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ADMINISTRATIVE PROBLEMS INVOLVING MARITAL DEDUCTION GIFTS

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INTRODUCTION

Revenue Procedure 64-19[1] is primarily an attempt to curb certain fiduciary administrative practices in the funding of marital deduction gifts. Thus, for the first time in the sixteen year history of the marital deduction, the Internal Revenue Service has focused its critical attention on operational matters involving the marital deduction which occur after the decedent's death. As to estates involving instruments executed prior to October 1, 1964, Revenue Procedure 64-19 requires that fiduciaries in some cases must report the details of their distributions to the Internal Revenue Service.[2] The scrutiny of post-death events may therefore become more intense in the future. In recognition of their growing importance, this article will discuss some of the problems and principles involved in the administration of estates or trusts which contain marital deduction gifts.

PROBLEMS OF INTERPRETATION

Perhaps the most critical administrative question facing the fiduciary is whether he has before him a pecuniary or fractional type formula clause marital deduction gift. The resolution of this question may determine whether the surviving spouse is to share in the appreciation or depreciation of the assets of the estate during the period of administration.[3] In some cases, it may also determine whether such surviving spouse shall be entitled to income from his or her gift during the period of administration.[4] The inquiry is relatively simple: Did the decedent intend to give an exact dollar amount which remains constant in value during the period of administration, or did he, instead, intend to give a percentage of the residue which changes in value as asset values change? There is a growing body of state court decisions which have decided this

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1. Rev. Proc. 64-19, 1964 INT. REV. BULL. NO. 15, at 30.

2. Rev. Proc. 64-19, 1964 INT. REV. BULL. NO. 15, § 5.02, at 33.

3. The surviving spouse does not participate in the appreciation or depreciation of estate assets if such spouse is given a *pecuniary* gift which is to be satisfied by a distribution of assets valued *currently* at the time of distribution; the spouse does participate in such appreciation or depreciation if she is given a *fractional* gift.

4. See discussion at p. 303 *infra*.

question.[5] Unfortunately, however, these decisions provide little aid to the fiduciary faced with a clause containing doubtful language. Such fiduciary would no doubt assume that the words "sum" or "amount" create pecuniary gifts. Yet, in *In The Matter of The Estate of Mueller*[6] and *In The Matter of The Estate of Bing*,[7] clauses containing those words were held to create fractional gifts. Conversely, the words "portion of my estate" would appear to indicate that a fractional gift was intended. Yet, in *In The Matter of The Estate of Kantner*[8] a clause containing this phrase was held to create a pecuniary gift. In fact, the words "a portion of my estate" have enabled the New Jersey court in the *Kantner* case[9] and the Oregon court in *Nicolai v Hoffman*[10] to reach opposite conclusions. The descriptive words employed in defining the marital gift, therefore, cannot be regarded as reliable indices of the nature of the gift.

Determining the Nature of the Marital Deduction Gift

The courts have stressed a variety of factors in arriving at their decisions. Some courts have emphasized the fact that the surviving spouse is the primary object of the decedent's bounty and therefore have concluded that the clause defining the marital deduction gift should be so construed that the spouse be treated liberally in the distribution of estate

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5. The following cases construed the language involved as creating a *pecuniary* gift: Maguire v. Stirling, 317 F.2d 147 (D.C. Cir. 1963) (gift of "whichever of the following amounts shall be the greater "); King v. Citizens & So. Nat'l Bank, 103 So. 2d 689 (Fla. Dist. Ct. App. 1958) (gift of "fifty percentum (50%) of my adjusted gross estate "); In the Matter of the Estate of Kantner, 50 N.J. Super. 582, 143 A.2d 243 (App. Div. 1958) (gift of "a portion of my estate equal in value to "); In the Matter of Gilmour, 18 App. Div. 2d 154, 238 N.Y.S.2d 624 (1963) (gift of "an amount equal to "); In the Matter of the Estate of Gauff, 27 Misc. 2d 407, 211 N.Y.S.2d 583 (Surr. Ct. 1960) (gift of "a sum equal to "); In the Matter of the Estate of McTarnahan, 27 Misc. 2d 13, 202 N.Y.S.2d 618 (Surr. Ct. 1960) (gift of " a fund either in cash or securities as shall be equal in value to one-half "); *In re* Lewis' Will, 115 N.Y.S.2d 791 (Surr. Ct. 1952) (gift of "such portion of my estate, as when added to all other property shall result in an amount equal to "); Althouse Estate, 404 Pa. 412, 172 A.2d 146 (1961) (gift of "so much of my estate [as] shall equal the maximum marital deduction ").

The following cases construed the language involved as creating a *fractional* gift: In the Matter of the Estate of Mueller, 34 Misc. 2d 584, 228 N.Y.S.2d 399 (Surr. Ct. 1962) (gift of "a portion of my estate, the value of which shall be exactly the sum needed to obtain the maximum marital deduction "); In the Matter of Ossman, 27 Misc. 2d 632, 209 N.Y.S.2d 251 (Surr. Ct. 1960) (gift of "one-half of the value of my adjusted gross estate "); In the Matter of the Estate of Bing, 23 Misc. 2d 326, 200 N.Y.S.2d 913 (Surr. Ct. 1960) (gift of "that part of my residuary estate which shall be an amount by which "); Nicolai v. Hoffman, 232 Ore. 105, 373 P.2d 967 (1962) (gift of "a portion of my estate equal in value to the maximum marital deduction ").

