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MARITAL DEDUCTION PITFALLS — METHODS OF LOSING THE MARITAL DEDUCTION

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Of the three learned professions, the lawyer should be most aware of the axiom that the chains he forges in life are the ones that bind his clients in death. This is especially true for the attorney who would venture into the area of the marital deduction. This article will not discuss the use of the marital deduction, but rather its misuse, *i.e.*, marital deduction pitfalls under the 1954 Internal Revenue Code. Further, the discussion in this article will be limited to marital deduction pitfalls and drafting problems in the following areas: (1) terminable interests; (2) tax clauses; and (3) certain administrative provisions.

TERMINABLE INTERESTS

The greatest pitfall and most prolific cause of marital deduction litigation is the so-called "terminable interest." In defining terminable interest, the code and Treasury Regulations state that no marital deduction is allowed with respect to property interests which will terminate on the lapse of time, or on the occurrence or failure to occur of some contingency.[1] The code makes three exceptions to the nondeductible terminable interest rule. These exceptions, when not used with care, may prove to be formidable obstacles to attorneys who would have their clients reap the tax harvest of the marital deduction. These exceptions may be designated as: (1) the survivorship exception,[2] (2) the life estate power of appointment exception,[3] and (3) the insurance exception.[4]

Survivorship Exception

The survivorship exception to the terminable interest rule provides that the interest passing to a surviving spouse will not be a nondeductible interest because it is conditioned upon her surviving the decedent by not more than six months, or dying as a result of a common disaster which results in the death of the decedent, or both, provided that, as a matter of fact, the surviving spouse does not die within the prescribed period or as a result of a common disaster.[5] The problem in this exception to the

1. INT. REV. CODE OF 1954, § 2056(b) (1) [hereinafter cited as CODE §].
2. CODE § 2056(b) (3).
3. CODE § 2056(b) (5).
4. CODE § 2056(b) (6).
5. Treas. Reg. § 20.2056(b)-3 (1958) [hereinafter cited as Reg. §].

terminable interest rule is most often created by the legal draftsman who strays from the language set forth in the code and regulations in designating the limited period of survival. Usually, the draftsman decides to substitute his own ingenuity for the language of the code and regulations. Such survivorship conditions as "to my wife if living at the time of the distribution of my estate,"[6] or "to my spouse if she survives the administration of my estate"[7] have often led to unwanted federal estate tax results. In the recent case of *Bookwalter v Lamar*,[8] the decedent left everything to his wife provided she survived the administration of his estate. Clearly, the completion of the administration of an estate can take more than six months, as viewed at the moment of the testator's death. It is well established that unless the widow's indefeasible interest vests at the moment of the testator's death, the marital deduction is not available. The district court found the will to be ambiguous and stated that local law favors early vesting thereby making the marital deduction available. However, the Eighth Circuit Court of Appeals, also applying local law, held that the conditional disposition created a terminable interest within the meaning of the 1954 Code, thereby defeating the right to the marital deduction. The court was probably influenced by the earlier decision of *United States v Mappes*[9] in which the fatal clause was: "in the event that my wife should die before my estate has been administered. " The Tenth Circuit held in the *Mappes* case that under state law the marital deduction was lost. Thus, the important point to remember is that courts are not concerned with what *actually* happens, but what *could* happen!

The survivorship exception to the terminable interest rule also has certain ramifications where insurance is involved. If the payment of insurance proceeds to the surviving spouse is conditioned upon her being alive upon receipt by the insurer of proof of the insured's death, the settlement arrangement with respect to such insurance proceeds will not qualify for the marital deduction. In this situation, the survivorship exception to the terminable interest rule is not applicable because submission of due proof of the insured's death may or may not occur within the six month period or thereafter.[10] Thus, with respect to survivorship clauses, whether in wills, trusts, or insurance contracts, the attorney should religiously follow the requirements of section 2056(b)(3) of the code, namely, that the limited survival period must not exceed six months.

