# DUDE, WHERE'S MY INCOME? EXAMINING PROPERTY CONVERSION CLAUSES IN MARITAL TRUSTS

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*Author's Synopsis: The "Marital Deduction" matters. As an instrument of public policy, it is a powerful statement by Congress that spouses are a single taxable unit. As a planning tool it is a flexible technique, subject to no dollar limitation, with few technical restrictions, and with relatively simple practical application. For these reasons and others, it is widely used both during life and at death. In fact, there is no single deduction that is more significant. It is, simply, the foundation of an estate plan for the quintessential married couple.*

*But there is a peculiar, technical, and inflexible requirement of the Marital Deduction that, though extraordinarily important, is often overlooked by planners who largely rely on form documents to provide the necessary "boilerplate" provisions required for modern trusts: spousal conversion of unproductive property. This required power, often effectuated by a trust provision (a Property Conversion Clause), operates to fulfill the substance behind the command found in the Treasury Regulations (Regulations) that trustees must distribute all income from trust property in order to qualify for the Marital Deduction. When a trust holds a significant amount of unproductive property, that rule is rendered toothless without a power, exercisable by the spouse, to force the trustee to sell that property and purchase income-producing property in its place.*

*The questions raised by the spousal conversion power are numerous. When, if ever, does underproductive property become "unproductive" for purposes of the Regulations? What timing requirements are associated with the spouse's right of conversion? When will local law suffice to fulfill this requirement? What portion of trust assets must be unproductive in order to trigger application of the conversion requirement? What portion of trust assets must be unproductive in order to trigger application of a given Property Conversion Clause? May the trustee use alternate methods to make adequate distributions to the spouse while preserving otherwise desirable (or unmarketable) trust property?*

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*The Regulations, case law, and Internal Revenue Service (Service) provide guidance in this area that implicate these issues and more. All are worthy of comment. Although this Article does address those discrete issues, its central focus is the inexorably interrelated dichotomy between the role of Property Conversion Clauses as check-the-box requirements for a tax deduction and as substantive provisions in millions of trusts that hold billions of dollars in endlessly varying assets. This duality is examined both from the perspective of a planner looking to draft such a clause and the perspective of an administrator struggling with a flawed or missing provision. Towards that end, this Article includes sample provisions and practical suggestions drawn from analysis of state and federal law, including statutes, regulations, published guidance, and case law.*

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## I. INTRODUCTION

The Marital Deduction matters.[1] As an instrument of public policy, it is a powerful statement by Congress that spouses are a single taxable unit. As a planning tool it is a flexible technique, subject to no dollar limitation, with few technical restrictions, and with relatively simple

[1] Please take note that, in an effort to simplify a complex subject and avoid unnecessary confusion, the pronouns used in this Article will assume, as in the Regulations, a male donor, whether living or deceased, and a female donee. Any references to the "Code" or "I.R.C." refer to the Internal Revenue Code, Title 26, United States Code; any reference to the Regulations refers to the Regulations promulgated thereunder. All statutory citations in this Article refer to the current statute unless otherwise indicated.

practical application.[2] For these reasons and others, it is widely used both during life and at death. In fact, there is no single deduction that is more significant.[3] It is, simply, the foundation of an estate plan for the quintessential married couple.

But there is more to the Marital Deduction than an unlimited deduction for transfers between spouses. Congress has placed a limit on its largess. When gifts or bequests to spouses are made in the form of terminable interests, such as trusts, planners must be more calculating in order to preserve the Marital Deduction.[4] Either a "Marital Power of Appointment" trust[5] or a "Qualified Terminable Interest Property" (QTIP) trust[6] (collectively Marital Trusts) will satisfy the "Terminable

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[2] The Marital Deduction is, of course, unlimited in amount—although not in duration. *See* I.R.C. §§ 2056, 2523; *see also* I.R.C. § 2044 (including property for which the Marital Deduction was previously allowed in the gross estate of the surviving spouse). As a result, the technique is more of a *deferral* than a traditional deduction.

[3] The Service reports that of 9,412 estate tax returns filed in 2012, reporting total Gross Estates of $124,320,687,000, 4,734 returns (50% of all returns) reported bequests to the surviving spouse in amounts totaling $42,862,866,000 (35% of the total value of all Gross Estates). *See* I.R.S. Statistics of Income Div., *Estate Tax Statistics Table 1, Estate Tax Returns Filed in 2012 by Tax Status and Size of Gross Estate*, IRS (September 15, 2015, 5:36 PM), http://www.irs.gov/pub/irs-soi/12es01fy.xls. It is worth noting that the figures reported are *bequests* to the surviving spouse and, as discussed in greater detail later, not all transfers to spouses are subject to the Marital Deduction. Unfortunately, the Service's corresponding publication on "Gift Tax" statistics does not distinguish between the Marital Deduction and the "Charitable Deduction," so an apples-to-apples comparison against the "Estate Tax" figures is unavailing. Suffice it to say, however, that the Marital Deduction—whether in the context of the "Federal Gift Tax" or the "Federal Estate Tax"—is a planning item of enormous import.

[4] *See* I.R.C. §§ 2056(b), 2523(b) (limiting the application of the Marital Deduction in the case of a transfer of a life estate or other terminable interest). Note that although a transfer of a joint interest in property, specifically ownership as joint tenants with a right of survivorship or tenants-by-the-entireties, would otherwise be classified as a transfer of a terminable interest, such transfers are specifically exempted and thus not dealt with here. *See* I.R.C. § 2523(d); Treas. Reg. § 25.2523(d)-1.

[5] *See* I.R.C. §§ 2056(b)(5), 2523(e) (providing for an exception to the rule denying the Marital Deduction for transfers of terminable interest in cases involving marital power of appointment trusts).

[6] *See* I.R.C. §§ 2056(b)(7), 2523(f) (providing for an exception to the rule denying the Marital Deduction for transfers of terminable interest in cases involving qualified terminable interest property).

Interests Rule."[7] Both techniques are creatures of statute with specific requirements set forth in the Code and Regulations.