6. 34 Misc. 2d 584, 228 N.Y.S.2d 399 (Surr. Ct. 1962)

7. 23 Misc. 2d 326, 200 N.Y.S.2d 913 (Surr. Ct. 1960).

8. 50 N.J. Super. 582, 143 A.2d 243 (App. Div. 1958). The decision was based largely upon other provisions of the will which referred to the non-marital gift as a residuary gift.

9. *Ibid.*

10. 232 Ore. 105, 373 P.2d 967 (1962), holding that such words created a fractional gift.

assets.[11] This reasoning is unconvincing. Whether the spouse is treated liberally or not may depend upon the course of the stock market during the period of administration of the estate. If it goes up, the spouse will desire that the marital deduction gift be characterized as fractional; if it goes down, a pecuniary gift will be desired. The question ought to be decided upon the language of the will and not upon stock market action. It has also been held that the testator's words should not be taken literally on the ground that he was primarily concerned with describing a tax objective and only secondarily with making a testamentary gift.[12] This approach in effect creates a language vacuum; the words cannot be taken to mean what they say

It is axiomatic that the will must be construed as a whole, and the courts have also examined the structure and related provisions of the testamentary instrument in the interpretation of marital deduction formula gifts. Thus, if the formula gift is stated in one paragraph of the will and the balance of the estate is disposed of in a succeeding paragraph, the formula gift probably will be held to be pecuniary in nature, particularly if the non-marital gift is referred to as "residuary."[13] The tax burden clause may also be a determinant in the decision. If that clause directs that death taxes be paid from the non-marital share, and refers to that share as "the residuary share," the inference may be drawn that a pecuniary gift was intended.[14]

It may be seen that neither the interpretation of the phraseology utilized by the testator nor the reasoning advanced by the courts is sufficiently consistent to provide reliable guides to the fiduciary confronted with questionable language. Thus, in view of such developments it is likely that fiduciaries in the future will apply with increasing frequency to the courts for assistance in proper interpretation of formula clause bequests.[15]

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11. In the Matter of the Estate of Mueller, 34 Misc. 2d 584, 228 N.Y.S.2d 399 (Surr. Ct. 1962); In the Matter of Ossman, 27 Misc. 2d 632, 209 N.Y.S.2d 251 (Surr. Ct. 1960)

12. In the Matter of Ossman, *supra* note 11.

13. In the Matter of the Estate of Kantner, 50 N.J. Super. 582, 143 A.2d 243 (App. Div. 1958). Nicolai v. Hoffman, 232 Ore. 105, 273 P.2d 967 (1962), however, rejected the contention advanced in Revenue Ruling 60-87, 1960-1 CUM. BULL. 286, that a fractional gift must be included in the residuary clause of the will.

14. In the Matter of the Estate of Kantner, *supra* note 13. It has also been argued that a testator who was tax conscious enough to adopt a formula clause would not have intended to create a capital gain by a distribution in satisfaction of the marital deduction gift and that he therefore must have intended to create a fractional gift. Nicolai v. Hoffman, *supra* note 13.

15. The phrase "that fractional share of my estate equal in value to" is frequently encountered by corporate fiduciaries. Although a court is likely to find that this language creates a fractional gift in view of the specific use of the word "fractional," it is not inconceivable that a pecuniary gift may be held to have been created. As has been pointed out, no fractional gift is created if the fraction is to be applied against a fund which is itself a fixed dollar amount. Rev. Rul. 56-270, 1956-1 CUM. BULL. 325; 1 CASNER, ESTATE PLANNING 797 (3d ed. 1961) Similarly, a "fractional share" may be equated to a fixed dollar amount

Two other interpretive principles seem to be developing in the state courts. First, the formula clause gift is not to be reduced by property which has passed to the spouse other than by the terms of the formula clause gift, unless fairly explicit reference is made to such "outside" property.[16] Second, the courts appear to favor marital deduction gifts when a question of abatement of legacies is present.[17] The latter principle is based upon the decedent's presumed intention to prefer a spouse in all events in order to obtain the maximum tax savings possible. This is the very reason he adopted a formula clause type bequest. The courts adhering to this view disregard the traditional rules concerning the abatement of legacies on the ground that they were developed in a pre-marital deduction era and hence are not applicable to what is essentially a new type of bequest.

Principles Applicable In Making Distribution of Assets

In making distribution of the assets of an estate or trust, a fiduciary is controlled by the overriding principle that he must treat each beneficiary impartially and fairly. This principle is as old as the fiduciary concept itself, and applies with equal force to distributions involving marital deduction gifts.[18] The existence of such a duty would appear to preclude any post-mortem estate planning which involves inequality of treatment of the various beneficiaries, and Revenue Procedure 64-19[19] can only be regarded as a punitive disallowance of the marital deduction for fiduciary violations of the law.

