FUNDING FORMULAS AND OTHER ISSUES IN FINALIZING AN ESTATE – YOU CAN'T ALWAYS GET WHAT YOU WANT, BUT IF YOU TRY SOMETIMES YOU GET WHAT YOU NEED

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Contents

I. INTRODUCTION

This article discusses funding agreements, estate funding calculations, and timing issues relating to estate funding.

A. Funding Agreements

Once the personal representative of the estate is ready to fund, there are a number of matters that the personal representative and the beneficiaries of the estate may wish to address in a written agreement. Some of those issues are as follows: (i) releases and indemnities, (ii) documenting the division of estate assets, (iii) assumption of debts and expenses by the beneficiaries of the estate, and (iv) reserves. The section of this article titled "Funding Agreements" addresses each of those issues in further detail.

B. Estate Funding Calculations

Determining the appropriate manner in which to fund following trusts can be a complex endeavor. Understanding the implications of each of the various types of fundings is essential prior to beginning the funding process. The characteristics and complexities involved in fractional and pecuniary fundings are discussed in the section of this article entitled "Funding Formulas."

The most complicated estate funding calculations arise when the personal representative of an estate is required to fund trusts to which the testator's GST exemption under section 2631 of the Internal Revenue Code (the "Code") will be allocated (referred to below as "GST Trusts"). The section of this article titled "Funding GST Trusts" first explains the rationale behind the various funding requirements, then illustrates means of satisfying these funding requirements with hands-on mathematical examples.

C. Timing

Personal representatives and beneficiaries of estates invariably ask early on in the estate administration process "how long is this going to take?" Clients often want to have things wrapped up within a relatively short time frame (*i.e.*, a time frame measured in months rather than years), which probably is not practical or advisable for a taxable estate. Simply achieving finality with respect to the amount of federal estate tax due can take years. The section of this article titled "Timing" addresses why the personal representative of the estate may wish to wait until matters have been settled with the IRS before distributing the assets of the estate to its beneficiaries, as well as other timing issues.

II. FUNDING AGREEMENTS

A. Releases and Indemnities

1. Releases

Speak now or forever hold your peace! It is not uncommon at the end of an estate administration for the personal representative of an estate to ask the beneficiaries of the estate for a release from any liability relating to the administration of the estate. In asking for a release, the personal representative is attempting to achieve some finality with respect to his or her responsibilities and duties, which makes sense in light of the fact that the personal representative is trying to wrap up the estate administration. In the absence of obtaining a release (or, alternatively, a judicial discharge from liability), it is hard for the personal representative to feel comfortable that he or she has achieved that finality because there may be a claim relating to the estate that will need to be defended at some time in the future. On the other hand, requesting a release may prompt a beneficiary to consider what claims the beneficiary might have, ask questions or otherwise investigate how the estate was handled, and ultimately perhaps bring a claim that otherwise might never have been brought. On balance, however, if there is some claim that a beneficiary might have, the personal representative likely is in a better position to defend against that claim while

memories are fresher, documents and other materials are easier to find, and the personal representative is still serving as the personal representative of the estate.

For those instances in which requesting a release is appropriate, sample release language is provided in Appendix A to this article. Some points to highlight regarding this language are as follows: (a) the language includes a release of the personal representative both as a fiduciary and individually, (b) the release also extends to persons acting for or on behalf of the personal representative, (c) the sample provision contains language in all caps relating to the release of claims for negligence and gross negligence because the sample provision was taken from an agreement governed by Texas law, which has what is known as the express negligence rule requiring these types of releases to be conspicuous (other states may have other requirements), (d) it can be helpful to include a laundry list of particular concerns within the defined term "Matters," although there are disadvantages to doing so as well, and (e) the language includes a release for both acts and omissions. One of the advantages to including a laundry list of specific claims that are released is that, generally speaking, more specificity is helpful if a releasing party later has buyer's remorse and tries to claim that the release is unenforceable. One potential disadvantage to doing so relates to the possible consequences of not including a specific claim that a releasing party later tries to bring (despite language in the agreement indicating that the list is illustrative only). On balance, it generally is better to include a list of illustrative claims that are being released in addition to the broader release of all claims relating to the personal representative's administration of the estate.

As an alternative to requesting a release, the personal representative of an estate potentially could seek protection via a "judicial blessing" of its accounts. Judicial options will vary from state to state. As one example, under Texas law, even an independent executor may file an action for a declaratory judgement seeking to discharge the independent executor from any liability involving matters relating to the past administration of the estate that have been fully and fairly disclosed. Tex. Est. Code § 405.003. Further, under section 405.003(e) of the Texas Estates Code, the independent executor generally is entitled to pay attorneys fees and other costs associated with such a judicial proceeding from the assets of the estate. Tex. Est. Code § 405.003(e). However, section 405.003(e) of the Texas Estates Code also provides that if the costs are not approved by the court as a proper charge against the estate, the independent executor is *personally liable* to refund the amount of the unapproved costs to the estate. Tex. Est. Code § 405.003(e). Under Illinois law, where most decedent's estates are handled via revocable trusts, a trustee may request approval of the trustee's accounts at the trustee's election, with all costs paid by the trust. 760 ILCS 3/813.1(i)

Any personal representative considering judicial options will need to carefully consider the rules under the laws of the state governing that particular estate. However, regardless of which state's laws will govern the proceeding, judicial proceedings generally can be costly and time-consuming. In addition, in some circumstances, bringing a court action may allow a beneficiary to bring a claim that otherwise would have been barred by reason of the statute of limitations. If the personal representative decides not to seek protection from liability through a judicial proceeding, and does obtain a release, the consideration for the release could be the personal representative's waiver of the right to seek a judicial review and discharge. Sample language relating to this waiver serving as consideration is provided in Appendix A to this Article. Consideration for a release is discussed in more detail in paragraph 4 below.

2. Indemnities

Although a release may (or may not) prevent a beneficiary from prevailing in a lawsuit against a personal representative, the release does not prevent a beneficiary from bringing a lawsuit. Defending any breach of fiduciary duty claim, whether frivolous or not, will entail some level of legal expense. Thus, in addition to requesting a release, a personal representative also may request that the beneficiaries indemnify the personal representative for any claims relating to the estate administration, including "attorney's fees and costs incurred in defending against [a released] claim, demand, or cause of action that is threatened or brought . . ." Sample indemnity language that includes this quoted language is provided in Appendix A to this article. Note that this sample language would include

indemnification not only for attorney's fees incurred in defending against a claim that has been brought, but also for attorney's fees incurred in defending against a *threatened* claim or action.

The personal representative of an estate may be particularly interested in obtaining indemnities when some of the beneficiaries of the estate are minors, when estate assets will pass to trusts of which some of the beneficiaries may be unknown at the time of the distribution, or when a beneficiary's adult children will not be signing the release along with his or her parent. An attorney representing a beneficiary might seek to limit the scope of the indemnity (for example, to claims brought by the beneficiary or the beneficiary's descendants) or might advise a beneficiary to decline to give an indemnity altogether. In addition, if estate assets are being distributed to the trustee of a trust, and an indemnity is requested from the trustee, the trustee may seek to limit the scope of the indemnity to trust assets. Some trustees also might seek consent from the beneficiaries of the trust before providing an indemnity (or a release), while others will merely fulfill their duty of full disclosure by informing the beneficiaries that a release or indemnity has been provided.

3. Virtual Representation

In situations where a personal representative would expect minors or unborn or unascertained beneficiaries to be bound by virtue of virtual representation, it is best to include a provision in the agreement providing the facts or representations or warranties necessary to establish that the virtual representation requirements have been met. Having a provision in the agreement that ties to the applicable state law requirements is helpful not only to confirming the parties' understanding of the applicable facts, but also can serve as a checklist for the personal representative to ensure that virtual representation does indeed apply. Sample language relating to virtual representation under Texas law is included in Appendix A to this Article. Depending on state law, there may be situations where a Guardian ad Litem needs to be appointed to represent minor or unborn beneficiaries; this may occur where there are no adult beneficiaries without a conflict of interest vis a vis the minor or unborn beneficiaries.

4. Consideration

The agreement containing the releases and indemnities should make reference to the consideration for the releases and indemnities. The consideration for the releases and indemnities will vary depending on the unique circumstances of the estate administration. However, one common form of consideration is for the personal representative of the estate to forgo obtaining a judicial release unless in defense of a claim relating to the estate administration or unless required to do so by a court of competent jurisdiction, as noted in the section above discussing releases generally. Forgoing a judicial release can end the estate administration sooner and save expenses that otherwise would reduce the value of the assets passing to the estate beneficiaries.

