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Current Marital Deduction Problems: An Analysis In Depth

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THE MARITAL DEDUCTION: WHEN AND HOW TO USE IT

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THE STATUTE

Probably the most important single factor in estate planning today, and certainly the most timely tax problem, is the estate tax marital deduction. It is appropriate to begin this analysis of current marital deduction problems with a brief review of the statutory pattern.

In general, the estate tax law allows a deduction subject to certain limitations for the value of interests in property which pass or have passed from the decedent to his surviving spouse, limited to one-half the adjusted gross estate.[1] A very important exception to that general rule, however, is the terminable interest exception under which certain interests passing to the wife will not qualify for the deduction.[2] The terminable interest rule, in its most common application, is a two-legged rule. If the interest passing to the wife is a terminable interest,[3] *and* if an interest in the same property passes or has passed to someone other than the wife or her estate for less than an adequate and full consideration, and such other person may enjoy the property upon termination of the wife's interest, then no deduction is allowed for the interest passing to the wife. Three simple examples illustrating this exception are:

(1) Life estate to wife, remainder to children.
(2) Trust for wife for life, on her death to children.
(3) Insurance under installment option for wife for period certain, amount remaining on her death to be paid to children.

In each of these cases, the interest passing to the wife is disqualified under the terminable interest exception.[4]

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1. INT. REV. CODE OF 1954, § 2056(a), (c) [hereinafter cited as CODE §]. The deduction is allowable in the estate of the first spouse to die. For convenience in this article, reference will generally be made to the marital deduction in the husband's estate for property passing to the surviving wife.

2. CODE § 2056(b).

3. A terminable interest is "an interest which will terminate or fail on the lapse of time or on the occurrence or failure to occur of some contingency." Treas. Reg. § 20.2056(b)-1(b) (1958) [hereinafter cited as Reg. §].

4. Two other facets of the terminable interest rule not to be overlooked are:
a. If a terminable interest is to be acquired for the surviving spouse pursuant to direc-

The statute, however, spells out three exceptions to the terminable interest exception — three "exceptions to the exception." The first is the common disaster exception.[5] It is possible, for example, to condition the wife's interest on her not dying within a specified period not to exceed six months after the husband's death. The second exception to the exception is the life estate with power of appointment.[6] It is under this exception that the power of appointment marital deduction trust is customarily drawn. The third exception to the exception relates to life insurance proceeds under interest or installment option with the power of appointment in the wife.[7]

In addition to the power of appointment arrangements, however, there is another arrangement for avoiding the terminable interest rule that is often overlooked. This is the so-called "estate" arrangement.[8] Suppose, for example, that a substantial proportion of a client's estate consists of stock of the family corporation and it is unproductive of income; it is wished to place the stock in a marital deduction trust for the wife without incurring any risk of the trustee having to sell the stock to generate income for the wife. Under these circumstances one may be reluctant — indeed it may be difficult — to use the power of appointment trust. Nevertheless, that family corporation stock might be placed in a trust qualifying for the marital deduction. In the trust provisions it would be required that the property be held for the wife during her lifetime; it is possible if desired to give the trustee discretion to distribute income if there be income; and it would be provided that on the wife's death the assets remaining in the trust shall pass to her estate.

Three examples of estate arrangements qualifying for the marital deduction are:

(1) Trust income payable to W for life; upon her death the corpus is distributable to her estate.
(2) Trust income to be accumulated for a term of years or for W's life, the augmented fund to be paid to W or her estate.
(3) Insurance payable in installments to W for life; after her death any remaining installments are payable to her estate.

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tions of the decedent, by his executor or by the trustee of a trust, then no deduction is allowed with respect to such interest. CODE § 2056(b)(1)

b. Where the assets in the estate out of which the legacy to the spouse may be satisfied *include* terminable interests for which no deduction would be allowed if such assets passed from the decedent to the spouse, then the value of the interest passing to the spouse shall for marital deduction purposes be reduced by the value of such terminable interests. CODE § 2056(b)(2). To avoid this pitfall it is desirable to require the executor to satisfy the marital deduction legacy only out of assets (or the proceeds of sale of assets) which qualify for the deduction. See 1 CASNER, ESTATE PLANNING 835 (3d ed. 1961).

