CARTER LEDYARD

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Marital Deduction and Credit Shelter Dispositions; Use of Five Percent Power of Withdrawal in Surviving Spouse

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2023-1

A. Introduction

IRC Secs. 2041(b)(2) and 2514(e), relating to five percent powers of withdrawal, have been part of the estate tax law since the enactment of the Internal Revenue Code of 1939. They state:

2041(b)(2) Lapse of power. The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. The preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent that the property, which could have been appointed by exercise of such lapsed powers, exceeded in value, at the time of such lapse, the greater of the following amounts:

(A) $5,000, or

(B) 5 percent of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied.

2514(e) Lapse of power. The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. The rule of the preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent that the property which could have been appointed by exercise of such lapsed powers exceeds in value the greater of the following amounts:

(1) $5,000, or

(2) 5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied.

These provisions are, in our judgment, underused, which may be explained by clients' difficulty understanding the subject matter. This article will explore whether, with their added flexibility, they deserve a place in drafting wills and trusts.

B. Discussion

IRC Sec. 678(a) provides:

General rule. A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

The requirement that the holder of a power of withdrawal for a year is treated as the grantor of the trust for income tax purposes as to the extent of the amount withdrawable is understandable. In the current environment, this result is viewed as a loophole, at least where the powerholder is a surviving spouse, because the powerholder is permitted to make a tax-free gift transfer to the trust by paying a part of its income tax for each year during the holder's life. Under IRC Sec. 678(a)(2), the income tax consequences of a failure to exercise the power in one year may be to increase the percentage taxable to the powerholder in each succeeding year although, as discussed below, this issue is uncertain. As noted in Issue 2022-5, the current administration desires to change the result.

A common residuary disposition with spouses is for the first to die spouse to create a discretionary trust equal to his or her remaining credit shelter amount and a marital deduction QTIP trust for the surviving spouse covering the balance. The division can be mandated by the will or the will can authorize the executor to elect to divide the estate into marital deduction and credit share fractional portions. The terms of the credit shelter trust are often income or principal to the spouse or descendants and the spouse has a non-general testamentary power of appointment; if the power is not exercised, separate trusts are created for children. A modification is to give a lapsing five percent power of withdrawal each year to the surviving spouse over each trust.

The Will and Trust Provisions dated January 1, 2014, published by Bank of America contain forms using a spousal five percent power of withdrawal over both the credit shelter trust and the marital deduction trust. See Part H of the Will Provisions with an explanatory note on pages 48-51 and Part C of the Trust Provisions with an explanatory note on pages 15-18. The Will Provisions note provides:

The form that follows provides a starting point for preparing residuary dispositions in wills and revocable trusts for spouses. It is based on two premises. First, the use of potential QTIP trusts where the terms of the trust will not change but making a QTIP election will shift property from being taxable to being nontaxable in the estate of the first spouse to die is desirable. Second, trust transfers for the surviving spouse should provide maximum control for the spouse; the surviving spouse is given, in addition to the trust income, both an annual noncumulative power to withdraw trust property and a testamentary power to appoint the trust property at his or her death. The spouse may also receive trust principal in the discretion of the trustees. If a principal power is not desired, it can be eliminated. Maximum control may be more significant in smaller estates than in larger estates. The only difference in the dispositive provisions relating to the spouse between the Marital Trust and the Family Trust is that the spouse has an income interest in the former as contrasted to a discretionary income interest in the latter.

The use of limited annual powers of withdrawal provides flexibility which continues on a year-by-year basis and a "preferred" status for transfer tax purposes. Its utility may be illustrated by an example. The estate owner ("A") has a spouse ("B") and three children. A has an estate of $7.5 million and B an estate of $2 million. One approach would be to provide a credit shelter disposition equal to the federal AEA (now $5.34 million) and leave the balance in a marital deduction disposition. The question then becomes how to provide for B in the credit shelter disposition. B could, of course, be given the income but might not need all of the income. Another approach would be to make B a discretionary beneficiary of income and principal. A third approach, which we believe has considerable merit, is to provide B with a noncumulative annual power of withdrawal over the credit shelter disposition equal to 5 percent which can be exercised if needed.