If the personal representative wishes to obtain a release or indemnity, but does not wish to waive his or her right to seek a judicial review and discharge, the personal representative should determine what consideration is being provided in exchange for the releases and indemnities. The personal representative needs to be careful to avoid referencing the mere making of the distribution as consideration in states that prohibit a personal representative from requiring a waiver or release from a beneficiary as a condition to the distribution. For example, in Texas, this language should not be included (nor should the personal representative in any way imply to a beneficiary that a distribution will be withheld pending a release) because section 405.002(b) of the Texas Estates Code provides that "[a]n independent executor may not require a waiver or release from the distributee as a condition of delivery of property to a distributee." By contrast, Illinois law explicitly allows a trustee to "require from the beneficiary a written approval of the trustee's accountings provided to the beneficiary and, at the trustee's election, a refunding agreement from the beneficiary for liabilities that would otherwise be payable from the trust property to the extent of the beneficiary's share of the distribution." 760 ILCS 3/817

5. Disclosure

The personal representative and the beneficiaries of the estate should discuss the information to be provided to the beneficiaries before the beneficiaries provide any releases or indemnities. The agreement containing the releases and indemnities should include a provision under which the beneficiaries agree that they have been provided with full and adequate information upon which to provide the releases and indemnities, but the releases and indemnities will not be effective as to any claim if the beneficiary was not provided with information sufficient for the beneficiary to be aware of that claim. The agreement also should state that the beneficiary has received full access to the books and records of the estate, and waives any further disclosure. Including this language may prompt the beneficiary to request additional information, which is easier to provide at this point in time instead of years down the road in the context of defending a claim. The general thought here is to get everything on the table and have it dealt with now instead of later. Sample language relating to the provision of information to the beneficiaries is included in Appendix A.

6. Involvement of Independent Counsel

Although sample release and indemnity language is provided, any release or indemnity needs to be customized to reflect the specific circumstances of the particular estate administration. Often, the release and indemnity language is negotiated by the various attorneys representing the interested parties. Although the personal representative cannot force the beneficiaries to obtain independent legal counsel before giving a release or indemnity, the personal representative should encourage the beneficiaries to do so. The beneficiary and the beneficiary's counsel also should be given sufficient time to review and consider the terms of the release or indemnity. It should be harder for a beneficiary represented by counsel to claim that the release and indemnity provided by a beneficiary is unenforceable. The agreement itself can recite whether the beneficiary was represented and, if not, that the beneficiary was encouraged to obtain independent legal counsel. The agreement also can provide that the agreement should not be construed against any particular party merely because that party's attorney drafted the agreement. Sample language relating to this issue and other representations that the parties may wish to include in agreements containing releases and indemnities is provided in Appendix A.

7. State Law Requirements Generally

In addition to specific representations relating to a beneficiary's capacity to enter into the Agreement that are contained in the sample language in Appendix A, consider including a reference in the agreement to any applicable state law governing releases and indemnities and representations and warranties intended to satisfy the requirements under that state law. Sample language relating to applicable state law is provided in Appendix A.

8. Duration and Scope of Releases and Indemnities

Finally, consider including a reference in the agreement to the duration and scope of the releases and indemnities. Sample language on this point is provided in Appendix A.

B. Documenting Division of Assets

Even if the personal representative of an estate does not intend to ask the beneficiaries of the estate to provide releases and indemnities, the personal representative may wish to prepare a funding agreement for other reasons. One reason would be to document the assets transferred to each beneficiary. Further, if the decedent resided in a community property state, it may be helpful to document the division of assets between the estate and the surviving spouse, if applicable. In that situation, the personal representative will need to work with the surviving spouse to determine if assets should be divided *pro rata* or not and, if not, whether the funding would trigger any capital gains taxes. A non-*pro rata* funding also raises valuation issues if the fair market value of any of the assets being divided is not readily ascertainable.

Documenting the manner in which the funding complied with the provisions of the Will and applicable state and federal laws is important for a number of reasons. An estate administration may be a lengthy process. A lot can happen during that process, and questions regarding funding may not arise until years later (particularly when the beneficiaries of the estate are trusts that are designed to last for as long as possible under applicable state law). In that situation, it may be helpful to have a roadmap that can help to answer those questions. In fact, depending on when the questions arise, the personal representative and other parties who were involved in the funding may no longer be available to answer questions, which would make a funding agreement documenting the manner in which the funding occurred perhaps the only place to go to for the answers.

In addition, the process of writing down the manner in which the funding complies with the provisions of the Will and applicable state and federal laws can help to identify issues that otherwise might have been overlooked or highlight better methods of achieving the desired goals. The personal representative also may wish to consider including exhibits listing the assets being distributed to each beneficiary and, if applicable, the document by which the asset was transferred, such as a deed, stock power, or other assignment document. Preparing this list may be helpful in identifying other issues that will need to be addressed. For example, if an interest in a closely-held entity will be transferred, the personal representative will need to review the entity's governing documents for purposes of ensuring that any transferability restrictions or potential changes in the management of the entity have been addressed.

C. Reserves

1. Expense Reserve

No matter how close the personal representative of the estate is to wrapping up the estate administration, there will always be final estate expenses. For example, there will be expenses incurred in filing the final income tax return, expenses incurred in actually accomplishing the distribution (*e.g.*, preparation of transfer documents and possibly filing fees), etc. The personal representative of an estate should review prior expenses and consult with the personal representative's accountant, attorney, and other advisors to identify what expenses might arise post-funding and decide on an appropriate reserve amount.

2. Debt Reserve

The personal representative may need to retain a reserve for any debts that are not yet due or otherwise remain unpaid. For example, there may be an outstanding loan that prohibits pre-payment. If so, and if all other estate administration matters have been completed, the personal representative of the estate and the beneficiaries of the estate may agree that the personal representative should retain a reserve sufficient to allow the personal representative to satisfy those debts in the future.

As a side note, if there is outstanding debt, a distribution of all or substantially all of the assets of the estate may trigger consent rights of third parties or result in a default under the loan documents. Thus, it may be necessary to obtain the consent of the parties to whom the debt is owed if the debt will not be satisfied prior to funding.

D. Assumption of Debts and Expenses

1. Outstanding Debts

If the personal representative of the estate does not wish to retain a reserve to satisfy any outstanding debt, the personal representative and the beneficiaries might agree to have one or more of the beneficiaries of the estate assume the outstanding debt, subject to approval by the parties to whom the debt is owed.

2. Unknown Debts; Future Expenses

The funding agreement should address the payment of any unknown debts and any expenses that might arise in the future that exceed any reserves retained by the personal representative. Under the funding agreement, such debts and expenses should be affirmatively assumed by one or more of the beneficiaries. If more than one beneficiary is assuming those debts and expenses, the funding agreement should explicitly address the manner in which the debts and expenses should be allocated between or among them. Even though the Will or default state law provides for the apportionment of debts, expenses, and taxes, it is better to address the issues in a funding agreement in order to avoid questions of interpretation post-funding.

III. FUNDING

A. Funding Formulas

The assets owned by the estate or trust must be allocated between the beneficiaries and/or following trusts in accordance with the terms of the documents and the reporting on the federal estate tax return. The funding, including the manner of valuing the assets, is determined by the estate plan; the implications of the language chosen can be significant.

A pecuniary formula bequest must, by its terms, be satisfied to a specific dollar amount. How the pecuniary amount is valued upon funding can dramatically alter the results. In a true worth (or Suisman) pecuniary funding, the residuary bequest will bear the burden or obtain the benefit of the market fluctuation. Note that, where it applies, Rev. Proc. 64-19, 1964-1 C.B. 682, will require that the allocation of assets fairly represent any appreciation or depreciation between the value for estate tax purposes and the value on the date of distribution.

A fractional formula will allocate the market risk between the shares. However, in theory, each share holds an undivided interest in each asset. Absent language that gives the fiduciary the power to "pick and choose," the law in some states (such as Illinois) requires the fractionalizing of each asset. In order to avoid having to fractionalize each asset (which may be impractical, or at least undesirable), it is important to include so called "pick and choose" language in the governing document, allowing the Trustee to allocate different assets and disproportionate shares in specific assets. For example, the Trustee may be given the power:

> To distribute income and principal in cash or in kind, or partly in each, and to allocate or distribute undivided assets or different assets or disproportionate interests in assets, and no adjustment shall be made to compensate for a disproportionate allocation of unrealized gain for federal income tax purposes;

Unless a fraction of each asset is allocated to each share, it will still be necessary to revalue each asset that is not being fractionalized to ensure that the allocation of assets is fair.

1. Fractional Bequest

A fractional bequest is a gift defined as a fraction of the whole; in many cases, the numerator and denominator are defined.

Example: "All the rest, residue and remainder I give to my children in equal shares."
"I give one-half of my residuary estate to my daughter and one-half to my grandson."
"I give a fractional share of my residuary estate of which (a) the numerator is the smallest amount that, if allowed as a federal estate tax marital deduction, would result in the least possible federal

estate tax being payable by reason of my death, and (b) the denominator is the value of my residuary estate as finally determined for federal estate tax purposes."

The principal characteristics of fractional bequests are:

1. In theory, beneficiaries are entitled to an undivided interest in each asset available for distribution.
2. Assets that are allocated proportionately among the shares do not need to be revalued at funding.
3. Taxes, claims, debts, expenses, appreciation and depreciation and trust accounting income are shared proportionately.
4. No capital gains are recognized if assets are distributed in kind, as long as the assets are allocated pro-rata among the shares. Rev. Rul. 69-486, 1969-2 C.B. 159. Non-prorata allocations may trigger a taxable event for income tax purposes unless authorized either by the governing document or state law.

