon the passage of time or the occurrence of an event or contingency ("terminable interest rule"). For example, a normal life estate (where the spouse owns the property for life and then it passes to the children or other heirs) does not qualify for the marital deduction.

◆ *Using a Marital Trust to Qualify for the Marital Deduction*

Despite the terminable interest rule, there are ways to make gifts in trust that qualify for the marital deduction. There are three types of marital trusts that qualify for the marital deduction: (1) power of appointment trust, (2) estate trust, (3) qualified terminable interest property (QTIP) trust. Of the three types the one used the most often is the QTIP trust.



◆ ***Power of Appointment Trust***


A power of appointment trust must pay the spouse all of the income at least annually. In addition, the spouse must have a general power of appointment over the trust assets. This power allows the spouse to appoint the property to himself or herself, his or her creditors, his or her estate, or the creditors of his or her estate. The power can be exercisable during life or at death, or both. The power of appointment trust gives the surviving spouse flexibility in managing assets. The spouse can be the trustee and can have the power to distribute principal to the heirs. There are some potential drawbacks to this flexibility. The spouse's creditors may be able to access the trust assets. The spouse could utilize the power of appointment to benefit persons other than those intended by the first spouse. For example, if the surviving spouse remarries, the surviving spouse could use the power of appointment to shift the assets to his or her new family rather than the children of the decedent.

◆ ***Estate Trust***

In an estate trust, the trustee can be given discretion to distribute income and principal to the surviving spouse. At the spouse's death, the trustee must distribute the entire trust to the spouse's estate and the spouse's will controls the ultimate distribution of the assets. An estate trust can be beneficial if the spouse does not need or cannot manage all the income from the trust. Like a power of appointment trust or an outright bequest, the surviving spouse has the power to redirect the trust assets against the decedent's wishes.

◆ ***Qualified Terminable Interest Property (QTIP) Trust***

Addressing concerns about the power of appointment trust and the estate trust, Congress created the QTIP exception to the termi-




nable interest rule. In a QTIP trust, like a power of appointment trust, the trustee must distribute the net income to the spouse at least annually. During the surviving spouse's lifetime, no one (including the surviving spouse) can have the right to appoint the assets to anyone other than the spouse. In order to claim the marital deduction, the executor of the deceased spouse's estate must make a QTIP election on the estate tax return. An executor can also make the QTIP election over assets not in trust, such as assets subject to a life estate. There is no requirement that the surviving spouse have a power of appointment or any other means of control over the trust assets. A QTIP trust allows the deceased spouse much more control over the final distribution of the trust assets. The lack of a power of appointment may also shelter the assets from the surviving spouse's creditors.

NON-CITIZEN SPOUSE

If a decedent's spouse is not a U.S. citizen, there is no estate tax marital deduction unless the estate places the assets in a qualified domestic trust (QDOT). In order for a trust to qualify as a QDOT, the trust instrument must require that there be at least one trustee who is a U.S. citizen or domestic corporation. The trust must withhold estate tax on distributions from the trust, except for income paid to the spouse or principal paid to the spouse on account of hardship. The estate tax also applies to amounts remaining in the QDOT at the spouse's death.

There is no gift tax marital deduction if the donor's spouse is not a U.S. citizen. There is, however, an increased annual exclusion amount for gifts to a non-citizen spouse. The annual exclusion allows a donor to



give a certain amount to a beneficiary without making a taxable gift. Normally, the annual exclusion amount is \$13,000 (increased for inflation in future years); however, if a donor's spouse is not a U.S. citizen, the donor's annual exclusion amount with respect to the spouse is \$136,000.

CONCLUSION

The marital deduction can be a useful tool for passing assets to a spouse without tax. The spouse transferring assets can tailor the transfer of assets to the couple's circumstances by using a combination of outright gifts or bequests and transfers to a marital trust(s).

APPLICABLE *Exclusion Amount* (UNIFIED CREDIT)

An estate tax is imposed on the transfer of an individual's property at death. A credit (referred to as the unified credit) against the estate tax due allows individuals to pass a specific amount of property free of estate tax. The amount sheltered by the unified credit is referred to as the "applicable exclusion amount."