Although there are several facets of the Marital Deduction that are worthy of comment, it is a single sub-element of one of the technical requirements imposed upon Marital Trusts that is the focus of this Article. Among other conditions, Marital Trusts must provide that the surviving spouse is entitled to all of the income from the trust property, paid at least annually, for life.[8] The sub-element of that requirement considered by this Article is the mandate that the surviving spouse possess the ability to make the trust assets productive.[9] More specifically, this Article will examine the practical necessity of a trust term allowing the surviving spouse to direct the trustee to convert non-income producing property into income producing property (Property Conversion Clause) in the context of other trust provisions and the applicable laws of various jurisdictions.

## II. MARITAL TRUST REQUIREMENTS

Before delving into the details of Property Conversion Clauses, some context by way of a brief discussion about the basic requirements of Marital Trusts is instructive. There are, as noted above, two primary types of Marital Trusts: Marital Power of Appointment trusts and QTIP trusts. Broadly, Marital Power of Appointment trusts must provide that the surviving spouse is entitled to all trust income for life, payable at least annually (Income Interest), and must give the surviving spouse a power of appointment over the property that is exercisable in favor of her or her estate (Spousal GPA).[10] QTIP trusts must confer upon the surviving spouse a "qualifying income interest for life"—a requirement indistinguishable from the "Income Requirement" provided in Marital Power of Appointment trusts.[11] QTIP trusts also require that an

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[7] While the Regulations do not actually require trusts be used, for purposes of simplicity, this Article will deal only with such transfers as they relate to trusts. *See* Treas. Reg. §§ 20.2056(b)-5(a), 20.2056(b)-7(d)(2), 25.2523(e)-1(a), 25.2523(f)-1(c)(1)(ii).

[8] *See* I.R.C. § 2056(b)(1).

[9] *See* Treas. Reg. § 20.2056(f)(4).

[10] *See* I.R.C. §§ 2056(b)(5), 2523(e); Treas. Reg. §§ 20.2056(b)-5(g), 25.2523(e)-1(g).

[11] *See* Treas. Reg. § 20.2056(b)-7(d)(2) ("The principles of § 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest, or a specific portion of the entire interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property . . . ."); *see also* Treas. Reg. § 25.2523(f)-1(c)(1)(i) ("The principles outlined in § 25.2523(e)-1(f)

affirmative election be made by the appropriate party on the gift or estate tax return, as applicable (the QTIP Election).[12] Thus, there are three core requirements for the Marital Deduction, although any given technique[13] to sidestep the Terminable Interest Rule uses only two of them: (1) the Spousal GPA; (2) the QTIP Election; and (3) the Income Interest.

A. The Spousal GPA

The Spousal GPA requirement—essential to valid Marital Power of Appointment trusts—is satisfied by the creation of a power of appointment in the surviving spouse that allows her to appoint the entire interest in favor of herself or her estate.[14] That, of course, renders the power of appointment a general power of appointment under both gift and estate tax principles.[15] The power must be exercisable by the surviving spouse alone and in all events.[16] While the power is exercisable by the surviving spouse in favor of others, it is not to be exercisable by others in favor of anyone but the surviving spouse.[17] The power may be *inter vivos* or testamentary in nature (or both).[18] From a practical planning perspective, this requirement offers very little in the way of flexibility; simply, the surviving spouse must have a permanent, unconditional, general power of appointment over the property for which the Marital Deduction is sought.[19] In essence, the only true limit that can be placed on the property

(relating to whether the spouse is entitled for life to all of the income from the entire interest or a specific portion of the entire interest) apply in determining whether the donee spouse is entitled to all of the income from the property . . . .").

[12] *See* I.R.C. §§ 2056(b)(7)(B)(i)(III), 2523(f)(2)(C); Treas. Reg. §§ 20.2056(b)-7(b)(4), 25.2523(f)-1(b)(4).

[13] That is to say either a Marital Power of Appointment Trust or a QTIP Trust.

[14] *See* I.R.C. §§ 2056(b)(5), 2523(e); Treas. Reg. §§ 20.2056(b)-5(g), 25.2523(e)-1(g).

[15] *See* I.R.C. §§ 2041(b)(1), 2514(c); Treas. Reg. §§ 20.2041-1(c), 25.2514-1(c). Note that the typical tax-centric objection to the creation of a general power of appointment—that it triggers inclusion of the property in the gross estate of the holder—is inapposite in the present context because the property will be included in the gross estate of the surviving spouse in all events. *See* I.R.C. § 2044.

[16] Treas. Reg. §§ 20.2056(b)-5(g)(1), (3), (4), 25.2523(e)-1(g)(1), (3). Thus, the power may not require the joinder or consent of any person other than the surviving spouse, nor may it be terminated for any reason (other than by exercise by the surviving spouse).

[17] *See* I.R.C. §§ 2056(b)(5), 2523(e). Note that even the surviving spouse may not appoint trust property to others during her life.

[18] *See* Treas. Reg. §§ 20.2056(b)-5(g)(1), 25.2523(e)-1(g)(1).

[19] *See id.*

is to make the power of appointment testamentary rather than *inter vivos*.[20]

B. The QTIP Election

Much ink has been spilled in the discussion of the various species of QTIP Election—whether ordinary, partial,[21] protective,[22] formula,[23] reverse,[24] or otherwise—and there is little sense in attempting to replicate those in-depth analyses here. While there are more intricate considerations and complex options, the QTIP Election requirement—essential to valid QTIP trusts—imposes an obligation on the taxpayer[25] to timely and irrevocably[26] elect to treat otherwise qualifying property as qualified terminable interest property.[27]

C. The Income Interest

The Income Interest requirement, though perhaps appearing straightforward at first blush, is in fact the most abstruse of the three elements. It is essential to both Marital Power of Appointment trusts[28] and QTIP trusts.[29] It requires that the surviving spouse, alone, be entitled to all income produced by the property, subject to no contingencies, and

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[20] *See id.*

[21] *See, e.g.*, RESEARCH INST. AM., FED. TAX COORDINATOR ¶R-6431 (2d ed. 2014), 1997 WL 478445; FED. TAX COORDINATOR ¶Q-6307, 1997 WL 505966.