In theory, each share holds an undivided interest in each asset held in the estate, and allocating assets fractionally is the preferred method. Picking and choosing assets is permitted if the power to make disproportionate allocation of assets is stated in the governing document or provided by state law. Non-pro-rata allocation of assets between shares can otherwise be construed as a taxable exchange between parties, which could trigger gain recognition on funding.

The fraction is applied to the market value of assets at funding date. The fraction cannot be finalized and therefore the funding cannot be finalized prior to receipt of the federal estate tax closing letter. Partial fundings must be considered preliminary and need to be reviewed upon closing.

No gain is recognized upon funding lead or residuary trusts. The tax basis passes from the parent to the following trusts. Assets that are not allocated pro-rata among following trusts must be valued as of the funding date.

2. Pecuniary Bequest

A pecuniary bequest is a gift of an actual dollar amount, either stated as an amount or defined in terms of a formula. When a pecuniary formula is used, the amount does not fluctuate with valuation changes in the estate.

Example: "I give my wife the sum of $1,000,000."

"I give the Trustee of the Family Trust the smallest pecuniary amount that, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax being payable by reason of my death."

The principal characteristics of pecuniary bequests are:

- The residuary taker benefits (or suffers) appreciation and depreciation through the funding date.
- The Executor or Trustee has the most flexibility in selecting the assets to sell or distribute to satisfy the bequest.
- Capital gains may be recognized if appreciated assets are used, or if assets are sold to satisfy the bequest.

- Assets distributed in kind in satisfaction of the bequest need to be valued as of the date of funding.

- Depending on the governing document or state law, pecuniary gifts may or may not share in trust accounting income earned during estate or trust administration.

Funding under a pecuniary formula requires consideration of how to value the assets used to fund the pecuniary amount. If the trust includes difficult to value assets, their use to fund the pecuniary amount can lead to dissatisfaction from those beneficiaries who disagree with the value assigned or are simply frustrated by the valuation costs incurred. Perhaps equally as important, valuation discounts may not be established with certainty until an estate tax audit has been concluded.

a. Types of Pecuniary Funding

While all pecuniary formulas give a gift of an actual dollar amount (as noted in the examples above), there are several different ways in which the assets are valued to reach the defined amount. Which method is used to value the assets will have a significant impact on the amount that is actually allocated under the pecuniary formula.

True Worth Language[1]

Using true worth language, the gift is described as an amount or sum and is determined on the federal estate tax return; the amount is satisfied using values as of date of distribution (i.e. current market values). Assets allocated in kind are valued using the current market value as of date of distribution. The fiduciary may pick and choose assets to satisfy the pecuniary amount. Because the amount to be funded is valued as of the date of distribution, the pecuniary share does not share in appreciation or depreciation through the date of funding. Any asset allocated to the pecuniary share must be valued as of the date of distribution. This may be an issue for assets that are difficult or expensive to value. Assets do not need to be revalued if they are being allocated to the non-pecuniary share.

> Example: "My Executor shall select and distribute to the Trustee the cash, securities and other property, including real estate and interests therein, that will constitute the trust, employing for that purpose values current at the time of distribution."

When the pecuniary amount is large relative to the residuary share, the residuary share can be significantly reduced or even wiped out in a falling market. In such an environment, it is recommended that pecuniary fundings be done as early in the administration as practical, to minimize this risk and to initiate investment in the following trusts, especially where pecuniary and non-pecuniary shares have different beneficiaries.

In the case of a marital trust funding, consider using the pick and choose authority to allocate highly appreciating assets to the credit shelter trust, thereby potentially minimizing the estate tax payable upon the death of the surviving spouse. In a rising market, where all beneficiaries are harmonious and tax savings is a priority, delaying the funding of a Suisman marital trust may help to minimize the estate tax due on the death of the surviving spouse. This will allow more assets to be allocated to the residuary or credit shelter trust, because the marital trust amount is already established.

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[1] True worth language is also known as a Suisman funding, after Suisman v. Eaton, D.C., D. Conn., 15 F.Supp. 113, affirmed Suisman v. Hartford-Connecticut Trust Co., 2 Cir., 83 F.2d 1019, certiorari denied, *Id*., 299 U.S. 573, 57 S.Ct. 37, 81 L.Ed. 422.

When the pecuniary amount is satisfied in kind, the transfer is treated as a constructive sale in the distributing trust for income tax purposes. The current market value of the asset allocated to the pecuniary gift becomes the tax cost to the recipient. The distributing trust recognizes gain on appreciated assets. Losses on depreciated assets may be deducted, to the extent the trust is not viewed as a related party. An estate and its following trusts are not viewed by the IRS as related parties for income tax purposes. In this case losses realized on funding of a pecuniary trust can be used as 1041 deductions to offset gains. However, a taxable trust and its following trusts are viewed as related parties, unless a Section 645 election is made to treat the trust as an estate for income tax purposes.

Allocation of assets containing income in respect of a decedent accelerates the recognition of income. The most common IRD asset is an IRA. It is preferable to allocate IRD assets to the non-pecuniary share to avoid income recognition.

If the trust property per the federal estate tax return includes accounting income (income on hand and accrued), the trust's share of this income is deducted from the principal amount to be funded, so that the total funded amount (principal plus accounting income) equals the pecuniary amount.

Fairly Representative Language:

Using fairly representative language, the gift is described as an amount or sum and is satisfied using values as finally determined for federal estate or income tax purposes.

Typical valuation language for a fairly representative formula is as follows:

> "My Executor shall select and distribute to the Trustee the cash, securities and other property that will constitute the trust, employing for the purpose of valuation the federal estate tax value of any asset, or the replacements of or the proceeds of any asset, included in my gross estate and the adjusted basis for federal income tax purpose of any assets, provided that the assets distributed shall be selected in such a manner that they have an aggregate fair market value fairly representative of the appreciation or depreciation in the value to the date or dates of distribution of all assets then available for distribution."

Assets allocated to the pecuniary share must be fairly representative of appreciation or depreciation of all assets available for distribution. To accomplish this, the trust's share of total tax cost is calculated; assets allocated in kind then are valued using tax cost. Allocating assets fractionally is one way to satisfy the fairly representative share of appreciation or depreciation but is not required (also see section C.3.e. below for a more detailed analysis relating to the use of a pro rata funding to satisfy fairly representative funding requirements). Picking and choosing assets to satisfy the pecuniary amount is permitted. Even though realized and unrealized appreciation or depreciation through funding must be pro-rata, one can allocate highly appreciating assets to the credit shelter trust.

Due to the requirement of allocating a pro-rata share of appreciation or depreciation of all assets available for distribution, the pecuniary trust cannot be fully funded until all estate tax issues have been resolved (i.e. the closing letter has been received). No gain should be recognized upon funding pecuniary or residuary trusts when a 64-19 formula is used (also see section C.3.d(ii) below). The tax basis passes from the parent to the following trusts.

Any asset allocated to the pecuniary share must be valued as of the date of distribution to demonstrate that the pecuniary share has received a fairly representative share of appreciation or depreciation, unless the asset is allocated pro-rata.

The funding matrix attached as Appendix B summarizes the various formulas and their attributes.

B. Getting to a Zero Inclusion Ratio

When funding a GST Trust, the typical goal is to create a trust that is "exempt" from the generation-skipping transfer tax (the "GST Tax"). A trust is "exempt" from the GST Tax if it has an inclusion ratio of zero (the zero inclusion ratio denotes that none of the trust's assets are subject to the GST Tax).

1. Inclusion Ratio = 1 - Applicable Fraction

In general, a trust's inclusion ratio is the excess of 1 over its "applicable fraction." I.R.C. § 2642(a)(1). Thus, to create a GST Trust with an inclusion ratio of zero, the applicable fraction for the trust must be 1.

2. Numerator of Applicable Fraction

The numerator of a trust's applicable fraction is the amount of GST exemption allocated to the properties transferred to the trust. I.R.C. § 2642(a)(2)(A). Thus, for the applicable fraction to be 1, the denominator of the applicable fraction also must be equal to the amount of GST exemption allocated to the properties of the GST Trust.

3. Denominator of Applicable Fraction

The denominator of the applicable fraction is equal to the value of the property transferred to the GST Trust, less certain taxes actually recovered from the trust and any charitable deduction allowed under section 2055 or 2522 of the Code with respect to the trust property. I.R.C. § 2642(a)(2)(B). Thus, for the applicable fraction to be 1 (resulting in a zero inclusion ratio), the GST Trust must be funded with properties having a "value" equal to the amount of GST exemption that will be allocated to the GST Trust. This can be done by way of a fractional share formula or a pecuniary gift.

a. "Value" under Fractional Share Approach

Under a fractional share formula, the gift to the GST Trust would be a fractional share of the residuary estate. For example, the Will could direct that the GST Trust's fractional share of the residuary estate be determined by dividing the testator's remaining GST exemption by the estate tax value of the residuary estate. In that case, Treas. Reg. § 26.2642-2(b)(1) provides that "in determining the denominator of the applicable fraction, the value of property included in the decedent's gross estate is its value for purposes of chapter 11." "Value for purposes of chapter 11" is not the same as the value of the property on the date the assets actually are distributed to the GST Trust. To illustrate this point, assume the following hypothetical facts:

remaining GST tax exemption	$5 million
estate tax value of residuary estate	$10 million
value of residuary estate as of date of distribution	$20 million

Under these hypothetical facts, the GST Trust's fractional share would be 50% ($5 million, divided by $10 million), meaning the GST Trust would receive assets with a value, as of the date of distribution, of $10 million (50% of $20 million). However, the $10 million date of distribution value is not the "value" used for purposes of determining the trust's inclusion ratio. Instead, it is the federal estate tax value of the property distributed to the GST Trust that is the relevant value. The total federal estate tax value of the residuary estate was $10 million and the GST Trust received 50% of those properties, meaning the federal estate tax value of the property transferred to the GST Trust was $5 million (50% of $10 million).