6. Kasper v. Kellar, 217 F.2d 744, 746 (8th Cir. 1954); Farrell v. United States, 198 F. Supp. 461 (S.D. Cal. 1961); Steele v. United States, 146 F. Supp. 316 (D. Mont. 1956).

7 United States v. Mappes, 318 F.2d 508 (10th Cir. 1963).

8. 323 F.2d 644 (8th Cir. 1963), *cert. denied*, 376 U.S. 969 (1964)

9. United States v. Mappes, 318 F.2d 508 (10th Cir. 1963).

10. Rev. Rul. 54-121, 1954-1 CUM. BULL. 196, 197

Life Estate Power of Appointment Exception

The second exception to the terminable interest rule is the life estate with a power of appointment in the surviving spouse which is exercisable by her alone and in all events.[11] Trouble usually arises in this area when the draftsman attempts to add or detract from the conditions set forth in the code and regulations, or from the application of state law on the standard set in the will or trust for invasion of principal.[12] Typical situations are where the testator leaves his entire estate in trust for his spouse for life, remainder to others, with an unlimited power in the spouse to use the principal of the trust for her comfort, health, and happiness;[13] or where the testator gives his spouse a legal life estate in land to sell as she deems it to be in her best interest.[14] Taxpayers have claimed that the wife's life estate, coupled with a power to consume, qualified the estate for the marital deduction. On the other hand, the Internal Revenue Service claims that such interests are terminable, and do not qualify for the marital deduction because what the spouse fails to consume during her life passes on her death to the remaindermen. The most perplexing cases occur where the power of invasion in the surviving spouse is so broad that it appears to be an unlimited power to invade which, of course, would qualify for the marital deduction. But, these cases have failed to qualify for several reasons. Some courts have said that the surviving spouse had no power to deal with property remaining at her death,[15] while other courts have held that application of local law cuts back the spouse's apparently "unlimited power" by imposing a standard for consuming the property which thereby creates a terminable interest.[16]

In *Estate of Tarver v. Commissioner*,[17] the decedent's spouse was given the right to receive portions of the principal as and when she may demand for her use and/or the use or benefit of her children as she deems advisable. This certainly would appear to be an unlimited power of invasion. However, the court held that under applicable state law the surviving spouse was not given an unlimited right to invade the corpus; thus, the trust did not qualify for the marital deduction. Again in *Estate of Pipe v. Commissioner*,[18] the court considered a situation

11. CODE § 2056(b)(5).

12. Reg. § 20.2056(b)-5 (1958).

13. United States v. Lincoln Rochester Trust Co., 297 F.2d 891 (2d Cir.), *cert. denied*, 369 U.S. 887 (1962); Estate of Tarver v. Commissioner, 255 F.2d 913 (4th Cir. 1958); Piatt v. Gray, 201 F. Supp. 401 (W.D. Ky. 1961), *aff'd*, 321 F.2d 79 (6th Cir. 1963).

14. Estate of Pipe v. Commissioner, 241 F.2d 210 (2d Cir.), *cert. denied*, 355 U.S. 814 (1957); Geyer v. Bookwalter, 193 F. Supp. 57 (W.D. Mo. 1961).

15. Estate of Ralph G. May, 32 T.C. 386 (1959), *aff'd*, 283 F.2d 853 (2d Cir. 1960).

16. See note 14 *supra*.

17. 255 F.2d 913 (4th Cir. 1958).

18. 241 F.2d 210 (2d Cir.), *cert. denied*, 355 U.S. 814 (1957)

where a legal life interest was given to the decedent's wife with an unlimited power to consume principal. The court held that a power to consume was not an unlimited power to invade because the surviving spouse had no power to deal with any unconsumed property. The court pointed out that the wife could not appoint the principal to herself or to her estate because as long as any of the principal of the estate remained, it was to pass to the named remainderman.