[22] *See, e.g.*, FED. TAX COORDINATOR ¶R-6430, 1997 WL 478444.

[23] *See, e.g.*, FED. TAX COORDINATOR ¶R-6434, 1997 WL 478448.

[24] *See, e.g.*, KOVE & KOSAKOW, 2 HANDLING FEDERAL ESTATE AND GIFT TAXES § 19:52 (6th ed. 2002).

[25] The taxpayer is the donor in the case of lifetime gifts and the personal representative in the case of testamentary bequests. *See* Treas. Reg. §§ 25.2523(f)-1(b)(4)(i). If there is no personal representative, the person in actual possession of the property—such as the trustee of the trust—may make the election. *See* Treas. Reg. § 20.2056(b)-7(3).

[26] Note that although a QTIP election is generally irrevocable, there is an exception in the limited circumstance where a later filed estate tax return revokes or modifies the election, provided that such later return is timely filed (including extensions). *See* Treas. Reg. § 20.2056(b)-7(b)(4)(ii). This exception is not available in the context of an *inter vivos* transfer. *See* Treas. Reg. § 25.2523(f)-1(b)(4)(ii).

[27] *See* I.R.C. §§ 2056(b)(7)(B)(i)(III), 2523(f)(2)(C).

[28] *See* I.R.C. §§ 2056(b)(5), 2523(e); Treas. Reg. §§ 20.2056(b)-5(f), 25.2523(e)-1(f).

[29] *See* I.R.C. §§ 2056(b)(7)(B)(i)(II), 2523(f)(2)(B); Treas. Reg. §§ 20.2056(b)-7(d), 25.2523(f)-1(c).

payable to her, at least annually, for her entire life.[30] Thus, the Income Interest must contain the following four components: (1) the surviving spouse must be entitled to all of the income produced by the property, subject to the deduction (the All Income element); (2) the interest must not be subject to any contingencies (the No Contingencies element); (3) payments must be made at least annually (the Annual Payments element); and (4) the surviving spouse must be entitled to the interest for her entire life (the Lifetime Interest element).[31]

Though the No Contingencies, Annual Payments, and Lifetime Interest elements each contain important subtleties with significant consequences, the primary subject of this Article is derived from a sub-element of the All Income element.

The guiding principle of the All Income element is that the trust must grant the spouse "substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust."[32] A usufruct interest—the right to use trust property as opposed to income generated by it—is contemplated in the definition of "income" for purposes of the Marital Deduction.[33] Generally, though,

> [t]he designation of the spouse as sole income beneficiary for life of the entire interest or a specific portion of the entire interest will be sufficient to qualify the trust unless the terms of the trust and the surrounding circumstances considered as a whole evidence an intention to

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[30] The spouse may instead be entitled to all the income from all the property or from a specific portion of the property; however, the Marital Deduction will be limited to a corresponding proportion of the value of the qualifying property. *See* Treas. Reg. §§ 20.2056(b)-5(b), 20.2056(b)-7(b)(2), 25.2523(e)-1(b), 25.2523(f)-1(b)(3). The portion may not be a partial interest in the property, but rather a percentage or fractional share of the whole; it may be defined by a formula. *See* I.R.C. § 2056(b)(10); Treas. Reg. §§ 20.2056(b)-5(c), 20.2056(b)-7(b)(2), 25.2523(e)-1(c), 25.2523(f)-1(b)(2). Note also that the term "income" specifically includes the concept of a "unitrust" interest. *See* Treas. Reg. §§ 20.2056(b)-5(f)(1), 25.2523(e)-1(f)(1).

[31] *See* Treas. Reg. § 20.2056(b)-5(a).

[32] Treas. Reg. § 20.2056(b)-5(f)(1); *accord* Treas. Reg. 20.2056(b)-7(d)(f) (citing §§ 20.2056(b)-5(f)(1)), 25.2523(e)-1(f)(1) (using language identical to § 20.2056(b)-5(f)(1)), 25.2523(f)-1(c)(1)(i) (citing § 25.2523(e)-1(f)).

[33] *See* Treas. Reg. §§ 20.2056(b)-5(f)(1), 25.2523(e)-1(f)(1).

> deprive the spouse of the requisite degree of enjoyment.[34]

While those "surrounding circumstances" are not specifically enumerated by the Regulations, they are perhaps evinced in the several sub-elements of the All Income element that *are* enumerated in the Regulations.

## III. THE ALL INCOME ELEMENT

At its most basic, the All Income element demands that the surviving spouse be entitled to all of the income produced by the assets that are the subject of the Marital Deduction.[35] When it is examined in the context of other trust terms, trust assets, and local law, that requirement is not as black and white as it may at first seem. In addressing various specific issues relating to the concept of "income," the Regulations effectively add several sub-elements to the All Income element. The Regulations deal principally with three specific issues that, when applicable, become sub-elements of the All Income element: (1) principal and income allocation;[36] (2) income accumulation;[37] and (3) unproductive property.[38]

### A. Principal and Income Allocation

Generally, the Regulations require consideration be given to "the rules to be applied by the trustee in allocation of receipts and expenses between income and corpus" with respect to the analysis of whether the surviving spouse's right to income qualifies in light of the nature of trust assets.[39] The "rules" to which the Regulations refer include all rules governing the trustee whether they are contained in trust terms or local law to the extent it is applicable.[40] By way of example, the Regulations provide that a trust that allocates receipts from rent, ordinary cash dividends, and interest to income would not be disqualified because it allocated receipts from stock dividends and proceeds from the conversion of assets to principal—provided that "it is evident from the

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[34] Treas. Reg. § 20.2056(b)-5(f)(1).

[35] *See* Treas. Reg. §§ 20.2056(b)-5(a)(1), 25.2523(e)-1(a)(1).