In the example above, the numerator of the applicable fraction also would be $5 million (the amount of GST exemption allocated to the properties of the GST Trust), which would result in an applicable fraction of 1 ($5 million

of GST exemption allocated, divided by $5 million of federal estate tax value) and an inclusion ration of zero (1 minus the applicable fraction of 1). Thus, the personal representative of the estate would have achieved the testator's goal of creating an "exempt" GST Trust using a fractional share formula.

b. "Value" under Pecuniary Gift Approach

Under a pecuniary gift approach, the testator typically would bequeath to the GST Trust an amount equal to the testator's remaining GST exemption. If the personal representative of the estate funds the GST Trust with cash equal to the amount of the testator's remaining GST exemption (and all of that GST exemption is allocated to the GST Trust), the numerator and the denominator of the applicable fraction will be the same, resulting in an applicable fraction of 1 and an inclusion ratio of zero (the same as described in the example above). Treas. Reg. § 26.2642-2(b)(2)(i). If, however, the personal representative of an estate satisfies the pecuniary gift to the GST Trust with property other than cash, Treas. Reg. § 26.2642-2(b)(2)(i) provides that

> "the denominator of the applicable fraction is the pecuniary amount only if payment must be made with property on the basis of the value of the property on—
>
> (A) The date of distribution; or
>
> (B) A date other than the date of distribution, but only if the pecuniary payment must be satisfied on a basis that fairly reflects net appreciation and depreciation (occurring between the valuation date and the date of distribution) in all of the assets from which the distribution could have been made."

Treas. Reg. § 26.2642-2(b)(2)(i). The language quoted in clause (A) above typically is referred to as true worth or date-of-distribution funding. The language quoted in clause (B) above typically is referred to as fairly representative funding.

To summarize, if the personal representative of the estate satisfies a pecuniary gift to a GST Trust with assets other than cash, the personal representative must be required to comply either with true worth or fairly representative funding in order for the denominator of the applicable fraction to be equal to the pecuniary amount of the gift. In that situation, the resulting GST Trust effectively should be "exempt" from the GST Tax because both the numerator and denominator of the applicable fraction should be equal to the pecuniary amount of the gift, resulting in an applicable fraction of 1 and an inclusion ratio of zero.

If the personal representative of the estate is not required to comply with true worth or fairly representative funding when satisfying a pecuniary gift to a GST Trust with property other than cash, the denominator of the applicable fraction will be the date of distribution value of the property. Treas. Reg. § 26.2642-2(b)(2)(ii). For example, assume the Will provides for a pecuniary gift to the GST Trust of an amount equal to the testator's remaining GST exemption, to be funded based on federal estate tax values. Assume also that the testator's remaining GST exemption is $5 million. If the personal representative of the estate satisfied the gift with property other than cash that had a federal estate tax value of $5 million, but was worth $10 million as of the date of the distribution, the numerator of the applicable fraction would be $5 million (the amount of GST exemption available to be allocated to the trust), but the denominator would be $10 million (the value of the assets as of the date of distribution). Thus, the applicable fraction would be 1/2 ($5 million, divided by $10 million), and the trust's inclusion ratio also would be 1/2 (1 minus the applicable fraction of 1/2), meaning the GST Trust would not be fully "exempt" from the GST Tax.

For estates governed by Texas law, the situation described in the preceding paragraph would not occur unless the Will explicitly authorized the personal representative to use something other than true worth or fairly representative funding when satisfying a pecuniary gift with property other than cash. Tex. Est. Code §§ 124.051 - 124.052. Sections 124.051 and 124.052 of the Texas Estates Code require either true worth or fairly representative

funding when satisfying pecuniary bequests with property other than cash, unless the Will provides otherwise. The default rule for using property other than cash to satisfy a pecuniary bequest intended to qualify for the federal estate tax marital deduction is fairly representative funding. Tex. Est. Code § 124.052. The default rule for using property other than cash to satisfy any other pecuniary bequest is true worth funding. Tex. Est. Code § 124.051. Thus, whether default Texas law would direct the personal representative of an estate to use true worth or fairly representative funding when satisfying a pecuniary bequest to a GST Trust with property other than cash would depend on whether that bequest also is intended to qualify for the federal estate tax marital deduction.

C. True Worth v. Fairly Representative Funding

To better compare the results obtained under the funding requirements discussed above, true worth and fairly representative funding are applied below to an expanded version of the hypothetical example presented in the discussion above of fractional share funding.

1. Hypothetical Example

The facts for the hypothetical example are set forth in the following table:

	Values	
Estate Assets	Date of Death	Dist. Date
Cash	$3,000,000.00	$6,000,000.00
Blackacre	$3,000,000.00	N/A (sold)
Redacre	$4,000,000.00	$3,000,000.00
Partnership Int.	$5,000,000.00	$11,000,000.00
Gross Value	$15,000,000.00	$20,000,000.00
Less DET	$(5,000,000.00)	N/A (paid)
Net Value	$10,000,000.00	$20,000,000.00
Pecuniary Gift to GST Trust		$5,000,000.00

The hypothetical facts set forth above assume that, other than income from the sale of Blackacre, no income was earned during the estate administration and Blackacre was sold for $8 million, resulting in $6 million of cash on date of distribution ($3 million starting cash, plus $8 million proceeds from sale of Blackacre, less $5 million debts, expenses, and taxes).

Under the facts set forth above, the net value of the estate doubled during the period of administration.

2. True Worth Funding Results

If the personal representative of the estate is required to comply with true worth funding, the gift to the GST Trust could be satisfied in a number of different ways.

a. True Worth Funding with Depreciated Asset

The personal representative could fund the GST Trust with all of Redacre, valued at $3 million on the date of distribution, plus $2 million cash, resulting in assets with an aggregate value of $5 million on the date of distribution being funded to the GST Trust. Under this scenario, the personal representative would be using assets with a basis of $6 million ($2 million cash, plus Redacre's basis of $4 million) to satisfy a pecuniary gift of $5 million, which is analogous to the personal representative selling assets with basis of $6 million in exchange for $5 million. Thus, the personal representative of the estate would need to consider the potential income tax consequences of funding with depreciated assets.

b. True Worth Funding with Appreciated Asset

Alternatively, the personal representative could fund the GST Trust with 45.5% of the partnership interest, which would be analogous to the personal representative selling assets with a basis of approximately $2.3 million (45.5% of the total basis of the partnership interest) in exchange for $5 million. In that situation, funding would result in capital gain.

c. True Worth Funding with Cash

At the risk of being obvious, also note that the personal representative could fund the GST Trust with $5 million cash, which would not trigger gain or loss.

d. True Worth Funding Summary

There are multiple ways in which the personal representative might choose to comply with true worth funding in the hypothetical example presented above. The income tax consequences may vary depending on the assets the personal representative selects to fund the GST Trust, but the GST Trust always must receive assets with a value, as of the date of distribution, of $5 million.

3. Fairly Representative Funding Results

a. No Official "How-To" Examples

Neither the Treasury Regulations nor any cases provide examples illustrating how a personal representative should fund on a "basis that fairly reflects net appreciation and depreciation (occurring between the valuation date and the date of distribution) in all of the assets from which the distribution could have been made." Treas. Reg. § 26.2642-2(b)(2)(i).

b. Historical Insight

The fairly representative funding requirement in Treas. Reg. § 26.2642-2(b)(2)(i) is based on an earlier version of the fairly representative funding requirement found in Rev. Proc. 64-19. While there are some minor differences between the wording of the fairly representative funding requirements in Treas. Reg. § 26.2642-2(b)(2)(i) and Rev. Proc. 64-19, the substance essentially is the same. Rev. Proc. 64-19, 1964-1 C.B. 682 ("the fiduciary must distribute assets, including cash, fairly representative of appreciation or depreciation in the value of all property thus available for distribution in satisfaction of such pecuniary bequest or transfer"). Therefore, understanding the rationale behind Rev. Proc. 64-19 can be instructive in formulating a funding plan designed to comply with fairly representative funding.

