What is a Clayton Election?

Take-Away: If a marital deduction is relied upon as part of a decedent's estate plan, the use of a *Clayton Election* to fund the marital trust can add considerable flexibility to the estate plan.

Background: I was recently asked to look at a marital deduction trust by a trust officer who was slightly confused after reading the trust, since the marital trust funding formula was something that he had never seen before. When I looked at the trust instrument, I found that what the settlor had chosen was to use what is sometimes called a *Clayton Election* which is an optional marital deduction funding choice that is not encountered too often due to the recent changes in the transfer tax laws.

Marital Deduction Formula: Recall that the federal estate tax marital deduction permits the deferral of federal estate taxes until the surviving spouse-beneficiary's death. [IRC 2056 (b)(5) or (7).] With the recent rise in an individual's applicable exemption amount to $15 million (annually adjusted for cost-of-living) along with the advent of *portability* of the deceased spouse's unused applicable exemption amount, there are fewer estate plans that continue to use the A-B Trust division and allocation formula where the deceased spouse's assets are divided into two portions, the B Trust portion that avoids federal estate taxes by relying on the deceased spouse's available applicable exemption amount, and the A Trust portion which is the balance of the decedent's assets on which federal estate taxes are deferred until the surviving spouse's death. That allocation of assets between the A Trust (marital) and the B Trust (either called the credit shelter, family, or bypass trust) in the decedent's trust instrument often uses different formulae to accomplish that division and allocation, sometimes relying on a *pecuniary amount* formula (which can sometimes trigger unexpected capital gains taxes on funding) and sometimes the division of assets between the two Trusts is accomplished using a fractionalization of all of the decedent's assets (which can be a challenge to administer.) These word-formulas can often run for a page or two in the trust instrument and frequently cause eyes to glaze over caused by the legal terminology; however, whatever the marital deduction formula, it is critical to the administration of the decedent's trust to save federal estate taxes.

Portability: With spouses able to use *portability* of the deceased spouse's unused applicable exemption amount (DSUEA) many marital couples now rely on a joint trust to accomplish their estate planning objectives. Simply relying on *portability* without other tax planning in an estate plan can be dangerous. For starters, *portability* is not available for the deceased spouse's unused generation skipping transfer tax (GSTT) exemption. If the goal is to use the decedent's unused GST exemption, then a QTIP trust will have to be used, and a *reverse QTIP election* made for that QTIP marital trust in order to use the decedent's unused GST exemption. In addition, the DSUEA does not adjust for inflation growth; it is a fixed amount that does not increase with inflation. Finally, the surviving spouse's DSUEA might be lost entirely if the surviving spouse remarries. In sum, relying totally on *portability* of the deceased spouse's unused available applicable exemption amount might not be enough if the goal is to avoid transfer taxes.

Clayton QTIP Trust: The *Clayton Election* comes from a 1992 court decision *Estate of Clayton v. Commissioner, 976 F.2d 1486 (5th Circuit, 1992)* that permitted more flexibility in funding a marital trust on the death of a spouse. With this type of formula, when the first spouse dies, his/her assets initially pass to the B (or bypass) Trust. The intent behind Trust B is to protect its assets from estate taxes and creditor claims of the surviving spouse. The Personal Representative of the deceased spouse's estate then makes a qualified terminable interest (QTIP) *election* on the decedent estate's Form 706 Federal Estate Tax Return for all or part of the assets that pass to Trust B. The *elected* portion then becomes a QTIP marital deduction trust, on which federal estate taxes are deferred until the death of the surviving spouse-beneficiary. Practically speaking, the decision to make the election creates the marital trust. If no election is made, then all of the decedent's assets remain in Trust B. effectively using the decedent's applicable exemption amount to shelter those non-elected assets from federal estate taxation. Accordingly, rather than rely on an inflexible word-formula marital deduction to allocate assets between the two Trusts, the Personal Representative of the decedent's estate decides what decedent's assets will pass to the marital deduction trust and how much (value) will be sheltered by the marital deduction.