See Form [H-1f], p. 54 and Form [H-1j], p. 56 of the Will Provisions and Form [C-6f], p. 20, [C-6j], p. 21 and [D-8], p. 70 of the Trust Provisions.

The power of withdrawal over each of the two trusts is the same. In Issue 2022-14, a revision of the language and a shortening of the power is suggested.

A release of the five percent power would be treated as a transfer to the trust by the spouse for gift and estate tax purposes under IRC Secs. 2514(b) and 2041(a)(2). The lapse resulting from the spouse's mere failure to exercise the power in a particular year is not treated as a release of the power by reason of IRC Sec. 2041(b)(2) and IRC Sec. 2514(e). Whether the spouse exercises the power each year, or in some years, or never, the spouse will not make a taxable gift and his or her gross estate will include no more than five percent of the value of the trust property by reason of the power (the marital trust will, of course, be includible because of the QTIP election).

Under Uniform Trust Code Sec. 505(b)(2), and the corresponding statutes of most states, the spouse's creditors do not acquire rights in trust property that could have been withdrawn under a five percent power; the "creditors' rights" doctrine will not apply to increase inclusion or affect the income tax result discussed below. For the credit shelter trust, it appears possible to avoid inclusion of five percent of the trust in the spouse's gross estate by providing that the power of withdrawal can be exercised for a year only if the spouse is alive on December 31 of that year.

The five percent power will cause five percent of the trust's taxable income to be taxed to the spouse under IRC Sec. 678(a)(1). As noted in the Introduction, under IRC Sec. 678(a)(2) the lapse of the power resulting from the spouse's failure to exercise it in a given year may cause him or her to be treated in subsequent years as the owner of a portion of the trust greater than five percent for income tax purposes, with this portion increasing over successive years each time the power lapses. IRC Sec. 678(a)(2) applies only if an actual transfer by the spouse would be subject to grantor trust treatment, but that would be the case for the marital and credit shelter trusts being discussed.

An argument may be made that IRC Sec. 678(a)(2) does not apply because it requires that the spouse have "previously partially released or otherwise modified" the power. The five percent power will not be modified, and while it may lapse each year, it will not be released. However, unlike IRC Secs. 2514 and 2041, IRC Sec. 678(a)(2) does not distinguish a lapse and a release or contain any five percent exception. IRC Secs. 2514 and 2041 specifically provide that a lapse is treated as a release except to the extent the five percent exception applies, by analogy supporting the application of IRC Sec. 678(a)(2) to a lapse. See *Westfall & Mair*, Estate Planning Law and Taxation, ¶17.07(2).

The significance of IRC Sec. 678(a)(2) is different for the two trusts. As to the marital trust, the surviving spouse is, because of her income interest, already taxable on the trust's ordinary income. The additional effect is for items of principal (such as capital gains) to also be taxable. As to the credit shelter trust, the additional taxation relates to both ordinary income and capital gains or other principal items.

A power of withdrawal may be used in only one of the trusts. In which trust is it most useful? This depends upon the circumstances of the particular case, including the relative size of the trusts. In terms of reduction of the surviving spouse's taxable estate, dollar for dollar the power has a greater effect in reducing the spouse's taxable estate when held over the credit shelter trust, because it is possible that all the trust income on which the spouse pays the income tax may never be distributed to the spouse. The offsetting possibility of including in the gross estate five percent of a trust that would otherwise be excluded can be minimized by making the power exercisable only, for example, if the spouse is alive on December 31, as discussed above.

If the residuary disposition results in no federal estate tax, the size of the credit shelter trust would be $12.92 million (the 2023 figure) or higher, though the credit shelter amount is scheduled to be roughly cut in half for deaths after 2025. If the income produced is about two percent, the income of a $12.92 million trust will be about $258,000. A five percent withdrawal right will result in the surviving spouse being treated as owner of approximately $646,000, taxable on $12,920 of trust income, in the first year.