[36] *See* Treas. Reg. §§ 20.2056(b)-5(f)(3), 25.2523(e)-1(f)(3).

[37] *See* Treas. Reg. §§ 20.2056(b)-5(f)(7), 25.2523(e)-1(f)(7).

[38] *See id.*

[39] Treas. Reg. §§ 20.2056(b)-5(f)(3), 25.2523(e)-1(f)(3).

[40] *See* Treas. Reg. §§ 20.2056(b)-5(e), 20.2056(b)-7(g), 25.2523(e)-1(e), 25.2523(f)-1(e).

nature of the trust assets and the rules provided for management of the trust that the allocation[s] to income . . . will give to the spouse the substantial enjoyment during life required by the statute."[41] Other, more complex issues of allocation of various types of receipts and expenses between principal and income, such as depreciation reserves[42] or discretionary allocation of receipts,[43] can arise but are subject to the same principles.

B. Accumulation of Income

Trusts that require that income be accumulated—in whole or in part—do not satisfy the All Income element.[44] Even a temporary accumulation of income beyond a year will disqualify the trust.[45] An express or implied requirement to accumulate income should be distinguished, however, from a trustee exercising discretion in delaying the funding of the marital trust during the post-death administrative period of a formerly revocable trust.[46] That sort of administrative discretion, although not without practical substantive impact on the

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[41] Treas. Reg. §§ 20.2056(b)-5(f)(3), 25.2523(e)-1(f)(3).

[42] *See, e.g.*, Priv. Ltr. Rul. 91-25-016 (June 21, 1991) (stating that expected depreciation reserves related to real property held by the trust could reduce income and thereby render that property "unproductive," but the trust nevertheless qualified for the Marital Deduction because of the presence of a provision allowing trustees to hold unproductive property only with the consent of the spouse).

[43] *See, e.g.*, Rev. Rul. 66-39, 1966-1 C.B. 223 (stating that where trustees were given unfettered discretion to allocate receipts and disbursements between income and principal, the Marital Deduction was nevertheless allowed because local law imposed a duty to act in good faith and to apply reasonable accounting principles in their allocations).

[44] *See* Treas. Reg. §§ 20.2056(b)-5(f)(7), 25.2523(e)-1(f)(7). The courts, however, have allowed some flexibility with respect to this element. *Compare* Estate of Ellingson v. Comm'r, 964 F.2d 959, 960 (9th Cir. 1992) (allowing the Marital Deduction where the trustee was permitted to accumulate trust income if such income "exceed[ed] the amount which the Trustee deems to be necessary for [the surviving spouse's] needs, best interests and welfare") *with* Davis v. Comm'r, 394 F.3d 1294, 1297 (9th Cir. 2005) (denying the Marital Deduction where the spouse was entitled to "all of the net income from the trust estate as the trustee, in the trustee's reasonable discretion, shall determine to be proper for the health, education, or support, maintenance, comfort and welfare of grantor's surviving spouse in accordance with the surviving spouse's accustomed manner of living").

[45] *See* Priv. Ltr. Rul. 76-08-110120A (Aug. 11, 1976) (disallowing Marital Deduction allowed where spouse's income interest was deferred until the trust retained $40,000 in income for grandchildren).

[46] *See* Priv. Ltr. Rul. 91-25-016 (June 21, 1991); Rev. Rul. 77-346, 1977-2 C.B. 340.

surviving spouse, is generally differentiated from technically insufficient provisions regarding accumulation of income in a Marital Trust.[47]

Plainly, though, any discretion in the Marital Trust itself to distribute income that is vested in the trustee will violate this sub-element.[48] This is so because a discretionary power to distribute income inherently includes an impermissible discretionary power to accumulate income by not exercising that discretion.[49] Under the same principles, an income interest also fails to qualify where the distribution of income is subject to the consent of a person other than the surviving spouse.[50] Trusts with such discretionary powers cannot be saved by the fact that the spouse is the trustee because there remains a possibility that the spouse will not always be trustee of the trust.[51] The surviving spouse may, however, be given the discretion to accumulate income in her *personal*—as opposed to fiduciary—capacity.[52]

### C. Unproductive Property

Generally, a trust fails to qualify for the Marital Deduction where trust assets consist substantially of property that does not produce income and the trustees have the discretion or obligation to hold such unproductive assets.[53] Where, however, the surviving spouse has a power—whether under trust terms or local law—to compel the trustees to divest the unproductive property and invest instead in productive property, the mere ability to retain or invest in unproductive assets will not disqualify the trust.[54] In drafting provisions to retain such unproductive property, planners should be careful to ensure that the power vested in the spouse to convert unproductive assets is superior to any other trust provision.[55] As an alternative to reliance on trust provisions, if the trustees are required under local law to "use the degree of judgment and care in the

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[47] *See* Priv. Ltr. Rul. 91-25-016 (June 21, 1991); Rev. Rul. 77-346, 1977-2 C.B. 340.

[48] *See Davis*, 394 F.3d at 1298–99.

[49] *See id.* at 1302.

[50] *See* Treas. Reg. §§ 20.2056(b)-5(f)(7), 25.2523(e)-1(f)(4).

[51] *See Davis*, 394 F.3d at 1302.

[52] *See* Treas. Reg. §§ 20.2056(b)-5(f)(7), 25.2523(e)-1(f)(7).

[53] *See id.*

[54] *See id*.