Rev. Proc. 64-19 represented a compromise between Treasury officials and taxpayers' representatives in response to Treasury's concerns regarding the funding of marital gifts with assets valued at estate tax values. *See* Stanley M. Johanson, *Marital Deduction Planning*, 161, 231-32, The Ctr. for Am. and Int'l Law Estate Planning Course (April 28-30, 2010). The reason for Treasury's concerns can be illustrated by assuming a marital deduction pecuniary gift of $5 million that the taxpayer decides to fund with $1 million cash and the Redacre property referenced in the hypothetical example above (as noted above, Redacre has a $4 million federal estate tax value, but is worth only $3 million as of the date of distribution). Under these hypothetical facts, the marital gift has received assets with an estate tax value of $5 million, but a fair market value on the date of distribution of only $4 million. As noted by Professor Johanson, "the result would be instant depreciation in the value of the marital deduction amount," thereby reducing the value subject to estate tax upon the death of the surviving spouse. *Id.* In this example, the marital gift depreciated by 20%, despite the fact that the overall estate doubled in size!

These same concerns would be present in the funding of a pecuniary gift to a GST Trust, but in reverse. In that situation, the concern would be that the taxpayer would fund the gift with appreciated assets, thereby increasing the value of trust assets that are intended to be exempt from the federal estate tax for so long as they remain in trust.

The concerns that led to Rev. Proc. 64-19 and, later, Treas. Reg. § 26.2642-2(b)(2)(i) suggest that the focus in a fairly representative funding should be to make the increase or decrease in the value of the pecuniary gift from date of death to date of distribution mirror the increase or decrease in the overall value of the estate.

c. Indirect Support from Case Law

Although no cases directly address the proper method for complying with fairly representative funding, three cases indirectly support the theory that fairly representative funding requires the increase or decrease in the value of the pecuniary gift from date of funding to date of distribution to mirror the increase or decrease in the overall value of the estate.

In *Jacob v. Davis*, the Court of Special Appeals of Maryland held that a trustee under a will was required to account for its failure to fund a marital trust where the will called for fairly representative funding and the marital trust would have been funded with over $80,000 if funding had occurred on the testator's date of death (the pecuniary amount of the gift to the bypass trust was $600,000). *Jacob v. Davis*, 738 A.2d 904, 915-16 (Md. Ct. Spec. App. 1999). However, the trustee ultimately failed to fund the marital trust. The trustee in *Jacob* explained his failure to fund the marital trust by stating that the total assets available on the date of funding did not exceed $600,000 (the amount of the testator's credit against estate and gift taxes), and the trial court accepted the trustee's explanation.

On appeal, the *Jacob* court held that, under the fairly representative funding method, if the assets of the estate depreciate, "the Marital Trust would be diminished on a pro rata basis with the Family Trust and would absorb no more than its pro rata share of such decrease." *Id.* The *Jacob* court continued, "[i]n light of this mandatory directive we do not see how the Marital Trust could be legitimately 'wiped out' by a decrease in overall value, when the Family Trust bequest remained intact." *Id.* The *Jacob* court held that the trial court should not have accepted the trustee's failure to fund the marital trust without a better explanation. However, the court reserved making a decision with respect to whether the marital trust ultimately should have been funded until the trustee could provide a full accounting.

In *Estate of Goutmanovitch* and *Estate of De St. Aubin v. Commissioner*, a New York Surrogate's Court and the United States Tax Court, respectively, opined in dicta that fairly representative funding effectively "converts a pecuniary legacy to a fractional one." *Estate of Goutmanovitch*, 432 N.Y.S.2d 768, 773 (N.Y. Sur. Ct. 1980); *Estate of De St. Aubin v. Comm'r*, 76 T.C.M. (CCH) 409, 417-18 (1998). If that is true, then under the hypothetical example presented above, fairly representative funding would result in the GST Trust receiving assets that had doubled in value from date of death to date of funding, just as occurred in the hypothetical example presented in the section above discussing fractional shares. However, both *Goutmanovitch* and *De St. Aubin* were focused on interpreting and applying the requirements of minimum worth formula clauses in cases where a beneficiary argued that it was entitled to a share of appreciation. Thus, the courts discussed fairly representative funding in each case only for comparative or historical purposes.

While each of the three cases discussed above suggests that fairly representative funding should operate similarly to fractional share funding, none of the reasoning in these cases would be binding on a Texas court. Furthermore, because of the limited application of fairly representative funding to the facts in each opinion, it is not clear to what degree these courts would expect fairly representative funding to produce a result similar to that obtained in fractional share funding. Still, these cases do provide indirect support for a conclusion that the increase or decrease in the value of the pecuniary gift from date of funding to date of distribution should mirror the increase or decrease in the overall value of the estate.

d. Hypothetical Non-*Pro Rata* Funding Example

For purposes of making a true comparison to the true worth funding examples illustrated above, this funding example uses the same hypothetical facts, which are set forth in the following table:

	Values	
Estate Assets	Date of Death	Dist. Date
Cash	$3,000,000.00	$6,000,000.00
Blackacre	$3,000,000.00	N/A (sold)
Redacre	$4,000,000.00	$3,000,000.00
Partnership Int.	$5,000,000.00	$11,000,000.00
Gross Value	$15,000,000.00	$20,000,000.00
Less DET	$(5,000,000.00)	N/A (paid)
Net Value	$10,000,000.00	$20,000,000.00
Pecuniary Gift to GST Trust		$5,000,000.00

The hypothetical facts set forth above assume that, other than income from the sale of Blackacre, no income was earned during the estate administration and Blackacre was sold for $8 million, resulting in $6 million of cash on date of distribution ($3 million starting cash, plus $8 million proceeds from sale of Blackacre, less $5 million debts, expenses, and taxes).

In the hypothetical example above, the net value of the estate's assets doubled in value during the estate administration (from $10 million to $20 million). Thus, if the increase in the value of the GST Trust from date of death to date of distribution should mirror the overall increase in the value of the estate assets, the personal representative of the estate should fund the GST Trust with assets having a value, as of date of distribution, of $10 million (*i.e.*, double the amount of the pecuniary gift).

As is the case under a true worth funding regime, the personal representative of the estate has multiple options available for satisfying the pecuniary gift to the GST Trust with assets having a fair market value of $10 million. However, unlike in a true worth funding situation, the personal representative tasked with complying with fairly representative funding requirements also may be required to fund the pecuniary gift to the GST Trust with assets having an aggregate estate tax value equal to the amount of the pecuniary gift. *See* Rev. Proc. 64-19, 1964-1 C.B. 682 (requiring minimum worth or fairly representative funding only when the Will provides that a pecuniary gift may be satisfied by distributing assets in kind that are "valued at their values as finally determined for Federal estate tax purposes"). Alternatively, in order to avoid recognizing gain or loss on funding, the Will might require the personal representative to fund the pecuniary gift to the GST Trust with assets having an aggregate income tax basis equal to the amount of the gift (estate tax value and income tax basis are not always the same, as discussed further below). The remainder of this Article, however, assumes that the Will in question requires the personal representative to value each asset distributed in kind to the GST Trust at its federal estate tax value or, if the asset was acquired after date of death, at its income tax basis (an asset's federal estate tax value or income tax basis, as applicable, is referred to as "Tax Value" below in this article).

In the hypothetical example set forth above, it would be possible to fund the pecuniary gift to the GST Trust with assets having an aggregate Tax Value of $5 million and an aggregate fair market value, as of the date of distribution, of $10 million by funding the GST Trust with approximately 17.3% of Redacre and approximately 86.2% of the Partnership Interest, as follows:

GST Trust rec:	Tax Value	Dist. Date FMV
17.3% Redacre	$690,000.00	$518,000.00
86.2% P'ship Int	$4,310,000.00	$9,482,000.00
Total	$5,000,000.00	$10,000,000.00

Although the table above illustrates a funding in which all funding requirements are met, sometimes the fairly representative funding and the Tax Value "funding requirement" may be in conflict. The remainder of this section discusses that issue, as well as issues relating to income tax basis, fair market value of fractional interests, and other fractional interest funding issues.

(i) Tax Value

It may not always be possible to satisfy both fairly representative funding and the Tax Value "funding requirement." For example, assume that the personal representative in the hypothetical example presented above sold all of the estate's assets in exchange for stock in ABC, Inc. one day prior to the date of funding. That stock would have both a fair market value and a Tax Value of $20 million (because the stock was acquired after date of death, its Tax Value is its income tax basis). Therefore, it would be impossible to fund the GST Trust with stock having a Tax Value of $5 million and a fair market value as of the date of distribution of $10 million. Instead, the personal representative would be forced to fund the GST Trust either with stock valued at $5 million on the distribution date or stock valued at $10 million on the distribution date. Fortunately, this problem would not arise under Treas. Reg. § 26.2642-2(b) in the situation where the personal representative sells assets for cash because Treas. Reg. § 26.2642-2(b) would allow the personal representative to satisfy a pecuniary gift to a GST Trust with cash. However, if a conflict does arise between the Tax Value requirement and fairly representative funding, the personal representative will need to carefully consider the best way to resolve the conflict.