In *Estate of Field*,[19] which was decided under Ohio law, the decedent left his residuary estate in trust for his surviving spouse with all of the net income payable to her for life and with a power to consume the entire estate for any purposes. Remaindermen were named to take any unconsumed property The executor asked the local probate court for a construction of the will; the court held that the surviving spouse had an unrestricted power to dispose of the property which was exercisable by her alone and in all events. However, the Tax Court held that because of elaborate dispositive provisions relating to property that was not consumed by the surviving spouse, a general power of appointment was *not* created and the surviving spouse's interest was a terminable one.

The only ray of hope for the taxpayer seems to be embodied in about three or four cases. For example, in *Hoffman v McGinnis*,[20] decided in 1960, the decedent created a testamentary trust which provided that his surviving spouse be given income for her life and "the right to use and spend any or all of the principal of my said estate as she so desires", then the draftsman provided a new wrinkle and said that the trust was to terminate "as to that part of the principal so paid to her." The court held that the language of the will gave the surviving spouse a power to appoint principal to herself and free of trust, a power which was exercisable in all events. Thus, it can be easily seen that the draftsman who uses the power of invasion as a method to qualify an interest passing to a surviving spouse for the marital deduction is, to say the least, skating on thin ice.

To avoid this terminable interest pitfall, the attorney has an uncomplicated answer· create a trust for the spouse to pay her all of the net income with a discretionary power over principal in the trustee and a general testamentary power in the surviving spouse to appoint by will any principal that remains to anyone, including her estate, her creditors, and the creditors of her estate with remainder over in default of the exercise of her general testamentary power of appointment. By this change in form, the substance of the testator's wishes can be achieved without sacrificing the marital deduction.

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19. 40 T.C. 802 (1963)
20. 227 F.2d 598 (3d Cir. 1960)

Insurance Exception

The third exception to the nondeductible terminable interest rule is the life insurance and annuity exception.[21] This exception covers the situation where the proceeds of a life insurance or annuity contract are held by the insurer under an agreement by which the surviving spouse is to receive the proceeds in installments, or interest on the proceeds, during her life, and has power to appoint any balance remaining at her death to herself or her estate or withdraw proceeds during her lifetime. This exception gives rise to problems when limitations are placed by the policy upon the surviving spouse's powers to withdraw, or appoint amounts left with the insurers. The Treasury Regulations provide that *formal* limitations upon the surviving spouse to appoint insurance proceeds to herself or her estate will not prevent the power from being exercisable by the surviving spouse in all events.[22] However, in *Estate of Werbe v. United States*,[23] the insurance proceeds were left with the insurer who agreed to pay the surviving spouse the interest on the proceeds for life. In addition, the surviving spouse was given a power to withdraw the amount left with the insurer either in whole or in part, but the insurer placed certain limitations on the manner and time of such withdrawals. In one policy, withdrawals could be made only on interest due dates; no withdrawal less than $100 was permitted, and compliance with the withdrawal request could be deferred for six months after receipt of the request. The court held that the restrictions placed upon the surviving spouse's power to withdraw insurance proceeds went beyond mere formalities for the exercise of the surviving spouse's power, and prevented it from being exercisable in all events; thus, such an arrangement was held to be a terminable interest. However, under a similar fact situation in the *Werbe* case, the Tax Court held that this type of settlement arrangement for insurance proceeds did qualify for the marital deduction, for the limitations placed upon the manner of withdrawal by the spouse were strictly for the administrative convenience of the insurer.[24] The problem of qualifying insurance proceeds for the marital deduction should present no great problem to the attorney. He can and should analyze the policies, giving special attention to pre-1948 policies, to determine those which qualify for the marital deduction using as a guide line the appropriate Treasury Regulations.