[55] *See* Tech. Adv. Mem. 91-47-065 (Nov. 22, 1991) (denying the Marital Deduction where there was a *general* power in the spouse to prevent the trust from holding unproductive assets, but a *specific* power in the settlor's son to retain certain unproductive assets).

exercise of the power which a prudent man would use," the power to retain unproductive assets will not disqualify the trust.[56]

The Regulations leave several questions unanswered. The term "unproductive property" is left undefined and, under the Regulations, it is not clear if the term also encompasses property that is "under-productive" or whether the sole measure of productivity is income.[57] Furthermore, it is also unclear at what point a trust holding some unproductive property becomes a trust "consist[ing] substantially of" unproductive property.[58] Also, while the Regulations provide that asset conversion must be accomplished within "a reasonable time," the term reasonable time is undefined and not elucidated in the examples.[59]

Although unproductive property is never clearly delineated, Service publications provide several helpfully illustrative examples of offending property. Art, for example, is considered unproductive property.[60] An interest in timberland where it was "unlikely" that a significant portion of trees would be cut and sold was also characterized as unproductive.[61] Similarly, the Service concluded that commercial real estate subject to significant depreciation reserves was unproductive.[62] Thus, unproductive property seems to be property that does not produce income from a fiduciary accounting perspective, regardless of its potential for overall growth—a definition that makes sense in the context of an "all *income*" requirement.[63] The latter two examples augur the conclusion that it is not merely *un*productive property contemplated by the Regulations, but also *under*productive property—that is to say, property that is producing a

[56] Treas. Reg. §§ 20.2056(b)-5(f)(4), 25.2523(e)-1(f)(4).

[57] *See id.*

[58] *See id.*

[59] Treas. Reg. §§ 20.2056(b)-5(f)(7), 25.2523(e)-1(f)(4).

[60] *See* Tech. Adv. Mem. 92-37-009 (Sept. 11, 1992).

[61] *See* Tech. Adv. Mem. 97-17-005 (Apr. 25, 1997).

[62] *See* Priv. Ltr. Rul. 91-25-016 (June 21, 1991).

[63] *See In re* G.B. Van Dusen Marital Tr., 834 N.W.2d 514, 525 (Minn. Ct. App. 2013) ("[W]e conclude that the term 'unproductive property,' as used in [the trust instrument], refers to property that does not produce income."). In contrast, the trial court in that case found that "'productive property' includes both income-producing property and property that 'has the potential to appreciate or gain value over time,' even though it may not create a 'regular stream of income.'" *Id.* at 524; *see also* RESTATEMENT (THIRD) TRUSTS § 79 cmt. g(1) (AM. LAW INST. 2007) (using "unproductive" and "underproductive" synonymously with "low-income").

disproportionately small amount of income relative to its overall value.[64] Thus, unproductive property seems to be a floating concept that takes into account the specific circumstances of the investment, the terms of the trust in the context of applicable local law, and general market conditions.

The exact portion of a trust that must consist of unproductive property for the trust to be classified as "consisting substantially of" unproductive property is not established anywhere in the Code,[65] the Regulations, or Service publications, but it evidently does not require a majority.[66] A more precise estimate is unavailing because the underlying issue in the private letter rulings is often whether the trust holding unproductive property can be saved by a trust provision or local law and not whether there is a high enough proportion of unproductive property to fail to qualify for the deduction. Thus, most Service publications on the topic do not denote the exact portion of trust corpus comprised of the offending property.

The timing of asset conversion could be important, especially with respect to formerly revocable trusts that are in an administrative phase. These trusts may contain, for example, significant interests in closely-held business entities that, for one reason or another, may produce little to no income. Once a demand is made, the trustees must convert the assets into productive property within "a reasonable time," but because avoiding a fire sale of a block of closely-held assets would be an important consideration for a trustee observing the duty of impartiality, it may be desirable to delay conversion as long as possible.[67] The Service seems to take a pragmatic approach that takes into consideration the nature of the assets and all surrounding circumstances. For example, a hypothetical several year delay in the distribution of assets to the marital trust during an administrative period did not prevent the trust from qualifying for the Marital Deduction.[68] Similarly, an eighteen-month

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[64] By way of analogy, the Service has ruled that trust property was not eligible for QTIP treatment where the trust authorized the sale of trust property to the settlor's child at a below-market price and required the trustee to loan money to the child at a below-market rate in order to fund the purchase. *See* Tech. Adv. Mem. 88-43-004 (Oct. 28, 1988).

[65] *See supra* notes 57–58 and accompanying text.

[66] Tech. Adv. Mem. 92-37-009 (Aug. 7, 1992) (stating that a trust consisted substantially of unproductive assets where fifty percent of the value was derived from art).

[67] Treas. Reg. §§ 20.2056(b)-5(f)(7), 25.2523(e)-1(f)(4).

[68] Priv. Ltr. Rul. 91-25-016 (June 21, 1991).

delay in funding a marital trust did not prevent the trust from qualifying for the Marital Deduction.[69] While neither of these examples deals explicitly with the conversion of non-productive assets after a demand is made by the surviving spouse, they are instructive because they address the predicate issue of delivering the underlying property to the spouse in the first place.

## IV. THE CONSTRUCTION AND EXIGENCY OF PROPERTY CONVERSION CLAUSES

A Property Conversion Clause is simply a trust provision that compels the trustees to diversify unproductive property in favor of productive property at the direction of the spouse.[70] While the concept may be simple, the practice is more complex.

For example, a Property Conversion Clause may be narrowly drafted and reference the requirements contained in the Regulations: "My [spouse] may require the Trustees to invest the Marital Trust so that it is productive as a whole, as contemplated by the Treasury Regulations, despite any other provisions of this Trust."[71]

Alternatively, a Property Conversion Clause might be more broadly drafted to, at least arguably, apply in more instances than would be strictly required under the Regulations:

> If any unproductive property is held by the Trustees in the Marital Trust, my [spouse], at any time, by written instrument to the Trustees, may compel conversion of such unproductive property to productive property, it being the Grantor's intention that [the surviving spouse] shall have the full beneficial enjoyment of the Marital Trust.[72]

One commentator advocated a uniquely drafted QTIP distribution provision that avoided the use of a Property Conversion Clause with the stated purpose of enhancing the asset protection aspects of the trust:

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[69] *See* Rev. Rul. 77-346, 1977-2 C.B. 340. The ruling notes that "a determination was made that the period of administration was reasonable" but did not give any indication as to who or what made that determination. *Id.*

[70] *See, e.g.*, *In re* G. B. Van Dusen Marital Tr., 834 N.W.2d 514, 518 (Minn. Ct. App. 2013).