The unified credit applies to lifetime gifts to the extent the gifts exceed the annual gift tax exclusion and to gifts that do not qualify as a gift of a present interest. After computing the tax on the taxable gifts


made in a year, the donor can reduce the gift tax due by the amount of any remaining unified credit. At death, the executor of the decedent's estate can reduce the amount of estate tax due by any unified credit not utilized during life.

The schedule below reflects the applicable exclusion amounts for estate and gift taxes as well as estate and gift tax rates.

Year of Death or Gift	Estate Tax Applicable Exclusion Amount	Maximum Estate/ Gift Tax Rates	Lifetime Gift Tax Exclusion
2010	N/A	N/A	\$1,000,000
2011	\$5,000,000	35%	\$5,000,000
2012	\$5,000,000	35%	\$5,000,000
2013	\$1,000,000	55%	\$1,000,000

Wills or trusts can be structured to utilize any remaining unified credit at death. The simplest method is, of course, an outright transfer of the applicable exclusion amount to family members other than the spouse. If a donor does not want to give his or her heirs the money outright, the donor could create a "credit shelter bypass trust" (CSBT) in the will or revocable trust. The will or trust agreement will typically have language to fund the CSBT with assets worth the remaining applicable exclusion amount.

In order for a married couple to fully utilize the unified credit (if desired), the first spouse-to-die must generally own assets at least equal in value to his or her remaining applicable exclusion amount. Some types of assets cannot utilize the credit. For example, assets the couple



own as joint tenants with a right of survivorship will pass automatically to the surviving spouse. These assets can be used to allow the first spouse to take advantage of the unified credit with proper planning. Similarly, qualified retirement plans, IRAs, and life insurance will pass directly to the surviving spouse if he or she is the designated beneficiary. These types of assets can pass free of estate tax under the marital deduction, but cannot utilize the first spouse's unified credit.

In order to fund the first spouse's unified credit, the couple may have to partition joint property into separate property so that each spouse has separate property worth the applicable exclusion amount (since the identity of the spouse to die first is usually unknown). Changing the beneficiary of qualified retirement plans and IRAs to someone other than the spouse can also fund the credit. However, designating someone other than the surviving spouse as the beneficiary of a qualified plan or IRA will accelerate the time at which distribution will need to be made causing it to be subject to income taxes earlier/sooner. Changing the beneficiary of life insurance can work also, but it is usually better for estate tax purposes to simply transfer ownership of the policy altogether.

Spouses with community property may have an easier time funding the first spouse's unified credit because community property, while owned one-half by each spouse, does not pass automatically to the surviving spouse. The first spouse to die can use his or her share of the community property to fund the unified credit.



THE TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010

The *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act* (“the Act”) was enacted on December 17, 2010. For 2011 and 2012, the Act provides for a \$5 million Federal gift, estate and generation skipping transfer tax exemption amount (indexed for inflation starting in 2012) and a top gift, estate and GST tax rate of 35%. On January 1, 2013, a \$1 million Federal gift, estate and GST exemption amount and a maximum gift, estate and GST tax rate of 55% is scheduled to go into effect. These considerations apply only to the Federal transfer taxes. Any state-level estate or inheritance tax should be evaluated separately.



Estate at First Death

At the first death, a portion equal to the current applicable exclusion amount passes to the Credit Shelter Bypass Trust.

The remainder passes to the Marital/QTIP Trust.



Assets pass to spouse (No estate tax due)



Marital/QTIP Trust (A Trust)

The remainder of the estate assets pass to this trust.

All net income must be distributed to the surviving spouse at least annually.

Depending on the type of trust, the spouse may or may not have a general power of appointment.

In order for the trust to qualify for the unlimited marital deduction, the entire value of the remaining trust principal will be included in the surviving spouse's estate.



Estate tax due on assets over spouse's applicable exclusion amount (\$5,000,000 in 2011)



Applicable Exclusion Amount (\$5,000,000 in 2011) passes to the Bypass trust (No estate tax due)



Credit Shelter Bypass Trust (B Trust)

Amount equal to the applicable exclusion amount is received from the estate.

Surviving spouse receives the net income from the trust.

The trustee may also have the power to distribute trust principal for the surviving spouse's health, education, maintenance, or support.

At spouse's death, assets passing to heirs will avoid estate taxes.




No estate tax due



Heirs

The heirs receive distributions from the trustee according to the terms of the trust agreement.

Basic estate planning takes advantage of the unified credit, thereby sheltering a portion of your assets from federal estate and gift taxes.



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