Joint and Mutual Wills

Joint and mutual wills are not uncommon in several midwestern states. The typical situation is for the husband and wife to execute a

21. CODE § 2056(b)(6).
22. Reg. § 20.2056(b)-6 (1958).
23. 273 F.2d 201 (7th Cir. 1959).
24. Estate of John J. Cornwell, 37 T.C. 688, 694 (1962).

joint will or mutual wills leaving their entire estates to the survivor and the estate of the survivor to the children. Such wills are held to be contractual in nature, binding the survivor to leave his estate to the children. The questions presented under such an arrangement are usually twofold, namely: (1) whether assets passing under the will of the spouse first to die qualify for the marital deduction;[25] and (2) whether assets passing outside the will qualify for the marital deduction.[26] Differences in state law have led to seemingly conflicting decisions concerning the availability of the marital deduction where husband and wife have entered into joint and mutual wills. The Eighth Circuit Court of Appeals has held that, under Nebraska law, the surviving spouse's interest in property passing under and outside a joint will was terminable by reason of the contractual nature of the joint will, and therefore none of such property qualified for the marital deduction.[27] On the other hand, the same court held that, under Iowa law, the terminable interest rule did not preclude the allowance for the marital deduction with regard to property passing outside the terms of a joint will.[28] *United States v. Spicer*[29] is another example of the importance of state law in the area of joint and mutual wills. In this case, the decedent and his wife were residents of Kansas and held certain property in joint and survivorship form; the decedent also had other property in his own name. In 1952, they executed a joint and contractual will. Aside from certain specific bequests, the will left all the property to the survivor with the right to sell and convey the property At the death of the survivor the property went to the children. The Commissioner denied the marital deduction on the ground that the joint tenancies were severed by the execution of the will and that the surviving spouse had only a life estate without a general power of appointment. The district court allowed the marital deduction for all property that passed to the widow, holding that the joint tenancies had not been severed. In affirming the district court decisions, the Tenth Circuit Court of Appeals held that the surviving spouse had absolute control over the property; therefore, the marital deduction was allowed. This is not to suggest that joint and mutual wills are not proper tools for estate planning should spouses desire to dispose of their estates in that manner; but the hazards of such wills should be taken into consideration, and it is well for the attorney to consider carefully the applicable state law

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25. Nettz v. Phillips, 202 F. Supp. 270 (S.D. Iowa 1962); Estate of Charles Elson, 28 T.C. 442 (1957).

26. Estate of Awtry v. Commissioner, 221 F.2d 749 (8th Cir. 1955).

27 Estate of Peterson v. Commissioner, 299 F.2d 741 (8th Cir.), *reversing* 23 T.C. 1020 (1955).

28. Estate of Awtry v. Commissioner, 221 F.2d 749 (8th Cir. 1955).

29. 332 F.2d 750 (10th Cir. 1964).

TAX CLAUSES

The tax clause, of course, sets out the sources from which federal estate taxes, inheritance taxes, and other succession taxes should be paid. But misuse or lack of a tax clause can create a tax planner's Frankenstein. The regulations state that if death taxes are to be paid from the marital deduction share, the marital deduction is reduced accordingly, thus reducing the federal estate tax benefit.[30] Problems usually arise where the testator leaves a share of his residuary estate to his spouse so as to qualify for the marital deduction, and then either directs that all federal estate taxes be paid out of the residuary estate, or fails to include any tax clause. Problems also arise where the surviving spouse elects against the will. In *Estate of Albert L. Rice*,[31] the decedent, a Massachusetts resident, had created a revocable trust agreement during his lifetime which created a maximum marital deduction trust and a nonmarital trust. The decedent's will "poured over" his probate estate to the trusts. The will contained no tax clause, but the trustee was given *discretion* to pay taxes out of either the marital or nonmarital trusts. The trust estate encompassed most of the decedent's property, and the trustee chose the nonmarital trust as the source of all death taxes, claiming the maximum marital deduction for the estate. The Commissioner, on the other hand, claimed that the marital deduction should be reduced by a share of the death taxes. The Tax Court in sustaining the Commissioner stated that the Massachusetts apportionment statute contains no provision whereby, in the absence of a provision of the will or trust, the marital deduction property is to be relieved from bearing any portion of federal estate taxes, and the fact that the trustee had actually selected the nonmarital trust as the source of payment was of no moment because the trustee could have chosen either as a source of payment.