5. CODE § 2056(b)(3).
6. CODE § 2056(b)(5).
7. CODE § 2056(b)(6).
8. See Commissioner v. Estate of Ellis, 252 F.2d 109 (3d Cir. 1958); Reg. § 20.2056(e)(2)(b) (1958); 1 CASNER, *op. cit. supra* note 4, at 840, 868.

Under such arrangements, all interests in the property are in the wife or her estate, and accordingly the terminable interest rule does not apply. There is therefore no requirement of mandatory distributions of income to the wife. Thus, it is incumbent on the attorney not to overlook the estate arrangement for qualifying property for the marital deduction.

When to Use the Marital Deduction

The question of when to use the marital deduction will turn on many factors, but the most important will usually be the tax factor. By way of illustration, let us take two simple examples, the first illustrating the tax results where the husband's estate is substantially greater than the wife's, and the second illustrating the tax results where the two estates are equal in size. In each case it will be assumed that the husband predeceases the wife; it will be further assumed first that no marital deduction is taken in the husband's estate, and second that the maximum marital deduction is taken in his estate. The anticipated tax results[9] in the first case may be illustrated as follows:

Estate:	
H's adjusted gross estate	$200,000
W's adjusted gross estate	0
First assumption: (no marital deduction)	
H's adjusted gross estate	$200,000
Marital deduction	0
Taxable estate (before deducting exemption)	$200,000
Estate tax	32,700
W's estate tax	0
Aggregate estate tax on H's and W's estates	$ 32,700
Second assumption: (maximum marital deduction)	
H's adjusted gross estate	$200,000
Marital deduction	100,000
Taxable estate (before deducting exemption)	$100,000
Estate tax	4,800
W's estate tax (on $100,000)	4,800
Aggregate estate tax on H's and W's estates	$ 9,600
Minimum saving ($9,600 vs. $32,700)	$ 23,100

9. The Ohio inheritance tax is ignored for simplicity, for when it is taken into account the over-all picture is substantially the same.

The foregoing example indicates that in this situation, *i.e.*, where the husband has a substantial estate and the wife has no estate of her own, use of the maximum marital deduction will reduce the estate tax on the husband's prior death from a tax of $32,700, if no marital deduction is used, to a tax of $4,800 if the maximum marital deduction is availed of; this results in a savings on the husband's death of approximately $28,000. Viewing the husband's and wife's estates in the aggregate, use of the maximum marital deduction has resulted in reducing the estate taxes on the two estates from $32,700 to approximately $9,600, with an over-all saving of $23,000. In brief, those are the principal "dollars and cents" considerations in the use of the marital deduction — the lower estate tax on the estate of the spouse first to die and the lower over-all estate tax on the two estates.

In attempting to assure those tax savings, it is important to make certain that the marital deduction will be allowed if at all possible. This requires that consideration be given to section 2105.21 of the Ohio Revised Code which provides in part that if the spouse does not survive the decedent by thirty days she will be deemed to have predeceased him. In the above example, the attorney will wish to provide in the husband's will that the statute shall be inapplicable, and that if the wife in fact survives the husband by any period of time she will be recognized as having survived. Indeed, the attorney may go further and provide in the husband's will that if there is no proof of the order in which the deaths of the husband and wife occur, the wife will be presumed to have survived. The regulations[10] recognize that if the wife or her estate takes as a result of such a presumption, the marital deduction will be allowed. However, in this situation where the husband has a substantial estate and the wife has no property, it is important to recognize that the wife may predecease the husband. In that event, the husband's marital deduction will be lost unless he remarries, and the wife's $60,000 federal estate tax exemption[11] will be "wasted." If the husband's estate is $200,000 on his later death, his estate tax will be approximately $32,700.

To avoid such an increase in estate taxes in the event the wife should predecease the husband, the attorney should consider not only what marital deduction provisions should be made in favor of the wife, but also what gifts should be made by the husband to the wife during their lifetimes. If, for example, the husband gives the wife $60,000 of property during their lifetimes, then the property so given may be free from estate tax on the husband's death even though his wife has predeceased him;[12]

10. Reg. § 20.2056(e)-2(e) (1958)

11. CODE § 2052.

12. This assumes, of course, that the lifetime transfers by the husband will not be includible in his gross estate for estate tax purposes on the grounds that the transfers were in contemplation of death, or that the husband retained an interest in the property. CODE §§ 2035-38.

and if the wife has predeceased the husband the $60,000 owned by her will be exempt from estate tax in her estate under the federal estate tax exemption.