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and held to be pecuniary. Note that the words "a portion of my estate," when coupled with the words "equal to," have been held to produce pecuniary gifts. In the Matter of the Estate of Kantner, 50 N.J. Super. 582, 143 A.2d 243 (App. Div. 1958); *In re* Lewis' Will, 115 N.Y.S.2d 791 (Surr. Ct. 1962) It would appear to be better practice for the draftsman to substitute the phrase "required to obtain the maximum marital deduction" for "equal in value to."

If the marital deduction gift is to be funded by distribution at federal estate tax values, the distinction between fractional and pecuniary gifts may not be so critical, at least insofar as appreciation or depreciation of estate assets are concerned. The distinction may still be relevant as to distribution of income during the period of administration. However, the requirement that distribution be made at federal estate tax values should be expressly stated. The phrase "all values shall be those finally determined for federal estate tax purposes" has been held to refer only to the calculation of the amount of the gift and not to the values at which distribution is to be made. In the Matter of the Estate of Kantner, *supra.*

16. King v. Citizens & So. Nat'l Bank, 103 So. 2d 689 (Fla. Dist. Ct. App. 1958); In the Matter of Walsh, 14 Misc. 2d 1012, 178 N.Y.S.2d 223 (Surr. Ct. 1958); *In re* Rebens Will, 115 N.Y.S.2d 228 (Surr. Ct. 1952).

17. In the Matter of the Estate of Lorberbaum, 35 Misc. 2d 647, 231 N.Y.S.2d 252 (Surr. Ct. 1962); *In re* Lewis Will, 115 N.Y.S.2d 791 (Surr. Ct. 1952). *Contra,* In the Matter of Estate of Goldman, 4 Misc. 2d 31, 153 N.Y.S.2d 140 (1956).

18. In the Matter of the Will of Bush, 2 App. Div. 2d 526, 156 N.Y.S.2d 897 (1956); Hildreth Estate, 13 Pa. Fid. Rep. 151 (1963).

19. 1964 Int. Rev. Bull. No. 15, at 30.

It is also well established that unless the dispositive instrument provides otherwise, the division of the assets of the estate or trust should be made at current values, *i.e.*, values as of the time of distribution.[20] It is not so clear, however, whether the concept of fiduciary impartiality requires that he make a pro rata division of the assets available for distribution to beneficiaries entitled to a fractional share of the estate or trust. The *Restatement of Trusts* apparently adopts the position that there is a general duty to divide the assets on a pro rata basis in the absence of special circumstances such as a resulting impairment of value by reason of such division.[21] However, this position is not supported by any reported court decisions. The issue has apparently been raised directly in only one court case. In the case of *In re Fiedler*,[22] the court approved a non-pro rata distribution despite the insistence of several beneficiaries that they were entitled to a portion of each security in the estate. The decedent's will contained the usual clause authorizing distribution in kind, conferring upon the executor power to value assets. However, the court's opinion contains no discussion of a beneficiary's legal right to a pro rata distribution; it was largely concerned with the fairness of the appraisals made by the executor. The Internal Revenue Service apparently adopts the position that a pro rata division must be made. In *Alice*

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20. In the Matter of the Estate of Kantner, 50 N.J. Super. 582, 143 A.2d 243 (App. Div. 1958); In the Matter of the Estate of Gauff, 27 Misc. 2d 407, 211 N.Y.S.2d 583 (Surr. Ct. 1960); Hanson s Estate, 344 Pa. 12, 23 A.2d 880 (1942); 3 SCOTT, TRUSTS § 347 (2d ed. 1956).

21. RESTATEMENT, TRUSTS § 347(f) (1935) This section reads as follows:

> If upon the termination of the trust there are several beneficiaries among whom the trust estate is to be distributed, and the trust estate consists in whole or in part of fungible property, that is property which it is possible to divide into shares of the designated proportions regardless of the value of the property so that each beneficiary receives his specified share of the property, each beneficiary is ordinarily entitled to receive his proportionate share of the property in kind. Thus, if the trust estate includes a number of shares of stock of the same kind or a number of bonds of the same issue, each of the beneficiaries who is entitled to a share of the trust estate on the termination of the trust can require the trustee to transfer to him his proportionate share of the shares of stock or bonds.
>
> Although by the terms of the trust the trustee is directed to sell the trust property and distribute the proceeds among several beneficiaries, a beneficiary can compel the trustee to transfer to him his proportionate share of fungible property which is part of the trust estate with the consent of the other beneficiaries, or without their consent if their interests are not adversely affected thereby.

22. 55 N.J. Super. 500, 151 A.2d 201 (App. Div. 1959) In In the Matter of the Estate of Kantner, 50 N.J. Super. 582, 143 A.2d 243 (App. Div. 1958), the court rejected the beneficary's claim to a pro rata portion of certain assets on the ground that the will conferred upon the executor the right to distribute on a non-pro rata basis. However, the requirement that the fiduciary treat each beneficiary fairly may compel a pro rata distribution in some instances. Unless the will directs a specific distribution, obviously, assets which are subject to income tax liability, such as income in respect of a decedent, can only be fairly distributed by a pro rata division. Where securities are to be distributed at current values and have substantially different income tax cost bases, it would appear that a pro rata distribution is virtually compelled in order to treat the beneficiaries fairly from a cost basis viewpoint as well as from a market value viewpoint.