Tax Apportionment in Ohio

Ohio has no tax apportionment statute; federal taxes are apportioned, in the absence of contrary direction in the will, on equitable principles — but this is questionable. The case of *Campbell v. Lloyd*[32] is the leading case in Ohio on apportionment of federal estate taxes in the absence of a tax clause. In *Campbell,* the widow elected to take against the will and under the statute of descent and distribution. The question presented to the court was: If the spouse elects to take under the law, should the amount of the federal estate tax be deducted from the estate before computing the spouse's share? The Ohio Supreme Court answered in the

30. Reg. § 20.2056(b)-4(c) (1958).
31. 41 T.C. 344 (1963).
32. 162 Ohio St. 203, 122 N.E.2d 695 (1954).

affirmative, stating that the federal estate tax should first be deducted in the same fashion as an administrative expense or other debt, with the surviving spouse taking after the federal estate tax has been deducted from the estate. Thus, the surviving spouse bears her share of the taxes, and the overall tax bill is increased. In Ohio, the principle of apportionment of federal estate taxes has also been carried into the fields of insurance and other nonprobate assets.[33] Thus, it would appear that where the will is silent on the subject of payment of taxes, or the tax clause in the will is too ambiguous to be effective, or the surviving spouse elects to take against the will, the burden of federal estate taxes must fall proportionately on all beneficiaries. However, ominous developments have taken place in the last few months which cast a shadow on these principles. The case of *Union Commerce Bank v Roth*[34] has put a question mark after federal estate tax apportionment in Ohio. In *Roth*, the decedent executed his will in 1957 creating the typical maximum marital deduction trust and a nonmarital trust. Item VIII of the will directed that "all estate, inheritance and succession taxes with respect to any property, whether passing under this will or *otherwise* shall be paid by my executors out of my residuary estate passing under Item IV of this, my Last Will and Testament. " Item IV of the decedent's will created the nonmarital trust. The widow elected to take under the law and against the will, and maintained that her intestate share should not have to bear its proportionate share of federal estate taxes. The court, without referring to the *Campbell* case, held that the widow's election to take under the law and against the will did not destroy the effect of the tax clause in the will since the tax clause was not a provision in the decedent's will which gave a "benefit" to the widow Furthermore, the decedent, by using the tax clause in question, had contemplated that his spouse might elect to take against the will. The court stated that when the decedent used the word *otherwise* in the tax clause, it was clearly contemplated by the decedent that his spouse might elect to take against the will. Therefore, the widow's intestate share was not required to bear its proportionate share of federal estate taxes. Where does this leave the status of Ohio law regarding the apportionment of death taxes? Should the *Roth* case be viewed as a decision which is limited to a particular fact situation? It is true that there was no tax clause in *Campbell v. Lloyd*, but the inconsistencies in these cases may cause attorneys to be somewhat hesitant in advising a surviving spouse of the tax consequences to her if she elects to take against the will. Other jurisdictions have refused to apply the principles of the

33. McDougall v. Central Nat'l Bank, 157 Ohio St. 45, 104 N.E.2d 441 (1952); Foerster v. Foerster, 122 N.E.2d 314 (Ohio P. Ct. 1954)

34. 197 N.E.2d 216 (Ohio Ct. App. 1964)

Roth case,[35] and the federal government may continue, as it has in the past, to apply the legal principles of *Campbell v. Lloyd*.[36]

The *Roth* case will not be appealed, and so a cloak of darkness surrounds apportionment by equitable principles in Ohio. The great lesson to be learned from the *Roth* case is that the draftsman can never adopt an "Alice-in-Wonderland" approach to his trade, because words *do not mean* what you want them to mean; the remedy is the absolute necessity of clearly spelling out in the will or trust where the tax burden is to fall under all possible circumstances.[37]

Administrative Provisions

It is important at this point to discuss a few administrative provisions that could affect the marital deduction. It goes without saying that broad administrative powers add to the flexibility of an inter vivos or testamentary trust, but the draftsman must be aware that too broad a use of a trustee's administrative powers may have unwelcomed federal estate tax consequences. For example, many trust instruments contain a clause which authorizes the trustee to retain property whether productive or nonproductive of income, received from the decedent. The regulations state that where a trust contains such a provision, the retention of unproductive property will not necessarily disqualify it for the marital deduction if the applicable rules for administration of the trust require or permit the surviving spouse to require that the trustee either make the property productive or convert it within a reasonable time.[38]