As a first step, the personal representative might consider whether the two funding requirements are so closely interrelated that the Tax Value requirement must be satisfied in order to comply with fairly representative funding. Despite the fact that fairly representative funding arose because of estate tax value funding formulas, Treas. Reg. § 26.2642-2(b)(2)(i) does not require that pecuniary gifts be funded on the basis of estate tax value in order to satisfy fairly representative funding. Instead, Treas. Reg. § 26.2642-2(b)(2)(i) requires fairly representative funding if satisfaction of a pecuniary amount "must be made with property on the basis of the value of the property on . . . [a] date other than the date of distribution." This suggests that fairly representative funding may be satisfied even if properties are not distributed on a Tax Value basis. At least one commentator agrees, stating that "[b]ecause it may not be possible or prudent to have date-of-death value of the distribution equal to the amount of marital deduction *and also* have date-of-distribution value fairly represent the appreciation or depreciation in the estate, the latter requirement will be followed even if the former is not." *See* Elliott M. Friedman, *Choosing the Proper Formula Marital Bequest (What We Don't Know Might Hurt Us)*, 58 TAXES 632, 640 (CCH Sept. 1980).

As a next step, the personal representative should consider the consequences of not complying with either requirement. If the personal representative does not comply with fairly representative funding, the denominator of the GST Trust's applicable fraction will be the aggregate value of the trust property as of the date of distribution. The personal representative needs to consider the potential GST Tax consequences of such a result, and weigh those consequences against income tax issues and fairness to the various beneficiaries under the Will.

(ii) Income Tax Basis

The funding illustrated in the table above funds the pecuniary gift with assets having an aggregate income tax basis equal to the amount of the gift. Courts and commentators have acknowledged that fairly representative pecuniary bequests do not result in taxable gain or loss upon funding "because the basis of the assets distributed equals the value of the obligation satisfied." *Estate of De St. Aubin*, 76 T.C.M. at 417. *See, e.g.,* Richard B. Covey, THE

MARITAL DEDUCTION AND THE USE OF FORMULA PROVISIONS 100 (2d ed. 1978). Of course, such statements may be assuming that the basis and Tax Value of the assets distributed are the same, which may not be the case. For example, if the partnership in which the estate held an interest earned income which was allocated to the estate without corresponding distributions, the basis of the partnership interest might exceed its Tax Value.

(iii) Fair Market Value of Fractional Interests

The table above illustrates a funding that results in the pecuniary gift to the GST Trust receiving assets with a fair market value, as of date of distribution, of $10 million, but this assumes that a fractional share of Redacre has a value that is proportional to the value of Redacre as a whole. This may not be the case. Often, the value of a partial interest in real property will be worth less than a *pro rata* share of the property as a whole due to the nature of a fractional interest.

In contrast, one advantage to funding with a limited partner interest is that the value of a portion of the limited partner interest probably is proportional to the value of the interest as a whole, particularly if the holder of a 99% limited partner interest has no more control over the partnership than the holder of a 1% limited partner interest.

(iv) Other Fractional Interest Funding Issues

Another point raised by funding with fractional interests relates to the nature of the assets. By its nature, a partnership is designed to be owned by multiple parties. Splitting a partnership interest formerly held by one party into multiple interests should not result in some of the difficulties that occur when multiple parties own undivided fractional interests in real estate. These issues, along with other issues that arise in the transfer of assets (*e.g.*, admission of assignees to a partnership or possible rights of first refusal in the case of real estate or partnership interests) all need to be analyzed by the personal representative prior to funding.

e. *Pro Rata* Fairly Representative Funding Example

As an alternative to the non-*pro rata* approach, the personal representative of the estate could fund the pecuniary gift to the GST Trust with assets valued at $10 million by means of a *pro rata* distribution (*i.e.*, distributing to the GST Trust one-half of each asset held in the estate on the date of distribution), which would result in the GST Trust being funded as follows:

GST Trust rec:	Tax Value	Dist. Date FMV
1/2 Cash	$3,000,000.00	$3,000,000.00
1/2 Redacre	$2,000,000.00	$1,500,000.00
1/2 P'ship Int.	$2,500,000.00	$5,500,000.00
Total	$7,500,000.00	$10,000,000.00

Under this example, the overall increase in the value of the pecuniary gift from the date of death to the date of distribution mirrors the overall increase in the value of the estate (doubling), but the GST Trust receives assets with a Tax Value in excess of the pecuniary amount.

In this particular hypothetical example, a *pro rata* distribution will never fund the GST Trust with assets that have a Tax Value equal to the amount of the gift *and* fund the GST Trust with assets that mirror the overall increase in the value of the estate. The reason relates to the sale of Blackacre. The sale of Blackacre increased the amount of cash in the estate, which increased the Tax Value of the assets available for distribution. If the facts of the hypothetical example were altered to eliminate the need for a sale of assets to satisfy debts, expenses, and taxes, a *pro rata* funding would have satisfied both the Tax Value requirement and fairly representative funding. For example, consider the modified hypothetical example presented in the following table:

	Values	
Estate Assets	Date of Death	Dist. Date
Cash	$5,000,000.00	$0
Blackacre	$1,000,000.00	$6,000,000.00
Redacre	$4,000,000.00	$3,000,000.00
Partnership Int.	$5,000,000.00	$11,000,000.00
Gross Value	$15,000,000.00	$20,000,000.00
Less DET	$(5,000,000.00)	N/A (paid)
Net Value	$10,000,000.00	$20,000,000.00
Pecuniary Gift to GST Trust		$5,000,000.00

If the GST Trust had received 50% of the assets available for distribution in the modified hypothetical example above, the result would have been as follows:

GST Trust rec:	Tax Value	Dist. Date FMV
1/2 Blackacre	$500,000.00	$3,000,000.00
1/2 Redacre	$2,000,000.00	$1,500,000.00
1/2 P'ship Int.	$2,500,000.00	$5,500,000.00
Total	$5,000,000.00	$10,000,000.00

This modified example shows that, absent a sale of appreciated or depreciated assets, a *pro rata* funding can satisfy both the Tax Value requirement and fairly representative funding. Indeed, commentators generally recognize that fairly representative funding may be satisfied by a *pro rata* funding, which is referred to by some as the "easy" way to satisfy fairly representative funding. Jeffery N. Pennell, 843-2nd T.M., *Estate Tax Marital Deduction* A-138; *see also* Johanson, *supra*, at 233. Commentators also generally agree that a *pro rata* distribution under fairly representative funding should be "functionally the same as a fractional share of the residue bequest." Pennell, *supra*, at A-138; *see* John T. Sheets, Assistant Chief, Estate and Gift Tax Branch, Tax Rulings Division, Internal Revenue Service, Speech at Chicago Bar Ass'n: *Determination of the Interest in Property Passing to the Surviving Spouse Required by Section 2056 of the Internal Revenue Code of 1954 and Revenue Procedure 64-19*, p. 26 (Dec. 1, 1964) ("The construction adopted by Rev. Proc. 64-19 treats bequests covered by its provisions as bequests of fractional shares."). It may be that these commentators were focusing only on the fairly representative funding requirements and not considering the fact that the Will also might contain a Tax Value requirement. Alternatively, perhaps the commentators were not considering a situation in which estate assets were sold during the period of estate administration at a gain or loss.

Interestingly, in *Ellis Estate*, 7 Pa. D. & C. 3d 42, the court declined to hold that "the *necessary effect* of [fairly representative funding] is to wipe out the use of pecuniary formulas and replace them all with fractional share formulas." *Ellis Estate*, 7 Pa. D. & C. 3d 42, 48 (Pa. Ct. Com. Pl. 1977) (emphasis added). In *Ellis Estate*, the court was asked to determine whether a pre-residuary gift of a pecuniary amount to a marital trust was transformed into a residuary gift of a fractional share by reason of the fairly representative funding requirement contained in the Will, thereby increasing the pool of assets available to satisfy the marital gift and reducing the value of assets that would pass to charity. In that particular case, the court declined to do so, but the court's holding did not rule out the possibility that, in the right circumstances, a *pro rata* fairly representative funding might function the same as fractional share funding.

If *pro rata* funding may be used to satisfy fairly representative funding, one advantage would be that revaluation of the assets on date of distribution should not be necessary. In the hypothetical example presented above, the net value of the estate assets doubled between date of death and date of distribution. However, even if the net value of the estate assets had tripled in value or decreased by 75%, satisfying the pecuniary gift to the GST Trust with one-half of each asset available for distribution would cause the change in the value of the pecuniary gift to the GST Trust to mirror the overall change in the net value of the estate assets. Therefore, if a personal representative wishes to avoid re-valuing estate assets on date of distribution, the personal representative instead might give the pecuniary gift to the GST Trust a fractional share of each asset available for distribution, with the fraction to be determined by dividing the amount of the pecuniary gift by the net value of the estate assets on the decedent's date of death (or alternate valuation date, if applicable).

D. Funding Summary

Under a fractional share formula, the value of the assets received by each share increases or decreases proportionately to the value of the estate overall, and funding should not result in gain or loss. In the hypothetical example above, this resulted in the gift to the GST Trust being funded with assets having a fair market value, as of date of distribution, equal to $10 million.