[71] Hereinafter Example Clause 1.

[72] This clause is taken from the trust in *In re G.B. Van Dusen Marital Trust*, 834 N.W.2d at 518. Hereinafter Example Clause 2.

> [T]o the extent that the Settlor's personal representative makes a QTIP election for the Marital Trust, the Settlor intends, by the provisions of this Article, to obtain for his/her estate the advantage of the marital deduction or other similar benefit, if any, that may be available under the Federal estate tax law applicable to the Settlor's estate. No provision of this Agreement shall apply to the Marital Trust to the extent that its being made applicable would defeat the intent expressed in the preceding sentence. Furthermore, the amount of net income distributed to the Settlor's Spouse from the Marital Trust shall never be less than the amount required to be treated as "income" under the marital deduction provisions of the Internal Revenue Code and the Treasury Regulations issued thereunder, and the composition of such net income shall include all items within the meaning of the term "income" in the marital deduction provisions of the Internal Revenue Code and the Treasury Regulations issued thereunder. Accordingly, the Settlor's Spouse shall have substantially that degree of beneficial enjoyment of the trust estate of the Marital Trust during his/her lifetime that the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust and the Trustees shall not exercise their discretion or apply any provision of this Agreement in a manner that is not consistent with this intention. The Trustees shall invest the trust estate of the Marital Trust so it will produce for the Settlor's Spouse during his/her life an income or use that is consistent with the value of the trust estate and with its preservation.[73]

The consequences of drafting choices could be significant for trusts holding any assets that might arguably be unproductive or underproductive. For example, a clause might be interpreted by a state court as going beyond the requirements of the Regulations. Thus, while the Regulations may permit a delay in the conversion of assets for a

[73] Jonathan E. Gopman, *Optimizing Asset Protection with QTIPs*, 15 PROB. PRAC. REP. 1, 3–4 (June 2003). Hereinafter Example Clause 3.

"reasonable time,"[74] a court examining a more expansive Property Conversion Clause might find that a trustee "had no discretion to maintain unproductive property once [the surviving spouse] properly sought to compel the conversion of unproductive property to productive property."[75] The more general language contained in Example Clauses 1 and 3 is therefore preferable to the specific language of Example Clause 2.

Example Clauses 1 and 3 are also superior insofar as they specifically adopt the flexible approach of the Regulations. As discussed above, the Regulations do not actually prevent the application of the Marital Deduction where a trust consists substantially of unproductive assets—even where the spouse lacks the express power to compel the trustees to convert the unproductive assets.[76] In such a situation, the Regulations provide that the spouse must be able to require that the "trustee *provide the required beneficial enjoyment* such as by payments to the spouse out of other assets of the trust."[77]

In drafting a Property Conversion Clause, the requirement that the spouse be able to convert unproductive assets[78] must be read in conjunction with the more flexible language allowing the trustee to merely provide "the required beneficial enjoyment" of trust property.[79] This approach takes full advantage of the flexibility offered by the Regulations without handcuffing the trustees. A Property Conversion Clause should expressly track the language of the Regulations in order to provide clarity to courts that may need to interpret the clause.[80] Practitioners might consider the following language:

> The purpose of this Trust is to give my [spouse] substantially that degree of beneficial enjoyment of the Trust property during [his/her] life which the principles of the law of trust accord to a person who is unqualifiedly designated as the life beneficiary of a trust.

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[74] *See* Treas. Reg. §§ 20.2056(b)-5(f)(4), 25.2523(e)-1(f)(4).

[75] *In re* G.B. Van Dusen Marital Tr., 834 N.W.2d at 525.

[76] *See supra* notes 53–56 and accompanying text.

[77] Treas. Reg. §§ 20.2056(b)-5(f)(5), 25.2523(e)-1(f)(5) (emphasis added).

[78] *See* Treas. Reg. §§ 20.2056(b)-5(f)(4), 25.2523(e)-1(f)(4).

[79] Treas. Reg. §§ 20.2056(b)-5(f)(5), 25.2523(e)-1(f)(5).

[80] This is the case whether a federal court is interpreting the clause in light of a challenge by the IRS with respect to the Marital Deduction, or a state court is interpreting the clause in light of a challenge by the surviving spouse with respect to conversion of trust assets.

> Therefore, my [spouse] may require the Trustees to invest the Marital Trust so that it is productive as a whole within a reasonable time, as contemplated by the Treasury Regulations. In lieu of converting Trust assets, the Trustees may, in their sole discretion, satisfy a demand made by my [spouse] under this Section by making corrective distributions to [him/her] of Trust principal in amounts equal to the income interest contemplated by the Treasury Regulations. The provisions of this, Section [##], shall apply despite any other provisions of this Trust, including any provisions that may purport to apply notwithstanding any other provisions of this Trust.

The Property Conversion Clause above tracks the language of the Regulations with respect to the overarching purpose of the marital trust;[81] this is useful to aid in any interpretation of the spouse's income interest from a purely tax perspective and serves as something of a savings clause. It adopts the flexible language of Example Clause 1 in providing the spouse with the ability to compel the trustee to convert trust assets but adds the caveat, contained in the Regulations, that the conversion can be done within a "reasonable time."[82] The clause also provides that the trustee has the discretion to satisfy a conversion demand by instead making a corrective distribution from the trust principal, which both clarifies the somewhat ambiguous language contained in Example Clauses 1 and 3 and satisfies the requirements of the Regulations.[83] Finally, the clause uses language that ensures that the power of the spouse to compel conversion of trust assets is superior to any other trust provision.[84]

Consider the application of the clause above to the previously discussed example of a revocable trust in its administrative phase that contains significant interests in closely-held business entities and will not produce income for the foreseeable future. This clause makes it clear that

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[81] *See* Treas. Reg. §§ 20.2056(b)-5(f)(1), 25.2523(e)-1(f)(1).

[82] *See* Treas. Reg. §§ 20.2056(b)-5(f)(4), 25.2523(e)-(1)(f)(4).