In the second case, involving equal estates of the husband and the wife (making the same assumptions as were mentioned above), the tax results may be illustrated as follows:

Estate:	
H's adjusted gross estate	$200,000
W's adjusted gross estate	200,000
First assumption: (no marital deduction)	
H's adjusted gross estate	$200,000
Marital deduction	0
Taxable estate (before deducting exemption)	$200,000
Estate tax	32,700
W's estate tax (on $200,000)	$ 32,700
Aggregate estate tax on H's and W's estates	$ 65,400
Second assumption: (maximum marital deduction)	
H's adjusted gross estate	$200,000
Marital deduction	100,000
Taxable estate (before deducting exemption)	$100,000
Estate tax	4,800
W's estate tax (on $300,000)	62,700
Aggregate estate tax on H's and W's estates	$ 67,500
Indicated loss from marital deduction ($67,500 vs. $65,400)	$ 2,100

The foregoing figures indicate that under these assumptions, if the husband predeceases his wife and if the maximum marital deduction is taken in the husband's estate, his estate tax is $4,800 compared with $32,700 if no marital deduction had been taken. Thus, the use of the maximum marital deduction has resulted in the saving of approximately $28,000 in estate taxes on the husband's prior death. The aggregate estate tax on the husband's and wife's two estates, however, is increased from $65,400 to $67,500, resulting in an indicated estate tax loss on the two estates, from the use of the marital deduction, of approximately $2,000. That indicated loss is misleading, however, because it fails to take into account several important factors. First, the estate tax saving of $28,000 on the husband's death is a "bird in the hand." Moreover, it reduces the cash demands at that time. Second, that $28,000 initial saving, if invested, will generate income during the wife's remaining lifetime. That additional income must be considered as a benefit of having taken the marital deduction in the husband's estate. Third, if the marital deduction property, having escaped estate tax in the husband's estate by reason of the deduction, is consumed or given away by the wife during her lifetime, then such property will not increase her estate tax on her later death, and the initial saving of $28,000 on the husband's death will have become an over-all saving. The case of *Isaac Harter*[13] is clear authority that even though the spouse intended all along to give the marital deduction property away, and does so, this will not jeopardize the marital deduction.

Where the estates of the husband and the wife are both substantial, however, the marital deduction generally will not be desired in the estate of the first to die if the other spouse were to survive by only a short period of time. The reason is that if this were to happen, then the survivor probably would not have the opportunity to benefit from the initial estate tax saving, or to consume or give away the marital deduction gift. Accordingly, where the estates of both spouses are substantial, it will generally be desirable to provide that the marital deduction gift will operate only if the spouse survives by a specified period of time not to exceed six months.[14]

DESCRIBING THE QUANTUM OF THE ESTATE TAX MARITAL DEDUCTION GIFT

Assuming that it would be desirable to take advantage of the maximum marital deduction, the next question is: how should the marital deduction gift be described? To minimize death taxes, it would be desirable to give the wife one-half of the adjusted gross estate, no more and no less. No less because it has been decided to obtain the maximum marital deduction. No more, because to the extent that the wife is given more than one-half of the husband's adjusted gross estate, such excess is not deductible in the husband's estate and accordingly generates estate tax in his estate; in addition, such excess, if retained by the wife, will generate estate tax in her estate as well. Thus, to the extent that more than one-half the husband's adjusted gross estate is given to the wife, such excess generates a needless double tax.

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13. 39 T.C. 511 (1962), *acq.*, 1963 INT. REV. BULL. No. 34, at 6.
14. CODE § 2056(b)(3).

Formula Marital Deduction Clause

The question now arises as to how best to accomplish this objective of giving the wife exactly one-half of the husband's adjusted gross estate. The only way to accomplish this is through the use of a formula.[15] This of course is the reason that the formula marital deduction clause has been and will continue to be used. The question that remains, however, is what kind of a formula should be used. Basically, the attorney has two different types of formula clauses from which to choose: the pecuniary formula, and the fractional share formula. An example of a pecuniary formula suggested by Professor A. James Casner appears in his treatise on estate planning.[16]

Pecuniary Formula.—The distinguishing language of such a pecuniary formula is that it gives the wife "an amount" equal to the maximum estate tax marital deduction, minus the value of assets passing otherwise than under this clause which qualify for the deduction.[17] Thus, the pecuniary formula creates a legacy or claim in a dollar amount, which is a fixed charge against the residue. The claim does not participate in appreciation or depreciation of the value of assets in the residue.