In some states, including New York (see Practical Drafting, April 2014 at pages 11569-11602), a state death tax will be required because its exemption from tax is below the amount covered by the AEA exemption. In such cases, a decision will be required as to whether the credit shelter disposition should be based upon the estate exemption rather than the federal credit shelter.

C. Conclusion

The addition of powers of withdrawal to the credit shelter and marital deduction trusts should be used where the family relationship is strong. The advantage is that flexibility and control is increased in the surviving spouse and a useful tax result occurs as to the credit shelter trust, that spouse becomes the grantor of the trust to the extent of the value of the unexercised power and pays the income tax on a share of the trust income which results in a nontaxable gift to the other beneficiaries of the trust. The withdrawal powers also have the effect of permitting the spouse to use assets in either trust to make transfers to family members for any purpose. Arguably, the surviving spouse's increased powers are more significant in "smaller" estates than in "larger" estates.

SECURE Act Developments

The SECURE Act was discussed in Issue 2022-7. As noted there, an outstanding issue is whether the position in the proposed regulations that annual distributions are required for a designated beneficiary who dies after the owner's required beginning date. A December 22, 2022 letter from the American Institute of Certified Public Accountants (AICPA) to representatives of the Treasury and IRS discusses this subject and states:

I. Minimum Distribution Requirements for Designated Beneficiaries when Death of the Employee or IRA Owner Occurs After the Required Beginning Date

Overview

Section 401(a)(9)(H) was added to the Internal Revenue Code (IRC or Code), by the SECURE Act, to change the requirements for RMDs for retirement plans and IRAs that apply after the employee or IRA owner's death. The new rules apply to distributions from account balance type retirement arrangements made to designated beneficiaries, other than Eligible Designated Beneficiaries (EDBs). The new rules apply to designated beneficiaries (including EDBs) of employees or IRA owners who die after December 31, 2019.

Under section 401(a)(9)(H), if the retirement plan is a defined contribution plan, distributions are required to be made within 10 years of the death of the employee/IRA owner. The rules governing distributions after death are contained in two separate locations in the proposed regulations, which parallel the organization of the rules in the current final regulations, as follows:

- Proposed Reg. §1.401(a)(9)-3 provides rules applicable to determining RMDs in the case of the account owner's death prior to the RBD;
- Proposed Reg. §1.401(a)(9)-5 contains rules applicable to determining the lifetime minimum distributions to an employee or IRA owner, and the RMDs after the death of the employee or IRA owner if death occurs after the RBD.

Proposed Reg. §1.401(a)(9)-3 contains rules for implementing the new 10-year rule added by the SECURE Act in cases where the employee/IRA owner dies prior to the RBD. Under Prop. Reg. §1.401(a)(9)-3(c)(3), the entire interest in the retirement account must be distributed by the end of the tenth calendar year following the death of the employee/IRA owner. Proposed Reg. §1.401(a)(9)-3 does not require any amount to be distributed in any year following the year of death, until the tenth year following the death of the employee/IRS owner.

When the employee/IRS owner dies after the RBD, the distribution requirements are set forth in Prop. Regs. §1.401(a)(9)-5(d) and Prop. Regs. §1.401(a)(9)-5 (e). Proposed Reg. §1.401(a)(9)-5(d)(1)(i) requires the designated beneficiary to take a distribution in each year following the death of the employee/account owner. In addition, Prop. Reg. §1.401(a)(9)-5(e) states that if the designated beneficiary is not an EDB, any remaining interest must be distributed in the tenth year following the year of death. The requirement for the designated beneficiary to take annual distributions each year between the year of death and the tenth year following death is the main difference in the rules that apply in cases of death before the RBD and death after the RBD for account-type plans.