In contrast, under true worth funding, the pecuniary gift is guaranteed to receive assets with a value, as of the date of distribution, equal to the amount of the gift, but funding may trigger gain or loss (depending on the value and basis of the assets used to fund the gift). Under the hypothetical example illustrated above, the GST Trust was funded with assets valued at $5 million under a true worth funding, as opposed to the $10 million received by the GST Trust under a fractional share approach. Of course, if the overall value of the estate had decreased from date of death to date of funding, the GST Trust would have received assets valued at *less* than $5 million as of date of distribution under a fractional share approach. Under the true worth funding, the value of the assets passing to the GST Trust would not decrease below $5 million unless the net value of the entire estate decreased below $5 million.

The results under fairly representative funding were the same as those under the fractional share approach in terms of value (*i.e.*, in the hypothetical example, the GST Trust received assets with a value, as of the date of distribution, equal to $10 million). The income tax consequences, however, are not entirely clear when the pecuniary gift is funded with assets that have an income tax basis that differs from the amount of the gift. In addition, a Will that requires fairly representative funding also may impose a Tax Value requirement, which might prevent the personal representative from making a *pro rata* distribution of assets, which should not be the case under a fractional share approach.

IV. TIMING

A. Don't Fund until Asset Values are Finally Determined (and any Estate Taxes are Paid)

1. Final Determination of Asset Values

As illustrated by the examples above, it is not uncommon for a testator to provide for his or her residuary estate to be divided between or among multiple beneficiaries based on the amount that can be sheltered from the federal estate tax or the testator's remaining GST exemption amount under section 2631 of the Code. In such a situation, the amount of the non-exempt gifts would depend on the overall value of the testator's estate. Thus, the personal representative of the estate would not be able to determine the relative amounts of the gifts under the Will until a final determination has been made regarding the value of estate assets.

Further, if the personal representative of an estate wishes to satisfy a gift with assets in kind prior to a final determination of the value of those assets, the personal representative runs the risk that the IRS might disagree with the personal representative as to the value of the assets used to fund the gift. Although the focus of the IRS in an

estate tax audit is the value of the assets as of the decedent's date of death (or alternate valuation date, if applicable), if the IRS objects to the method used to value the assets for estate tax purposes, the personal representative (and beneficiaries) may have concerns if the assets used to fund a gift on a later date were valued using that same method.

2. Personal Liability

"Personal liability" is a two-word phrase that always seems to catch the attention of clients. U.S.C. § 3713(b) provides that "[a] representative of a person or an estate (except a trustee acting under title 11) paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government." Title 31 U.S.C. § 3713(b) (West 2011). If an estate has ample funds to pay all debts, expenses, and taxes, the personal representative may feel comfortable making a partial distribution to the beneficiaries of the estate, but any time that a distribution is made, the personal representative must determine the amount that should be paid to each beneficiary (assuming there are multiple beneficiaries), determine how this distribution might affect the calculations required in future distributions, consider whether to ask for releases and indemnities, etc. The more distributions a personal representative makes, the more expense and hassle will be involved in the estate administration. Therefore, it would be better if the beneficiaries of the estate can wait until the personal representative of the estate can distribute all or substantially all of the assets of the estate in one fell swoop.

3. Tax Controversy Expenses

If the personal representative of an estate wishes to fund prior to knowing whether the IRS will audit the estate tax return or prior to a final settlement or court decision regarding the amount of any estate tax deficiency, the personal representative will have difficulty determining the amount of expenses that might be incurred in dealing with the IRS (let alone the other estate administration expenses that will continue to be incurred during the course of the estate administration). If a personal representative decides to fund before resolving any potential dealings with the IRS, the personal representative will have to reserve an estimated amount for future expenses or enter into an agreement with the beneficiaries regarding the payment of future expenses. Unless the personal representative also is the beneficiary of the estate, the latter option likely will be undesirable to the personal representative. Under the former option, the more conservative approach would be to overestimate the amount of the reserve fund rather than underestimate. A reserve that ends up being larger than the amount of expenses incurred will lead to multiple distributions from the estate, which will increase the hassle and expense of the estate administration.

Another issue with funding prior to knowing what expenses might be incurred in settling a tax controversy is that the amount of estate expenses might affect the personal representative's ability to determine the value of the properties that should be distributed to the beneficiaries under the Will. This might be an issue where the Will uses a fractional share formula or where the personal representative of the estate wishes to comply with fairly representative funding by distributing a *pro rata* share of each estate asset to the residuary beneficiaries. As illustrated above, fractional share formulas and satisfaction of fairly representative funding through a *pro rata* distribution of assets both involve the creation of a fraction representing the share of the estate to which each beneficiary is entitled. Alan N. Polasky, 63 MICH. L. REV. 809, 840-44 (1965); Jeffery N. Pennell, 843-2nd T.M., *Estate Tax Marital Deduction* A-138 (comparing fairly representative funding to the funding of fractional shares). If estate expenses must be subtracted from the denominator of that fraction, the personal representative will need to know the amount of estate expenses in order to properly calculate those fractions.

B. How Long Will it Take?

For the reasons set forth above, in an estate where an estate tax return is due, if at all possible, the personal representative of a taxable estate should wait to fund until the federal estate tax return has been filed, there has been a final determination of the amount of federal estate tax due, and that tax (and interest, if applicable) has been paid. This means that, in these types of estates, funding may not occur for some time after the decedent's date of death. The federal estate tax return is not due until nine months after the decedent's date of death, and may be

extended automatically for an additional six months (and, for some estates, the personal representative will need all 15 months to properly prepare the federal estate tax return!). After the estate tax return is filed, if requested to do so, the IRS may issue a closing letter indicating that they have accepted the estate tax return as filed. It may take more than a year after the estate tax return is filed before the IRS issues a closing letter.

Alternatively, the IRS might choose to audit the estate tax return. If the IRS does so, the time before funding is likely to be lengthy. If matters are going to be resolved at the audit stage, that resolution must occur within three years after the date the estate tax return is filed, but that already might be more than four years after the date the decedent died. If matters cannot be resolved at the audit stage, the process can be extended for years after that. Despite this daunting prospect, there are good reasons for waiting to have matters settled with the IRS before funding.

C. Lag Time

Even after the personal representative of the estate is ready to fund, it is not unusual for there to be some lag time between the effective date of the funding and the actual distribution of assets. If there are multiple residuary beneficiaries, and the personal representative of the estate is not distributing a *pro rata* share of each asset to each of them, the personal representative likely will need to know the value of the assets on the date of funding. For estates holding a large number of assets or assets that are hard to value, it will not be possible for the personal representative of the estate to determine asset values in one day and then complete funding on that same day. Thus, it is typical for the personal representative of the estate and the beneficiaries to agree on a funding effective date (usually, to make accounting easier, the end of a month or a year). After the funding effective date, the personal representative can complete the valuation process and the logistical details necessary to complete the funding. The personal representative of the estate and the beneficiaries may wish to enter into a funding agreement to document the funding effective date and various other matters, some of which are discussed in the next section below.

V. CONCLUSION

From date of death to date of funding, the personal representative of an estate will have many issues to face and many decisions to make. Waiting to fund until the amount of estate tax due has been settled can make some of those issues and decisions easier, and the estate administration more efficient. Once it is time to fund, however, the personal representative of the estate and the beneficiaries should consider entering into a funding agreement.

Debts and expenses always need to be addressed in a funding agreement, whether by way of reserves, assumption of debts and expenses, or the impact on the value of the properties received by the beneficiaries.

Releases and indemnities may or may not be included in a funding agreement, but, if they are, it is desirable for both the personal representative of the estate and the beneficiaries of the estate to have independent counsel representing them in the negotiation of those releases and indemnities.

Finally, the funding agreement also should document the manner in which the personal representative complied with funding requirements contained in the Will and applicable state and federal law, whether those funding requirements are in the context of a fractional share formula, true worth funding, fairly representative funding, or some other funding regime. The manner in which the personal representative chooses to satisfy those funding requirements will depend on a number of complex factors, as discussed above.

APPENDIX A

Sample Release Language

The Releasing Parties hereby release, acquit, and discharge [name(s) of personal representative], individually and as Personal Representative and all persons acting for or on behalf of Personal Representative (collectively, the "**Released Parties**" and each a "**Released Party**"), with respect to any and all rights, claims, demands, liabilities, and causes of action (INCLUDING, WITHOUT LIMITATION, ANY CLAIM FOR NEGLIGENCE OR GROSS NEGLIGENCE), whether now known or unknown, in connection with, arising from, or attributable to the administration of the Estate and [insert other specific matters if desired] (collectively, the "**Matters**"), and for all other acts and omissions, if any, of any of the Released Parties regarding the Matters.

Sample Language Relating to Waiver of Right to Seek Judicial Review and Discharge

Sample recital – Personal Representative has expressed a desire for a judicial settlement of its accounts as executor of the Estate to completely resolve all matters and potential controversies regarding Personal Representative's administration of the Estate, but is willing to forgo its right to seek a judicial review and discharge in exchange for the releases and indemnities provided for in this Agreement.

Sample waiver – Personal Representative agrees to forgo its right to seek a judicial review and discharge from liability relating to the administration of the Estate. Notwithstanding the foregoing, Personal Representative reserves the right to seek a judicial review and defend against any claim raised against it in its individual corporate capacity or in its capacity as Personal Representative if required to do so by any court of competent jurisdiction.