Hemstead,[23] the Service attempted to revalue the marital trust in the widow's estate to reflect a pro rata distribution from her husband's estate, although no such distribution in fact had been made. The case was settled before trial, and Revenue Procedure 64-19[24] renders the form of the Service's attack in that case obsolete, but the position adopted in that attack is worth noting.

Non-pro Rata Distribution

From a planning and administrative viewpoint, a non-pro rata distribution may in some cases be desirable or necessary.

Planning viewpoint.—From a planning viewpoint, there are two important considerations: (1) It is absolutely necessary to exclude from the marital deduction gift any assets which do not qualify for the marital deduction.[25] (2) It is desirable to exclude from the marital deduction gift any assets which involve credits or deductions designed to avoid double taxation. Examples of these are the foreign death tax credit[26] and the income in respect of a decedent deduction.[27] To the extent that these assets are placed in the marital deduction gift, they generate no federal estate taxes, and the appropriate credit or deduction is thereby reduced.

Administrative viewpoint.—From an administrative viewpoint, pro rata distributions may be disadvantageous under a particular circumstance, as for example: (1) It is inconvenient to break up certain assets, as for example a vacant lot worth $500, and distribute them to two separate trusts; or worse, to distribute a portion to the spouse and retain a portion in trust.[28] (2) There is a substantial monetary penalty upon resale if municipal bonds are broken down into odd lots by reason of the distribution. (3) Notes due from a beneficiary preferably should be distributed to the share established for the benefit of such beneficiary. By doing so, the impact of collection problems is restricted to the beneficiary-obligor and interest may be waived without consequence.[29] (4) If bonds are

23. No. 87083 T.C.

24. 1964 INT. REV. BULL. No. 15, at 30.

25. If a fractional formula gift is employed, this may be accomplished by excluding such property from the residue and hence narrowing the fund against which the fraction is to be applied. The marital gift may then be entitled to a larger pro rata share of each asset in the defined residue; nevertheless, from an overall estate viewpoint, the distribution is no longer on a pro rata basis.

26. INT. REV. CODE OF 1954, § 2014 [hereinafter cited as CODE §].

27. CODE § 691(c).

28. The fiduciary may, of course, attempt to sell such an asset, but this frequently cannot be done prior to the time distribution must be made.

29. This assumes that the income is payable to the beneficiary so that in effect he is making payment of the interest to himself and that there is an offset of deduction against income for tax purposes.

pledged to secure contingent state inheritance taxes, such bonds should be distributed to the non-marital deduction trust if that trust is charged with death tax payments.

Conceivably, a limited form of post-mortem estate planning involving non-pro rata distributions may be both proper and desirable. Consider the following example: An estate which contains both common stocks and municipal bonds is distributable in part to a marital deduction trust and in part to a residuary trust in which the income is accumulated for the benefit of grandchildren. If the trustee would normally invest the assets of the marital trust in municipal bonds and the assets of the residuary trust in common stocks, it would appear to be a senseless ritual to adopt a pro rata distribution and thus compel the trustee to sell and repurchase assets he could well have received directly from the executor.[30]

The Question of a Capital Gains Tax

It has been suggested that a non-pro rata distribution may give rise to a capital gains tax.[31] Two theories may be advanced in support of the imposition of such a tax. First, the beneficiaries of the estate or trust may be regarded as having engaged in a taxable exchange of assets among themselves by reason of their consent to the non-pro rata distribution. Under this theory, the beneficiaries are charged with the gain. Second, the fiduciary may be regarded as being the seller. Thus, if two beneficiaries are entitled to equal shares of an estate, and the fiduciary distributes a particular asset entirely to one beneficiary, he may be regarded as having created a dollar obligation to the other beneficiary in an amount equal to the value of the distributed asset. The satisfaction of the dollar obligation by appreciated assets would give rise to the gain. Under this theory, the trustee is charged with the gain.

Neither theory is persuasive. As has been seen, the status of the law is such that a beneficiary cannot be regarded as having a clear legal right to a pro rata distribution. Not having a clear right to a particular asset, he cannot logically be charged with a taxable exchange because of his failure to insist upon its distribution to him. It is also conceptually difficult to regard the fiduciary as creating obligations against himself. The existing authority holds that no taxable gain is created by reason of a non-pro rata distribution of assets.[32] The most recent au-

30. A non-pro rata distribution should be acceptable from a fiduciary standpoint inasmuch as each trust is to be fairly funded insofar as values are concerned. The *value* of the assets to be distributed is not varied, only the *form* of the assets.

31. 1 CASNER, *op. cit. supra* note 15, at 804, 807

32. M. L. Long, 35 B.T.A. 95 (1936); Rev. Rul. 55-117, 1955-1 CUM. BULL. 233; Office Decision 667, 3 CUM. BULL. 52 (1920) It is understood, also, that at least one private ruling has been obtained to the effect that no gain resulted from a non-pro rata distribution in a multiple beneficiary situation.

thority is Revenue Ruling 55-117[33] in which the Service ruled that a non-pro rata distribution to a beneficiary entitled to a partial distribution from a trust did not give rise to a capital gain. There appears to be no significant distinction in principle between this situation and that involving multiple beneficiaries.