[83] *See* Treas. Reg. §§ 20.2056(b)-5(f)(5), 25.2523(e)-1(f)(5) ("[T]he applicable rules for the administration [must] require, or permit the spouse to require, that the trustee provide the required beneficial enjoyment, such as by payments to the spouse out of other assets of the trust.").

[84] *See generally supra* note 55.

the trustees may either convert the unproductive assets into productive assets *or* make corrective distributions to the spouse to approximate her overall income interest in the trust. Thus, the trustees could prevent the spouse from compelling a fire sale of the businesses by, for example, obtaining a line of credit secured by property of the businesses and making annual distributions to the spouse that would approximate a unitrust interest.

Other provisions providing additional clarification may also be desirable. For example, the Regulations do not specify a particular method by which the spouse must exercise her power to compel asset conversion. But it would be reasonable to require that the demand specifically reference the Property Conversion Clause and be written, signed by the spouse, and delivered to the trustees. Such requirements would provide a degree of certainty for the trustees. The precise amount of income required to be distributed under the "corrective distribution" provision might be clarified by a reference to the state's unitrust statute, or even a specific percentage that falls within the range provided by the statute.[85] A Property Conversion Clause might also provide for a specific method of conversion—for example, a right of first refusal among family members to purchase interests in a closely held-entity—which makes sense in the context of a particular asset.[86] A provision expressly allocating to trust principal the expenses relating to carrying unproductive property, although not strictly related to the conversion of that property, might also make sense in this context.[87]

Clarifying the timing of the conversion could also be helpful. As discussed above, the Regulations require simply that any conversion be done "within a reasonable time."[88] No publications by the Service offer any real clarification on that requirement, although decisions that allowed for significant delays in *funding* marital trusts given extenuating

[85] As noted above, the Regulations specifically contemplate that a unitrust interest would fulfill the All Income element. *See supra* note 30.

[86] *See, e.g.*, Priv. Ltr. Rul. 19-99-51029 (Dec. 24, 1999) (allowing the Marital Deduction where the trust provided that if stock in an S corporation was sold pursuant to a demand by the spouse to convert unproductive assets, the settlor's children would have the right to purchase the stock at fair market value as determined by an independent appraiser).

[87] Beyond the common sense notion that the costs of a purely "principal asset" ought to be borne by trust principal, the provision could be relied upon in making the subjective tax argument that the primary purpose of the trust is to provide the requisite degree of beneficial enjoyment to the spouse.

[88] Treas. Reg. §§ 20.2056(b)-5(f)(4), 25.2523(e)-1(f)(4).

circumstances might be considered instructive.[89] In contrast, a state court looking at Example Clause 2 found that the trustee breached its fiduciary duties by not immediately making the requested conversion.[90] Any provisions providing a specific time period for the conversion to occur would unnecessarily handcuff the trustees. More helpful, and certainly within the scope of the Regulations, would be a provision clarifying that the trustees' obligation to convert assets "within a reasonable time" begins on the date the spouse's written demand is delivered (as opposed to, for example, communicated) to the trustees and that the term "reasonable time" should be read in light of the requirements of the Regulations, not state law.

Other provisions should be avoided by drafters. For example, a bare power to compel asset conversion, such as the provision in Example Clause 2, is undesirable for a number of reasons.[91] References to the term "unproductive property" should be avoided as it is both underinclusive and creates problematic issues of interpretation.[92] Any express or implied power to maintain unproductive assets that is vested in a person other than the trustee should be avoided or, at least, made specifically subject to the Property Conversion Clause.[93] Finally, references to specific periods of time—for example, with respect to the conversion of

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[89] *See supra* notes 68–69 and accompanying text.

[90] *See In re* G.B. Van Dusen Marital Tr., 834 N.W.2d 514, 525 (Minn. Ct. App. 2013). There is another state court case on point. *See In re* Vincent Terranova, 873 N.Y.S.2d 651 (N.Y. App. Div. 2009). In *Terranova*, while there was no demand made by the spouse, there was an express ban on the retention of unproductive assets in the Trust "beyond a reasonable period of time." *Id.* at 653. Thus, in this context, *Terranova* is somewhat unhelpful as a practical matter since it stands for little more than the proposition that fifteen years is an unreasonable amount of time to hold unproductive assets. *See id.*

[91] Such a provision, without limitation, creates a potentially disruptive power in the spouse. At the same time, any limitations placed on the power might create issues for purposes of qualifying for the Marital Deduction.

[92] Narrowly read, that term excludes potentially disqualifying *under*productive property. *See supra* note 63 and accompanying text. From an administrative perspective, the term invites strict interpretation by state courts absent reference to the more flexible use of the term found in the Regulations. *See supra* note 74 and accompanying text.

[93] While a trustee would at least be subject to certain unwaivable duties with respect to the exercise of that discretion, a non-fiduciary would not. For example, the ability of the settlor's child, who is running the family business, to prevent the trustee from selling stock in that business would disqualify the trust for the Marital Deduction unless the power was made expressly subject to a Property Conversion Clause. *See supra* notes 54–55 and accompanying text.

unproductive assets after a demand is made—should be avoided as unnecessarily handcuffing the trustees.

## V. RELIANCE ON STATE LAW AND OTHER SOLUTIONS

While drafters can craft the ideal Property Conversion Clause, the provisions of existing trusts may prove challenging for practitioners advising trustees who are seeking the Marital Deduction or simply administering the trust. From a tax perspective, state law can be used as a savings clause for trusts with inadequate provisions regarding unproductive property. In contrast, trusts that have express provisions addressing unproductive property may not be able to be saved by state law, which typically provides for default provisions.

Generally, applicable local law may be relied upon as a method for the spouse to compel the trustees to convert unproductive assets.[94] The Service has relied upon the application of the "Prudent Investor Rule" to provide the spouse with a means to compel the trustees to convert unproductive property.[95] The Uniform Prudent Investor Act (UPIA), which codifies that rule and has been adopted by forty-one states and the District of Columbia, is on its face a default rule.[96] The Prudent Investor Rule is also generally a default rule in states that have not adopted the UPIA.[97] Therefore, trustees looking to rely on this provision as a savings clause must ensure that there is no trust provision to the contrary.