A legacy of a pecuniary amount may be satisfied by a distribution of property in kind if the will permits. Any property distributed in kind will be valued for this purpose at its value at the date of distribution, unless the will otherwise provides. This, however, presents a potential income tax problem — a capital gain problem. If a claim, in a dollar amount, is satisfied by an executor with property in kind, then there has been a sale or exchange.[18] For example, the executor may have distributed General Motors stock in satisfaction of the pecuniary claim of the wife. In that case the executor has given up the General Motors stock and in exchange has received the satisfaction of the estate's pecuniary debt to the wife. If the wife's pecuniary claim aggregates $100,000 and if the General Motors stock transferred to her had a basis to the estate of $80,000[19] (such stock having appreciated to a value of $100,000 at the date of distribution), then the estate has realized a capital gain of $20,000 on the exchange.[20]

15. The marital deduction provision, including the formula clause, may be in the will, or it may be in a trust agreement. For purposes of this discussion it will be assumed that the provision is to be made in the will.

16. CASNER, ESTATE PLANNING 305 (Supp. 1964).

17. For an example of basic pecuniary formula language see Sugarman, *"Pecuniary Formula" Marital Deduction Bequests: Application of Revenue Procedure 64-19*, 16 W RES. L. REV. 276 (1965).

18. Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940); Suisman v. Eaton, 15 F. Supp. 113 (D.C. Conn. 1935), *aff'd sub nom.*, Suisman v. Hartford-Connecticut Trust Co., 83 F.2d 1019 (2d Cir.), *cert. denied*, 299 U.S. 573 (1936).

19. CODE § 1014.

20. Rev. Rul. 60-87, 1960-1 CUM. BULL. 286; Rev. Rul. 56-270, 1956-1 CUM. BULL. 325.

Largely to avoid that problem, many practitioners have modified the pecuniary formula clause to provide that property distributed in kind in payment of the formula pecuniary legacy shall be transferred at its estate tax value. It is this type of clause that has given rise to Revenue Procedure 64-19[21]

Fractional Share Formula.—An alternative type of formula marital deduction clause is the fractional share provision. An example of a formula fractional share clause appears in Professor Casner's work on estate planning.[22] The distinguishing feature of this provision is that it gives the wife a "fractional share" of the residue or other fund to which the fraction relates. It does not describe a fixed dollar amount. The fraction which it describes will participate in appreciation or depreciation of the residue or other fund.

Thus, in Professor Casner's suggested fractional share clause it is provided that the wife is given "the following described fractional share" of the residuary estate. In arriving at the fraction, it is necessary to compute the numerator, which will be the maximum marital deduction figure minus the value of assets passing otherwise than under this clause which qualify for the deduction, and the denominator, which will be the value of the residue or other fund to which the fraction relates, at estate tax values.

An alternative method of describing the marital deduction fractional share is to describe such a fraction of the residue "as will afford my estate the maximum marital deduction." This type of provision will require the same computation of a numerator and a denominator.

If, for example, the fraction resulting from the formula is 3/8, then the wife will be entitled to 3/8 of the residue. At the date of distribution the executor will value the residue, and will give the wife her 3/8 share. Thereafter she has no further interest in the residue; the balance of the residue will go to the other beneficiaries. If the executor makes a partial distribution, such as 1/4, then the wife will continue to have a fractional interest in the residue, albeit a reduced fraction recomputed to reflect the partial distribution.

If, as is commonly the case, the will authorizes the executor to make distribution of assets in kind, he of course can do so. In addition, the attorney who drafts the will can clearly authorize the executor to allocate particular assets to particular shares.[23] There can be no question that such

21. 1964 INT. REV. BULL. NO. 15, at 30. For a discussion of this subject see pp. 257-76 of this *Symposium*.