VARIANCES IN AMOUNT OF THE MARITAL GIFT CAUSED BY FIDUCIARY ACTIONS

Claiming Administration Expenses as Income Tax Deductions

Whatever its merits, the formula clause mechanism has a serious defect in that actions by a fiduciary taken for tax and investment reasons may of themselves create variances in the amount of the marital deduction gift. Perhaps the most troublesome problem of this nature is created when the fiduciary elects to claim administration expenses as income tax deductions. By doing so, he waives the deduction of such expenses for federal estate tax purposes and thereby increases the adjusted gross estate.[34] Since the size of the formula clause gift is controlled by the adjusted gross estate, the election may have the effect of increasing the marital deduction gift itself by an amount equal to one-half of the waived deductions. However, there is substantial doubt as to whether the surviving spouse should be given additional property solely as an incident to a tax election by the fiduciary. Three New York cases have considered this question, but have come to different conclusions. In *In re Levy's Estate*,[35] the court held that the marital deduction gift was not enlarged by reason of the fiduciary's election. It considered property law and tax law to be two separate matters and refused to permit a tax election to change the interests of the legatees. In short, bequests should be made by a testator and not by a fiduciary. The *Levy* decision, however, was not followed in two later cases. Thus, in the cases of *In re Estate of Inman*[36] and *In The Matter of The Estate of McTarnahan*,[37] the court reasoned that a testator who was so tax conscious as to adopt a formula clause would have intended that his widow receive whatever property is necessary to achieve the maximum tax saving possible. He therefore would have intended that she receive the enlarged

33. 1955-1 CUM. BULL. 233.

34. It is now fairly settled that income beneficiaries should be required to reimburse principal by the amount of the resulting increase in federal estate tax. Thus, no "windfall" is permitted to income beneficiaries at the expense of remaindermen. Estate of Bixby, 140 Cal. App. 2d 326, 295 P.2d 68 (1956); Estate of Warms, 140 N.Y.S.2d 169 (Surr. Ct. 1955).

35. 9 Misc. 2d 561, 167 N.Y.S.2d 16 (Surr. Ct. 1957).

36. 22 Misc. 2d 573, 196 N.Y.S.2d 369 (Surr. Ct. 1959)

37. 27 Misc. 2d 13, 202 N.Y.S.2d 618 (Surr. Ct. 1960).

gift so that the estate would be entitled to an increased marital deduction.[38]

In *Empire Trust Co. v United States*,[39] the issue presented was the determination of the amount of the marital deduction gift. There, the court's decision was based upon the particular language used in describing the formula gift. The bequest was of "an amount equal to one-half the value of my adjusted gross taxable estate, as determined for federal estate tax purposes, after deducting all debts and funeral and administration expenses. " The executors elected to deduct fees on their income tax return, and argued that their election increased the adjusted gross estate and thus increased the marital deduction. The court rejected this contention, holding that the marital deduction bequest was limited to an amount equal to one-half the adjusted gross estate *minus* administration expenses and debts.

Election to Adopt Alternate Valuations

The election to adopt alternate valuations for federal estate tax purposes also will have an effect upon the amount of the formula clause bequest, particularly if it is pecuniary in nature. There are no reported cases which have challenged this election because of its effect upon a formula bequest to a spouse. This effect was noted in the *McTarnahan*[40] case. If a spouse is the sole fiduciary and is given a formula clause bequest, he has the power to enlarge his bequest by deliberately electing higher values. If he does not do so, the question may be raised as to whether he has not made a taxable gift. He probably has not inasmuch as he has a fiduciary duty to treat all beneficiaries fairly; but, as previously noted, the Internal Revenue Service virtually disregarded any concept of fiduciary fairness when it promulgated Revenue Procedure 64-19.[41]

If under the terms of the governing instrument, the fiduciary may satisfy a pecuniary formula gift by a distribution either in cash or in kind at federal estate tax values, he may vary the amount of the gift by his choice of methods in satisfying the gift. For example, if the bequest is determined to be $100,000 and the estate doubles in value, the bequest may be satisfied by the payment of cash in the amount of $100,000, or by a distribution of property valued at $200,000. This testamentary arrangement does not appear to violate the literal language of Revenue

38. In the *McTarnahan* case, the court attempted to distinguish *Levy* on the ground that the McTarnahan will contained the following language: "All values hereinabove provided for shall be as finally determined for the purpose of the federal estate tax upon my estate." It is difficult to justify a distinction upon this basis.

39. 226 F. Supp. 623 (S.D.N.Y. 1963)

40. 27 Misc. 2d 13, 202 N.Y.S.2d 618 (Surr. Ct. 1960)

41. 1964 INT. REV. BULL. No. 15, at 30.

Procedure 64-19,[42] since the proscribed fiduciary practice is the funding of a pecuniary bequest by *depreciated* property.

Investment Action

Investment action may also vary the amount of a formula gift. Revenue Procedure 64-19[43] requires that in certain cases the fiduciary must agree to fund a pecuniary formula gift by distributing assets which fairly reflect the pecuniary formula gift's proportionate share of appreciation or depreciation "of all property then available for distribution."[44] To some extent, the fiduciary may control the amount of the "unrealized" appreciation or depreciation existing as of the date of distribution by his selection of assets to be sold to meet estate obligations. For example, if he sells only those assets which have depreciated in value, the remaining assets will reflect, in the aggregate, a larger appreciation than if he had selected only appreciated assets for sale.