Where there are trust terms that appear to conflict with the state's Prudent Investor Rule, one strategy may be to attempt to characterize the trust terms as a mere general provision while characterizing the state law as an overriding provision that governs in that specific instance.[98] Another approach may be to argue that although there may be a facial conflict, under applicable state law, there is in fact no express conflict between the terms of the trust and the state's Prudent Investor Rule.[99] If

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[94] *See* Treas. Reg. §§ 20.2056(b)-5(e), 20.2056(b)-7(g), 25.2523(c)-1(e), 25.2523(f)-1(e).

[95] *See, e.g.*, Tech. Adv. Mem. 92-37-009 (Sept. 11, 1992) (citing to the New Hampshire Prudent Investor Rule); Tech. Adv. Mem. 86-38-004 (June 12, 1986) (citing to the South Carolina Prudent Investor Rule).

[96] *See* UNIF. PRUDENT INV'R ACT § 1(b), 783 U.L.A. 15 (2006).

[97] *See, e.g.*, FLA. STAT. §§ 518.11, 736.0105.

[98] *See supra* note 55 and accompanying text.

[99] *See* Tech. Adv. Mem. 92-37-009 (Sept. 11, 1992). There, the trust provided the trustees with generally broad discretion to invest and retain trust assets, including the unproductive trust assets at issue. *See id.* In allowing the Marital Deduction, the IRS

neither strategy is availing, the trustees may attempt an argument that has had mixed success in the courts. Put succinctly, the trustees may argue that the general duty of the trustees to administer the trust "in the best interests" of the beneficiaries would limit any discretion they might have to hold unproductive trust property because it would plainly not be in the best interests of the beneficiary if the trust did not qualify for the Marital Deduction.[100]

Unfortunately, state law provisions that purport to "save" Marital Deduction gifts[101] generally have not been effective.[102] At least one commentator has argued, however, that Washington's broad approach to defining the term "marital deduction gift" could make its savings statute effective where others have failed.[103] More states have adopted statutory provisions purporting to deal with unproductive property.[104] These provisions do not seem to address the issue from a tax standpoint, however, because their operation is typically predicated on the qualification for the Marital Deduction.

For a trustee administering a trust with suspect terms, another approach might be spousal ratification of the trust's investments. To be effective, any ratification would need to be binding on the spouse and might even be signed annually. The instrument would purport to prevent the spouse from current or future objection to the trustees' investment in unproductive property currently held by the trust. While the effectiveness of such an instrument under local law might vary, in the event of an audit, the trustee could argue that the lack of a spousal conversion power

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relied on a New Hampshire Supreme Court decision holding that in cases where trustees are granted broad investment discretion, the discretion is "interpreted to broaden the trustee's standard of investment so that the trustee can properly make investments based on the broader prudent man standard." *Id.* (citing Bartlett v. Dumaine, 523 A.2d 1 (1986)).

[100] *Compare* Estate of Ellingson v. Comm'r, 964 F.2d 959, 960 (9th Cir. 1992) (arguing successfully based on a trust provision) *with* Estate of Rapp v. Comm'r, 71 T.C.M. (CCH) 1709 (T.C. 1996), *aff'd*, 140 F.3d 1211 (9th Cir. 1998), *amended in part by reh'g* (May 15, 1998) (arguing unsuccessfully based on a provision of local law).

[101] *See, e.g.*, CAL. PROB. CODE § 21522; KAN. STAT. ANN. § 58-820; WASH. REV. CODE § 11.108.020; W. VA. CODE § 44B-5-507.

[102] *See, e.g.*, Davis v. Comm'r, 394 F.3d 1294, 1300 (9th Cir. 2005) (interpreting the gift as not being intended to qualify for the Marital Deduction and, therefore, not being governed by the California savings statute).

[103] *See* Edward C. Renenger, Note, *Can a State's Marital Deduction Savings Clause Reform a Defective Marital Deduction? Estate of Davis v. Commissioner*, 57 TAX LAW. 615 (2004).

[104] *See id.* at 620–21 n.41.

is rendered moot by the spouse's binding acceptance of the investment in unproductive property.

## VI. CONCLUSION

The Marital Deduction is generous in scope but unforgiving in application. The related provisions of the Code and Regulations contain a number of very specific, and sometimes very subtle, requirements that are as absolute as any found in tax law. Property Conversion Clauses—or their local law equivalent—are just one of those requirements.

As is always the case with tax-related trust provisions, the drafter of a Property Conversion Clause must effectively synthesize the requirements of the Code with applicable local law to create a technically *sufficient* provision. That provision must then be customized to suit the substantive preferences of the settlor. Those technical and substantive requirements must be balanced with the practical aspects of the real world application of the clause. In many cases, the Property Conversion Clause will be a "back-end" provision—"boilerplate" language included for technical reasons and probably never looked at or even considered by the settlor. They should not be.

Unlike many common trust provisions, these clauses are often overlooked by drafters and dismissed as an easily satisfied element of the Marital Deduction.[105] While local law may sometimes be *sufficient* to preserve the Marital Deduction, in the case of the prototypical modern trust that grants exceptionally broad investment powers to trustees, there is an absolute necessity for a well-drafted provision dealing with unproductive or underproductive property. The types of assets that will trigger the operation of such a clause—whether it is art, real estate, or a closely-held business—are exceptionally common among individuals who are engaging in estate planning. Property Conversion Clauses are important, intricate, and, all too often, ignored. All practitioners ought to review the Property Conversion Clause within their Marital Trust forms to ensure that the provision will operate as intended in its dual roles: first, as a technical provision satisfying a critical tax requirement and later as a substantive provision with the potential to substantially affect administration of the trust.

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[105] As at least one other commentator has noted, in some circumstances there is not even a technical necessity for a Property Conversion Clause. *See* Gopman, *supra* note 73.