Nonproductive Assets

The careful draftsman will provide either that the trustee must make nonproductive assets productive, or that the surviving spouse may

35. Merchants Nat'l Bank & Trust Co. v. United States, 246 F.2d 410 (7th Cir.), *cert. denied*, 355 U.S. 881 (1957); Herson v. Mills, 221 F. Supp. 741 (D.D.C. 1963)

36. Estate of Jaeger v. Commissioner, 252 F.2d 790 (6th Cir. 1958).

37. As one possible remedy to the *Roth* type situation, the following tax clause is submitted for the reader's consideration:

> If my said wife does not survive me, I direct that all inheritance, estate, succession and other taxes of a similar nature levied or assessed by reason of my death, together with interest or penalties thereon, if any, whether such taxes be levied or assessed with respect to property passing under this Will or otherwise, be paid by my Executor from my residuary estate. If my said wife survives me and elects to take under this Will, such taxes, interest and penalties shall be paid by my Executor from that fraction of my residuary estate which, pursuant to the provisions of Paragraph ____ hereof, does not qualify for the marital deduction; and I direct that my said Executor shall not be entitled to, nor shall he seek, reimbursement or contribution therefore from any person whomever or any property whatever. If my said wife survives me and elects to take against the provisions of this Will and in lieu thereof under the statute of descent and distribution, such taxes, interest and penalties shall be charged proportionately to all beneficiaries of my estate, whether such beneficiary's interest passed to him by my Will or otherwise or by said election.

38. Reg. § 20.2056(b)-5(f)(4) (1958).

require the trustee to do so. In the case of a large block of non-income producing assets, such as stock in a closely held corporation, the testator may desire that such an asset be retained by the trustee. The regulations provide an answer to such situations by stating that the marital deduction will not be lost even though the trustee cannot be required to make the property productive, if the trustee must invade the corpus for the requisite beneficial enjoyment of the surviving spouse, such as by payments to the surviving spouse out of other assets of the trust.[38] Another special situation to consider is the retention of the family residence for the surviving spouse in the marital deduction trust. This is, of course, non-income producing property, but the regulations provide that the retention of such property by the trustee will not disqualify the trust for the marital deduction.[40] Where the residence is retained for the benefit of the surviving spouse and children of the decedent, there is a risk that it would not qualify for the marital deduction even though the surviving spouse has a legal obligation to support the children.[41] The regulations may provide relief in this situation by implying that a residence which is furnished for a surviving spouse who has a legal obligation to support a child is, in fact, an amount paid to her.[42]

Allocation of Income

Many trusts give the trustee the power to determine what is income or principal and to allocate receipts and disbursements between income and principal. This presents a problem in that it could reduce the income to which the surviving spouse is entitled. The regulations provide that such a power in the trustee, if subject to reasonable limitations, will not disqualify the interest passing in trust for the marital deduction.[43] The question arises, however, as to whether such a power is subject to reasonable limitations. If state statutes or decisions provide a degree of control over such discretionary powers of the trustee, a provision giving the trustee discretion to allocate receipts and disbursements between principal and income should not endanger the marital deduction.

Spendthrift Trusts

Ever since *Sherrow v Brookover*,[44] decided by the Ohio Supreme Court in 1963, the validity of a spendthrift provision in Ohio has been an open question. However, it would appear that the *Sherrow* case did

39. Reg. § 20.2056(b)-5(f)(5) (1958)
40. See note 37 *supra*.
41. Estate of Morton H. Spero, 34 T.C. 1116 (1960)
42. Reg. § 20.2056(b)-5(j) (1958).
43. Reg. § 20.2056(b)-5(f)(2) (1958); Reg. § 20.2056(b)-5(f)(3) (1958).
44. 174 Ohio St. 310, 189 N.E.2d 90 (1963).