Sample representation – Personal Representative represents and agrees that the releases and indemnities provided for in this Agreement are a material inducement for it to enter into this Agreement.

Sample Indemnity Language

The Releasing Parties hereby agree to indemnify each Released Party from any and all claims, demands, liabilities, and causes of action (INCLUDING, WITHOUT LIMITATION, ANY CLAIM FOR NEGLIGENCE OR GROSS NEGLIGENCE) [brought by the Releasing Parties, or anyone claiming by, through, or under any of the Releasing Parties], whether now known or unknown, in connection with, arising from, or attributable to the Matters, including attorney's fees and costs incurred in defending against any such claim, demand, or cause of action that is threatened or brought against any of the Released Parties.

Sample Language Relating to Virtual Representation (reps and warranties mirror the requirements under Texas Trust Code Sec. 114.032(c) and (d))

Each Beneficiary represents, warrants, and agrees that no conflict of interest with respect to this Agreement exists between him or her and any of his or her minor children, and no guardian, including a guardian ad litem, has been appointed with respect to this Agreement on behalf of any of his or her minor children. Each Beneficiary further represents, warrants, and agrees that the interest that each of them has in the matters addressed in this Agreement is substantially identical to the interest of any of his or her unborn or unascertained descendants.

Sample Language Regarding Information Provided to Beneficiaries

The Releasing Parties acknowledge and agree that each of them (i) has received full access to the books and records of the Estate; (ii) has obtained sufficient and full information, including financial, accounting and legal advice, upon which to enter into this Agreement, (iii) has reviewed such information to the extent desired by that Party; (iv) has made such investigation as that Party deems necessary to enter into this Agreement; (v) has received all information requested by such Party; and (vi) waives any further disclosure.

Sample Representations Regarding Independent Counsel and Other Relevant Representations

[insert name] acknowledges that he/she/it has been represented by [insert name of law firm]. [repeat first sentence as necessary for each party]. Further, each Party represents and agrees that (i) before executing this Agreement, such Party read this Agreement, (ii) such Party has entered into this Agreement freely and voluntarily, (iii) such Party desires to be bound by this Agreement, (iv) such Party has fully informed himself, herself, or itself of the terms, conditions, and effects of this Agreement, (v) such Party has not relied on any other Party for advice regarding the

consequences of this Agreement, and (vi) such Party has full capacity and is not acting under fraud or duress. Each Party further agrees that, in the event of any dispute regarding this Agreement, this Agreement shall not be construed against any Party merely because of the involvement of that Party's counsel in the preparation and negotiation of this Agreement. Each of the Parties acknowledges that that Party's independent legal counsel has explained to them the meaning and legal consequences of executing this Agreement, and specifically the releases and indemnifications and the legal rights they may be waiving or releasing by executing this Agreement and that they are not relying upon any other Party to explain those consequences.

Sample Language Confirming Compliance with State Law for Releases and Indemnities (Texas specific)

The Parties acknowledge and agree that the releases and indemnities provided in this Agreement are governed specifically by Sections 114.005 and 114.032 of the Texas Trust Code, and that the requirements of those sections have been met.

Sample Language Regarding Scope of Releases and Indemnities

The full and complete releases and indemnities provided for in this Agreement shall survive and be binding upon the Releasing Parties and each such Releasing Party's heirs, beneficiaries, personal representatives, administrators, executors, trustees, successors, and assigns, as applicable, and shall inure to the benefit of the Released Parties and each Released Party's heirs, personal representatives, successors, or assigns, as applicable. Further, the releases and indemnities provided for in this Agreement are intended to provide the broadest protection possible to the Released Parties, and, in the event of any dispute, shall be interpreted in a manner designed to achieve that intent.

Appendix B-- Funding Matrix

Type of funding	**Language** (Phrases used)	**Funding**	**Issues**	**Tax consequences**	**Considerations**	**Recommendations**
Pecuniary						
Suisman (True Worth)	• An amount equal to, pecuniary amount • Values current at time or times of distribu tion	• Marital amount is equal to specific dollar amount on Schedule M of FET • Funding based on values current as of date of funding • May pick and choose assets • Adjust Principal amount for trust's share of income on hand and accrued if income retains character (as accounting income) after decedent's death	• Significant changes in market value may significantly affect disposition of assets. (In large estates the residuary trust can be wiped out in a falling market. Delays in funding delay opportunity for investment growth.) • When determining timing of funding based on tax consequences, note: funding trusts may reduce advantages of the estate entity as taxpayer.	• Recognition of gain from date of death to date of funding pecuniary gift. • If funding done from taxable trust account, losses cannot be taken as income tax deductions (unless 645 election has been made) • Losses can be taken as deduction if funding is done from a probate estate. • Allocation of IRD assets triggers immediate income recognition.	• Dissimilar beneficiaries of Pecuniary & Residuary trusts. • Income tax benefits of using fees as 1041 deductions Vs reductions to credit shelter trust. • Allocation of appreciating assets to credit shelter trust. • Consider using assets which have high yield as reserve in estate when partially funding trusts early.	• Make substantial distribution as early as possible. (Especially from taxable trust with differing beneficiaries). • When all beneficiaries are harmonious and tax savings is priority, consider timing the funding to minimize estate tax payable by the surviving spouse on her death. In rising market, this would require a late funding of a Suisman marital trust.

Type of funding	**Language** (Phrases used)	**Funding**	**Issues**	**Tax consequences**	**Considerations**	**Recommendations**
64-19	• An amount equal to, pecuniary amount • Value as finally determined for federal estate tax purposes / tax cost values • Assets allocated fairly representative of appreciation or depreciation	• Funding based on pecuniary trust's share of date of death value of residue • Funding based on pecuniary amount at tax cost value. Each asset is usually fractionalized, but may pick and choose assets	• Cannot be fully funded until estate or administrative taxable trust is ready to close. • Assets must be revalued at date of distribution to demonstrate that pecuniary trust has received representative amount of appreciation / depreciation (unless each asset is fractionalized.)	• No gain recognized upon funding pecuniary or residuary trusts. • Pecuniary and residuary trusts share in excess deductions.	• Partial distributions are based on estimated % (both income distributions and partial funding residuary distributions.)	• Cannot be fully funded until estate or administrative taxable trust is ready to close. • Fractionalize allocation of each asset if possible.

Type of funding	Language (Phrases used)	Funding	Issues	Tax consequences	Considerations	Recommendations
Pecuniary						
Lower of	• Pecuniary amount • Assets valued at F.E.T. values • Total current value of assets used to fund the gift cannot be less than the F.E.T. value	• Marital amount is equal to specific dollar amount on Schedule M • May pick and choose assets • Marital Trust funding value of each asset is lower of F.E.T. or acquisition date and current market value • Adjust Principal amount for trust's share of income on hand and accrued if income retains character (as income) after decedent's death		• No gains are recognized or passed to the pecuniary trust as trust is funded with the lower of market or FET values. Losses may result, which are taxed to the parent account and effectively to the residual share(s). Pecuniary trust does not share in excess deductions and losses on termination of the parent account.		• Market risk is born by the residuary share. Funding should be done as soon as possible after alternate valuation date.

Type of funding	**Language** (Phrases used)	**Funding**	**Issues**	**Tax consequences**	**Considerations**	**Recommendations**
Minimum worth	• Pecuniary Amount • Assets valued at F.E.T. values • Total current value of assets used to fund the trust cannot be less than the value of the gift on the F.E.T. return	• Marital amount is equal to specific dollar amount on Schedule M • Marital Trust is funded at F.E.T. values. The amount listed on Schedule M of the F.E.T. is the minimum current market value needed to fund the marital trust	• Pecuniary trust may share in appreciation but not depreciation to the date of funding.	• Capital gain recognition can be minimized upon funding pecuniary trust. • Pecuniary trust does not share in excess deductions and losses on termination of the parent account. • A loss may be realized on funding pecuniary trust with assets that have depreciated in value, but may not be deductible under IRC 267 (1) (1). • Consider post-mortem tax planning.	• Asset selection determines which trust gets appreciation or depreciation.	• Market risk is born by the residuary share. Funding should be done as soon as possible after alternate valuation date.

Type of funding	**Language** (Phrases used)	**Funding**	**Issues**	**Tax consequences**	**Considerations**	**Recommendations**
Fractional						
Fractional funding	• Fractional share of qualified property • Defines numerator and denominator of fraction	• Funding based on % of date of death value of residue • Each asset is fractionalized	• Cannot be fully funded until estate or administrative taxable trust is ready to close. • If document does not authorize picking and choosing assets, to do so creates a taxable exchange.	• No gain recognized upon funding. • Following trusts share in excess deductions.	• Partial distributions are based on estimated % (income distributions and partial fundings / residuary distributions). • No need to revalue assets as of date of distribution unless non-pro rata distributions are made.	• Cannot be fully funded until estate or administrative taxable trust is ready to close. • Fractionalize each asset if possible. • If assets are chosen on a non-pro rata basis, be mindful of equitable allocation among beneficiaries