Recommendation

As indicated in our prior comment letter dated July 1, 2022, the AICPA recommends that Treasury and the IRS eliminate the requirement in Prop. Reg. §1.401(a)(9)-5(d)(1) mandating that a designated beneficiary who is not an EDB take distributions in each of the 10 years following the death of the employee.

We also recommend that the final regulations follow the rule set forth in Prop. Reg. §1.401(a)(9)-3 requiring only that the entire interest in the retirement account is to be distributed no later than by the end of the tenth year following the death of the employee/IRA owner.

Analysis

The AICPA's comment letter dated July 1, 2022, states that the requirements of Prop. Reg. §1.401(a)(9)-5(d)(1) do not reflect the statutory language related to the changes made to RMDs by the SECURE Act. The statute, as amended, provides for the 10-year rule. As it is written, the 10-year rule operates like the 5-year rule, except with a longer period. The 5-year rule did not (and does not) require annual distributions. The change made by the SECURE Act extends 5 years to 10 years, and makes no other changes.

The proposed regulations mandate that in the case of a designated beneficiary of an employee/IRA owner who dies after the RBD, distributions must be completed by the end of the tenth year following death. However, they also require the designated beneficiary to take distributions in each year following the year of death. In order for there to be a requirement of annual distributions, one of the following statements must be correct:

- The 10-year rule itself requires a distribution to be made in each of the years prior to the tenth year based on life expectancy, with a full distribution by the end of year 10; or
- The 10-year rule applies simultaneously with the "at least as rapidly" rule, and the "at least as rapidly" rule continues to apply.

The 10-year rule does not require annual distributions between the year of death and the tenth year following death, since it operates identically to the 5-year rule, but with a 10- year period. Thus, the first statement above is not accurate.

The second statement above also is not accurate since the "at least as rapidly" rule has been rendered inoperative by section 401(a)(9)(H). Section 401(a)(9)(H)(i)(II) states that subparagraph (B)(ii) (i.e., the 5-year rule that is changed to 10 years) "shall apply whether or not distributions of the employees' interest have begun in accordance with subparagraph (A)" (i.e., whether or not the death occurred prior to the RBD). Therefore, the 10-year rule also applies if death occurs after distributions have begun. The language does not specifically indicate that the "at least as rapidly" rule continues to apply. Therefore, the "at least as rapidly" rule does not apply, making the 10-year rule the only rule applicable.

The "at least as rapidly" rule is inconsistent with the 10-year rule. The "at least as rapidly" rule requires distributions to be made on an annual basis, while the 10-year rule does not. Since the language of the statute states that the 10-year rule "shall apply" whether or not distributions have begun, Congress intended for the 10-year rule, and only the 10-year rule, to apply.

Our conclusion is further supported by the legislative history of the SECURE Act. House Report 116-65 explains the revisions to section 401(a)(9) as follows:

Under the provision, the five-year rule is expanded to become a 10-year period instead of five years ("the 10-year rule"), such that the 10-year rule is the general rule for distributions to designated beneficiaries after death (**regardless of whether the employee (or IRA owner) dies before, on, or after the required beginning date**) unless the designated beneficiary is an eligible beneficiary as defined in the provision. Thus, in the case of an ineligible beneficiary, distribution of the employee (or IRA owner's) entire benefit is required to be distributed by the end of the tenth calendar year following the year of the employee or IRA owner's death.

(Emphasis added.)

Congress intended the 10-year rule to be the exclusive rule for distributions made after the death of the employee/IRA owner (except to EDBs), which renders the "at least as rapidly" rule inapplicable. The "at least as rapidly" rule was not removed entirely because Congress did not intend to change the rules for beneficiaries of defined benefit plans or for beneficiaries of decedents who die prior to January 1, 2020. Thus, it was necessary to retain that statutory language, but its application is limited solely to those situations.

Final regulations should be issued later this year and resolve the issue. Hopefully, the position stated above by the AICPA will be accepted.

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related professionals

Jerome J. Caulfield / Partner
D 212 238-8809
caulfield@clm.com