22. CASNER, *op. cit. supra* note 16, at 308. A reprint of Professor Casner's example of a fractional share formula clause appears in Sugarman, *supra* note 17, at 277

23. For an example of the form of such authorization see Sugarman, *supra* note 17, at 279.

an authorization will be given effect. Pursuant to such authority to allocate specific assets to particular shares, the executor can select and allocate to the wife certain assets and/or cash equal in value to the value of her fraction of the residue at the date of distribution; he would have no duty to give her a fraction of each asset. Indeed, in *In the Matter of Fiedler's Estate*,[24] the New Jersey Superior Court held that the executor could allocate specific assets to the separate shares of the residue under a simple authorization to distribute assets in kind.

One further question to be considered here is whether, when the executor allocates certain assets to the marital deduction share and other assets to the nonmarital share, he is creating a dollar claim in favor of the wife, and whether the estate realizes a capital gain if the property distributed in kind to the wife has appreciated in value. One decision and two rulings on this point seem to indicate clearly that no dollar claim is being created or satisfied in this situation, and that there is no capital gain.[25] There appears to be no authority to the contrary.[26]

In Revenue Ruling 55-117,[27] the Commissioner considered the situation where the trustee of a trust was to distribute ¼ of the corpus to the beneficiary when she attained age 21 — a common situation which attorneys and trust officers meet frequently in trust administration. The trustee proposed to give the beneficiary not ¼ of each asset, but selected assets having a value equal to ¼ of the trust corpus. The Commissioner, citing Office Decision 667,[28] ruled that the proposed distribution was not in satisfaction of an obligation of the trust for a definite amount, but was in the nature of a distribution of a share of the trust principal. Therefore there was no sale or exchange, and no capital gain. The 1920 ruling and the *M. L. Long*[29] case both involved divisions of an estate by an executor and both applied the same principles. Thus it seems clear that where a non-pro rata division in satisfaction of a fractional share gift is made by the executor pursuant to authority contained in the will, there will be no sale or exchange and no danger of capital gain.

The remaining question respecting the formula fractional share gift is: what is its estate tax status in the light of Revenue Procedure 64-19?[30] The answer is that Revenue Procedure 64-19 applies only to formula pecuniary gifts; by its express terms it is inapplicable to the formula

24. 55 N.J. Super. 500, 151 A.2d 201 (App. Div. 1959).

25. M. L. Long, 35 B.T.A. 95 (1936); Office Decision 667, 3 CUM. BULL. 52 (1920); Rev. Rul. 55-117, 1955-1 CUM. BULL. 233.

26. *Cf.* 1 CASNER, *op. cit. supra* note 4, at 806.

27. 1955-1 CUM. BULL. 233.

28. 3 CUM. BULL. 52 (1920).

29. 35 B.T.A. 95 (1936).

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

fractional share gift.[31] Thus, the qualification of the formula fractional share gift for the estate tax marital deduction has not been questioned.

SUMMARY

To recapitulate briefly, the estate tax law allows a deduction, subject to certain limitations, for the value of interests in property which pass or have passed from the decedent to his surviving spouse, limited to one-half the adjusted gross estate. The terminable interest rule is an exception to the general rule; under the terminable interest exception no deduction is allowed for certain interests passing to the spouse.

There are three exceptions to the terminable interest exception: (1) the common disaster exception; (2) the life estate with power of appointment exception; and (3) the insurance with power of appointment exception. In addition, the attorney should not overlook the estate arrangement for avoiding the terminable interest rule.

The question of when to use the marital deduction will be decided largely by an appraisal of the mathematics of the estate tax savings resulting from the use of the deduction. If it is decided to use the maximum marital deduction, then it will ordinarily be desirable to describe the quantum of the marital deduction gift by a formula. A formula can be used to describe a pecuniary gift; or a formula can be used to describe a fractional share.

With the formula pecuniary gift language there are also capital gain questions to consider if distributions in kind are to be made at distribution date values. If distributions in kind are to be made at estate tax values, Revenue Procedure 64-19 raises the question whether the legacy will qualify for the marital deduction. With the formula fractional share gift, the capital gain problem is avoided; no question is presented of the gift qualifying for the marital deduction, and the wife will participate in any appreciation or depreciation of the value of assets occurring prior to the date of distribution.

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31. Rev. Proc. 64-19, § 4.01(1), 1964 INT. REV. No. 15, at 30.