The only practical course of action available to the fiduciary is to exclude from consideration the effect that his elections and administrative decisions may have upon the amount of the formula marital deduction gift. His tax elections should be exercised upon the basis of the largest tax savings inuring to the beneficiaries as a group, and purchases and sales should be based solely upon investment merit. No other conduct guide appears to be workable. In view of the unsettled status of the law, if administration expenses are claimed as income tax deductions, a fiduciary is well advised to obtain a judicial construction of the will before establishing the marital gift in an enlarged amount.

The Mechanics of Making Distribution

An administrative Utopia would be achieved if the assets of an estate could be allocated between the marital deduction share and the non-marital share immediately after death. If this were done, each estate transaction could be undertaken in the share which was properly concerned with such activity, and each payment could be made directly from the share charged with the burden of such payment. Partial distributions would present almost no problem. Unfortunately this Utopia is not possible, and during the course of administration, transactions occur in the estate as a whole which blur the course of the ultimate distribution of assets. The eventual distribution may therefore require adjustments designed to account for these transactions.[45]

42. Rev. Proc. 64-19, 1964 Int. Rev. Bull. No. 15, § 2.02, at 31.

43. *Ibid.*

44. Rev. Proc. 64-19, 1964 Int. Rev. Bull. No. 15, § 3.01, at 31.

45. The views expressed as to the mechanics of making distribution are largely those developed by the operations division of the Trust Department of The Cleveland Trust Company, and in particular by Mr. J. R. Finley, Jr.

Payment of Death Taxes

The payment of death taxes in mid-administration may alter the form of the final distribution. This may be illustrated by an example. Assume that an estate is to be divided equally between a marital deduction trust and a non-marital trust, but that death taxes are to be charged entirely to the non-marital trust. These death taxes are determined to be $20,000. The estate is valued at $200,000 at the date of death, but the assets remaining after payment of death taxes double in value. If the estate were divided immediately upon death, it is clear that the marital trust would be entitled to $100,000 which would double in value to $200,000. Knowing in advance that the marital trust should receive $200,000 in the final distribution, let us examine methods which have been used in making the division.

Tracing process.—An "as of" approach may be adopted under which a schedule of the assets is prepared as of a date prior to the sales for death tax purposes, and the marital trust is given one-half of each asset or its equivalent if the asset is no longer in existence. This is essentially a tracing process and should produce the correct result.[46]

Death taxes added to assets.—The amount of the death taxes may be added to the value of the assets on hand at the time of distribution, and the total divided by two to determine the amount distributable to the marital trust. However, this method creates a distortion in result when an appreciable change in the value of the estate assets takes place. In our example, after death taxes were paid, the estate assets amounted to $180,000 which subsequently doubled in value to $360,000. If death taxes of $20,000 are added to the latter amount, and the resulting total of $380,000 divided by two, the marital trust would receive $190,000. Yet, the correct result is known to be $200,000. The variance is accounted for by the fact that the non-marital trust has in effect borrowed $10,000 from the marital trust to pay death taxes and this amount has been frozen insofar as subsequent asset appreciation is concerned.[47]

Percentage formula.—An equitable percentage formula may be applied. Again referring to our example, immediately after the payment of death taxes, the marital trust was entitled to $100,000 out of the $180,000 of assets on hand, or stated fractionally, to 5/9 of the estate as it was then valued. The application of this fraction to the assets available for ultimate distribution, valued at $360,000, results in the correct distribution of $200,000 to the marital trust. This method becomes administratively impractical, however, if death taxes are paid in

46. This is essentially the method suggested by Professor Casner. See Casner, *Marital Deduction Gifts*, 99 TRUSTS & ESTATES 190 (1960).

47 This method has considerable appeal if there has been little or no change in the value of estate assets, or if the division is made very shortly after the first payment of death taxes.

several installments, unless the fraction is developed by using date of death values only, in which case the process must be regarded as a fairly rough approximation.[48]

Partial Distributions

Partial distributions introduce substantial complexities in the final distribution, particularly if a formula marital deduction gift is involved. They should be avoided unless there are compelling reasons for the distributions.[49] If the estate is distributable in easily ascertainable fractional shares, such as in halves or fourths, partial distributions may be disregarded in the ultimate division if a proportional partial distribution was made to each beneficiary entitled to a share of the estate. Absent this simple state of affairs, however, the partial distribution may be handled as follows:

(1) The schedule of distribution may be prepared as though no partial distribution had been made and as though the assets were still on hand. After the distributable shares of the various beneficiaries are determined, the partial distribution may be charged against the share of the beneficiary who received it.

(2) If a formula clause marital deduction bequest is involved, the numerator or denominator of the fraction may be adjusted, depending upon the recipient of the partial distribution, by removing therefrom the distributed asset at its federal estate tax value.[50] For example, if a distribution has been made to the spouse, the numerator of the fraction may be reduced by the federal estate tax value of the distributed asset so that the spouse thereafter will receive a smaller percentage of the assets available for distribution.