Perceived *Clayton Election* Benefits: Some of the perceived benefits of using a *Clayton Election* are the following:

Avoids Gift Tax Exposure: Normally the decedent's estate will require that a *Clayton Election* must be made by an independent Personal Representative. This is intended to avoid any potential federal gift tax exposure to the surviving spouse, if he/she acting as Personal Representative exercises control over assets that he/she will benefit from after the Trusts are funded, i.e., IRC 2036(a)(1)(2) exposure for the surviving spouse's estate if he/she makes the *Election*. This required objectivity of an independent Personal Representative is particularly important if there is a blended family situation.

Wait-and-See Approach: The *Election* offers a 'wait-and-see' approach to tax planning. The Personal Representative will decide *after* the first spouse's death which assets go into the QTIP marital Trust (or to the bypass Trust), based on the tax rules, gross estate size, and the potential for future asset appreciation. Since there will be a second basis adjustment to the QTIP marital trust assets on the surviving spouse-beneficiary's death, the decision which assets will be exposed to that second basis adjustment will be critically important for the family that wants to avoid capital gains taxes when the marital trust assets are ultimately inherited. [IRC 1014(a).]

Flexibility: Because the Personal Representative makes the *Election* he/she can adjust the allocation to reflect changes in the transfer tax laws. For example, a new Congress might decide to reduce the current $15 million applicable exemption amount in an effort to raise tax revenues to address the out-of-control federal deficit. As such, there might be more tax optimization decision-making with a *Clayton Election*.

Timing: Unlike some elections where there is a hard-and-fast deadline to deal with, e.g., the decision to disclaim assets, or interests in assets, must be made within 9 months of the decedent's death, the *Election* can be made on a federal estate tax return that has been extended for an additional 6 months, which means that the Form 706 on which the Personal Representative's *Clayton Election* is made is up to 15 months after the decedent's death. This gives the Personal Representative even more time to decide what to elect and how much to elect to go into the marital QTIP trust. The *Election* gives the Representative more power and time to assess the surviving spouse's needs, future asset appreciation potential, and the future transfer tax limits.

Disclaimer Planning: Some estate plans rely on the surviving spouse making a qualified disclaimer of assets that would otherwise pass to the marital trust. The problems with relying on the survivor's qualified disclaimer of assets that would otherwise pass to the marital trust include: (i) a qualified disclaimer must be made within 9 months of death, not 15 months; (ii) a qualified disclaimer is unavailable if the survivor has benefited from the intended disclaimed assets, e.g., he/she took possession of or used the asset; and (iii) the survivor is either unsophisticated or so distraught that he/she forgets to make the formal disclaimer in a timely manner. With the *Clayton Election* the decision is made by an independent Personal Representative within 15 months of the decedent's death.

State Estate Tax Exposure: The additional flexibility with a *Clayton Election* can be important if the decedent's estate faces some state estate tax exposure, since many state estate tax exemptions are much smaller than the federal estate tax exemption, but they permit an unlimited marital deduction to the state estate tax..

Drawbacks to a *Clayton Election:* Perhaps the biggest danger to the use of a *Clayton Election* is the Personal Representative's failure to timely make the *Election*. Which may also be why it is a good idea to use a professional independent Personal Representative, which is far less likely to miss such an important decision. If missed, the decedent's entire estate stays in the bypass trust, and therefore loses the possibility of a second basis step-up (unless the bypass trust can be amended to give the surviving spouse beneficiary a testamentary general power of appointment over the bypass trust corpus on his/her death.)

Conclusion: Flexibility is the byword to the *Clayton Election's* effectiveness. Medium sized estates may not know the best course of action until the death of the first spouse, so a locked-in marital deduction funding formula might want to be avoided. Some assets might intentionally be transferred to the marital QTIP trust just to gain a second basis step-up and thus enable children and heirs to avoid capital gains taxes after the survivor's death. On the other hand, some assets might not be expected to appreciate much in the future, or some assets will never be sold by the family, e.g., the heirloom family cottage, so future capital gain avoidance is not a priority, or other assets may need to be protected from potential creditor claims and thus might be better placed in the bypass trust. Giving the Personal Representative the flexibility to decide which assets go to which trust is an option that should not be overlooked when it comes to marital deduction planning in an unknown future.

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