Funding of Formula Marital Deduction Gifts

The funding of formula marital deduction gifts presents comparable difficulties. The numerator of a formula fraction is relatively simple to determine. It may be calculated from the federal estate tax return

48. Throughout this discussion it is assumed that the objective is the establishment of the marital and non-marital shares insofar as is possible in the same form such shares would have taken had the division been accomplished before the payment of death taxes or other obligations chargeable exclusively to one share. This approach seems necessary to avoid differences in result occasioned solely by the time of the payment of certain obligations, either before or after the division of assets.

49. One can only shudder at the complexities which will arise if Revenue Procedure 64-19 is literally construed to require that each *partial* distribution reflect a proportionate share of the appreciation or depreciation then existing in the assets available for distribution. If so construed, each partial distribution will require a valuation of the entire estate and the correlation of partial distributions to the final distribution may be a hopeless task.

50. If a pecuniary gift is to be satisfied by allocation at current values, the partial distribution, of course, is charged to the marital gift directly at current values.

as audited. The denominator, however, is not determined so simply. Testamentary instruments frequently either contain no definitions of the term or refer to it generally as "the residue", thus there is usually no help in this respect. Theoretically, the denominator may be determined from the federal estate tax return as audited, the will or trust agreement, and death tax receipts. These documents provide one with the gross estate as determined for tax purposes and with all exclusions therefrom necessary to calculate the residue. However, if realized profits or losses and capital gains taxes incurred by sales activity undertaken to meet death tax obligations are to be attributed to the non-marital trust, the denominator is more accurately developed from the federal estate tax values of the assets available for distribution. This is best illustrated by example. Assume that the will provides for a fractional formula marital deduction trust. The adjusted gross estate is determined to be $200,000 and no assets pass to the spouse other than under the formula gift. Death taxes amount to $20,000. The assets of the estate double in value before sales are made to meet death tax obligations. Consequently, assets having a current value of $20,000 but a federal estate tax value of $10,000 are sold, and the remaining assets have a current value of $380,000. Again, it is clear that the marital trust at death is entitled to $100,000 which subsequently appreciates in value to $200,000. The fraction developed from the tax return and other documents is $100,000 divided by $180,000 or 5/9.[51] If this fraction is applied to the assets available for distribution, valued at $380,000, the marital trust will receive $211,111, or an amount in excess of the $200,000 known to be correct. On the other hand, if the denominator is determined from the federal estate tax values of the assets on hand ($380,000 of assets which have a tax value of $190,000), the fraction is 10/19, and the application of this fraction results in the distribution of $200,000 to the marital trust.[52]

Problems Involving Distributions of Income

The Internal Revenue Code requires that the spouse be paid *all* the income from a marital deduction transfer in trust.[53] The calculation of the income due the spouse, however, is often a highly uncertain venture. Virtually no case law exists to point the way and consequently divisions

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51. The numerator is one-half of the adjusted gross estate of $200,000 and the denominator consists of the adjusted gross estate of $200,000 less death taxes in the amount of $20,000.

52. For the sake of simplifying the example, it has been assumed that no capital gains tax was payable by reason of the sale. The numerator and denominator may be required to be adjusted for a variety of transactions referable solely to one share or the other. The details of such adjustments are beyond the scope of this paper.

53. Code § 2056(b)(5).

of income have been made largely upon the basis of the fiduciary's sense of fairness. This has not prevented a considerable divergence of views.

When a division of income from a trust must be made between the spouse and other beneficiaries, the trustee may wish to simplify his accounting problems by dividing the trust into marital and non-marital shares as soon after death as is practicable. Fortunately, the Internal Revenue Service has ruled that the division of trust assets into shares "for the purpose of facilitating the payment of the income to the life beneficiaries" will not be considered a distribution which will "freeze" valuations for alternate valuation purposes.[54] However, the ruling defines a distribution as being, *inter alia,* the segregation or separation of property from an estate or trust in such manner that the property becomes unqualifiedly subject to the demand of the distributee. If the surviving spouse is given the right to withdraw principal from the marital trust upon request, a division of trust assets would appear to constitute a "distribution" as defined by the ruling, regardless of the reason for the division. It is not clear whether the "distribution" would be held to encompass only the allocation of assets to the marital trust, or would include an allocation to the non-marital trust as well. In either event it is hoped that further clarification will be forthcoming from the Internal Revenue Service on this matter.

Income During Period of Administration

If a will provides for a formula marital deduction gift, an initial determination must be made as to whether the spouse is entitled to income during the period of administration of the estate. If the formula gift is fractional in nature, the spouse is in effect an owner of a percentage of the assets of the estate and is clearly entitled to a percentage of the income earned by estate assets. If the formula gift is in trust, the spouse is entitled to income during the period of administration regardless of whether the gift is pecuniary or fractional in nature.[55] The presumed intention of the testator is that the life beneficiary is to receive income from the date of death regardless of any delay in physically establishing the trust. However, if the formula gift is an outright pecuniary bequest, existing case authority holds that the bequest constitutes a general legacy and that the spouse is entitled at most to a statutory interest upon such legacy.[56] No court has as yet been willing to regard

54. Rev. Rul. 57-495, 1957-2 CUM. BULL. 616.

55. Davidson v. Miners & Mechanics Sav. & Trust Co., 129 Ohio St. 418, 195 N.E. 845 (1935); 3 SCOTT, *op. cit. supra* note 20, §§ 234, 234.2.

56. King v. Citizens & So. Nat'l Bank, 103 So. 2d 689 (Fla. Dist. Ct. App. 1958); In the Matter of the Estate of McTarnahan, 27 Misc. 2d 13, 202 N.Y.S.2d 618 (Surr. Ct. 1960); *In re* Levy's Estate, 9 Misc. 2d 561, 167 N.Y.S. 2d 16 (Surr. Ct. 1957) OHIO REV. CODE § 2113.531 (Supp. 1964) provides that general legacies shall bear no interest unless specifically provided in the will.

the bequest as a new form of testamentary disposition and to abandon common law precepts in determining the income question.

Methods of Apportioning Income

In the absence of a reliable body of case law, fiduciaries have adopted a number of methods of apportioning income between marital and non-marital trusts. These methods are best illustrated by the following example. An estate valued at $200,000 is distributable one-half to the marital trust and one-half to the non-marital trust. Death taxes, determined to be $20,000, are chargeable to the non-marital trust. Income during the period of administration is $9,000. Income may be allocated as follows:[57]

Gross share method.—Under this method, the income is apportioned in accordance with fractions established in the will for distribution of principal without regard to death taxes. Hence, $4,500 of income is apportioned to the marital trust and $4,500 to the non-marital trust.[58]

Net share method.—The income is apportioned under this method in accordance with the shares of principal ultimately paid to the two trusts. Inasmuch as the marital trust eventually is entitled to 5/9 of the principal ($100,000 divided by $180,000), it is entitled to 5/9 of the income, or $5,000, and the non-marital trust to 4/9, or $4,000.

Combination method.—Using this method, income is apportioned by the gross share method until death taxes are paid and thereafter by the net share method. Thus, one-half of the income earned prior to the payment of death taxes is allocated to each trust, and thereafter 5/9 of the income is allocated to the marital trust and 4/9 to the residuary trust.[59]

Tracing method.—Under this method, the income earned by assets distributed to the marital trust is calculated and an equivalent amount is allocated to that trust. The balance of the income is allocated to the non-marital trust.

The gross share method is unfair to the spouse inasmuch as it ignores the fact that the spouse is entitled to a larger share of principal after death taxes have been paid. It has the virtue of simplicity. Conversely,

57 It should be noted that Ohio has adopted the so-called "Massachusetts Rule," under which income earned on assets sold to meet estate obligations is to be paid to life tenants, as opposed to the "New York Rule," under which such income is capitalized and added to principal. Holmes v. Hroban, 93 Ohio App. 1, 103 N.E.2d 845 (1952), *aff'd*, 158 Ohio St. 508, 110 N.E.2d 574 (1953)

58. This method has been adopted in the state of New York, partly as the result of statutory interpretation. Matter of Shubert, 10 N.Y.2d 461, 180 N.E.2d 410 (1962); *In re* Estate of Mattes, 12 Misc. 2d 502, 172 N.Y.S.2d 303 (Surr. Ct. 1958)

59. This method was proposed by a New York Surrogate Court in Matter of Meerbaum, N.Y.L.J., Sept. 29, 1961, p. 14 (Surr. Ct. 1961) It was later rejected by the New York Court of Appeals in Matter of Shubert, *supra* note 58.

the net share method is unfair to the other beneficiaries because its effect is to allocate to the spouse income earned on assets sold to pay death taxes which are chargeable to the non-marital share. It also requires that a valuation date be selected to determine the "net shares" of principal, and the result may vary appreciably depending upon which date is selected. The combination method is perhaps the most equitable, but becomes administratively impractical if death taxes are paid in several installments. The tracing method substantially duplicates the equitable result achieved by the combination method and avoids the valuation problem. However, it may also present administrative complexity if there have been substantial sales and reinvestments during the period of administration.[60]

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60. For an excellent discussion of the problems relating to the allocation of income between marital deduction trusts and non-marital trusts, see Committee on Probate and Estate Administration, American Bar Association, *Report*, 102 TRUSTS & ESTATES 916 (1963). The results of the various methods of allocation may be illustrated by an example. Assume that an estate contains 2,000 shares of XYZ Co. stock which is valued at $100 per share and which pays a yearly dividend of $1 per share. The estate is bequeathed one-half to a marital trust and one-half to a residuary trust with death taxes chargeable to the latter. One dividend is paid prior to the payment of death taxes and one dividend is paid after the payment of death taxes. The allocation of income resulting from the various methods of allocation is as follows:

	Marital Trust	*Death Taxes*	*Residuary Trust*
Share of Principal	$100,000	$20,000	$80,000
Income Earned			
Before death tax payment	$ 1,000	$ 200	$ 800
After death tax payment	$ 1,000	$ –0–	$ 800
Allocation of Income			
Gross share method	$ 1,900	–	$ 1,900
Net share method	$ 2,111	–	$ 1,689
Combination method	$ 2,000	–	$ 1,800
Tracing method	$ 2,000	–	$ 1,800