Case Western Reserve Law Review

Volume 16 | Issue 2

1965

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THE MARITAL DEDUCTION AND PARTICULAR KINDS OF PROPERTY

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Because of the limitations and restrictions imposed by section 2056 of the 1954 Internal Revenue Code,[1] it is incumbent upon the draftsman to pay particular attention to the specific assets which may be a part of a decedent's estate and to rights which his spouse may have under local law. Some of the problems in connection with particular kinds of property and property rights have been considered previously by commentators;[2] however, recent developments in many of these areas make a review appropriate. Also, this article will discuss problems raised by foreign property and property constituting income with respect to a decedent under section 691.[3]

INTERESTS AND RIGHTS ARISING UNDER STATE LAW

Under the laws of most states, a widow is given a number of rights or interests in property which can materially affect the marital deduction. Among these are support allowance, property exempt from administration, dower and homestead rights, and the right to elect to take an interest under the statute of descent and distribution, rather than under the will.

Widow's Allowance

Generally, a widow's allowance constitutes an award paid to the spouse for her support during a limited period of time after her husband's death. The regulations provide that such an award constitutes a property interest passing from the decedent to his spouse for purposes of section 2056.[4] The same regulation, however, takes the position that the terminable interest rules are applicable. The application of the terminable interest rules to the widow's allowance has been the subject of extensive litigation,[5] and as a result of a conflict between circuit courts of

1. INT. REV. CODE OF 1954 [hereinafter cited as CODE §].

2. Bush, *Widow's Exemption or Allowance and the Marital Deduction*, N.Y.U. 22D INST. ON FED. TAX 1131 (1964); Stevens, *Fourteen Years of Marital Deduction*, N.Y.U. 21ST INST. ON FED. TAX 257 (1963)

3. CODE § 691.

4. Treas. Reg. § 20.2056(e)-2(a) (1958) [hereinafter cited as Reg. §].

5. First Nat'l Bank & Trust Co. v. United States, 297 F.2d 312 (5th Cir. 1961); Estate of Cunha v. Commissioner, 279 F.2d 292 (9th Cir. 1960), *cert. denied*, 364 U.S. 942 (1961); Estate of William A. Landers, Sr., 38 T.C. 828 (1962), Estate of Michael G. Rudnick, 36 T.C. 1021 (1961); Estate of Margaret R. Gale, 35 T.C. 215 (1960); Estate of Proctor D. Rensenhouse, 31 T.C. 818 (1959).

appeals,[6] the issue was presented to the United States Supreme Court for the first time in 1964.[7] The case of *Jackson v. United States*[8] involved an award made to a widow under California law The decedent died on May 27, 1951, and on June 30, 1952, the state court allowed the widow a sum of $3,000 per month for her support for a period of 24 months beginning as of the date of the decedent's death. Under the terms of the order an allowance of $42,000 had accrued during the fourteen months from the time of death to the date of the order. The court awarded an additional $3,000 a month for the remainder of the two-year period, making a total of $72,000 which was in fact paid by the estate to the widow. California law was evidently clear that nothing accrued to the widow until the order granting the allowance. Thus, if the widow were to die or remarry prior to securing an order, the right would not survive. The court found that under these facts the widow did not have an indefeasible interest in the property at the moment of her husband's death. The taxpayer argued that the terminability be adjudged as of the date of the probate court order rather than the date of death. This was the effect of a number of prior lower court decisions.[9] The Court said that this construction was not within the meaning and spirit of the statute.

The petitioners in *Jackson* also argued that the purpose of the terminable interest provision was to assure that interests deducted from the estate of the deceased spouse would not also escape taxation in the estate of the survivor, and since, under the facts there, the entire $72,000 would be taxed to the widow's estate, it should not be included in her husband's estate. The Court answered that the determinative factor was not the taxability to the surviving spouse, but the terminability as defined in the statute; it was the Court's opinion that these provisions might be imperfect devices to achieve the desired end, but that they were the means which Congress had chosen. Justice White, speaking for the Court, added a bit of philosophy which should be taken to heart by all draftsmen.

> The achievement of the purposes of the marital deduction is dependent to a great degree upon the careful drafting of wills; we have no fear that our decision today will prevent either the full utilization of the marital deduction or the proper support of widows during the pendency of an estate proceeding.[10]

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6. *Compare* the decision of the ninth circuit in Estate of Cunha v. Commissioner, *supra* note 5, *with* the decision in the fifth circuit in United States v. First Nat'l Bank & Trust Co., *supra* note 5.

7. Jackson v. United States, 376 U.S. 503 (1964).

8. *Ibid.*

9. United States v. First Nat'l Bank & Trust Co., 297 F.2d 312 (5th Cir. 1961); Estate of Michael G. Rudnick, 36 T.C. 1021 (1961); Estate of Margaret R. Gale, 35 T.C. 215 (1960).

10. Jackson v. United States, 376 U.S. 503, 511 (1964).

The author does not have the same confidence that Justice White has regarding the effect of the *Jackson* decision. It is submitted that practitioners in many states will not be able to clearly determine whether the allowance does or does not, under current local law, qualify for the marital deduction. But if they are fortunate enough to be able to make a clear determination, and if they determine that the allowance will not qualify, then there is great difficulty in achieving the *maximum* marital deduction where a formula approach is used in connection with a trust.[11] It is not possible under such circumstances to treat an amount paid the widow as an allowance as an advance of the gift made to her under the will. Although it may be possible in some states to provide that the interest given the spouse under the will is in lieu of all rights under state law, this may not always be practical.

After *Jackson*, the sole question to be answered is whether the widow's allowance under state law is a right vested in her as of the time of death and one which will survive either her death or her remarriage during the period of the allowance. Prior to *Jackson*, the Government had acquiesced in a number of Tax Court decisions permitting the widow's allowance in, among other states, Michigan,[12] Maine,[13] and Massachusetts.[14] Since *Jackson*, the Government has withdrawn these prior acquiescences and substituted a non-acquiescence in each case.[15] Also, in a fifth circuit decision after *Jackson*, that circuit reversed its prior ruling, holding that under Georgia law the widow's allowance is a terminable interest.[16]

In Ohio, there has never been, to the author's knowledge, any question raised about the widow's allowance qualifying for the marital deduction; nor should that result be changed by the *Jackson* decision. In a 1951 decision, the Ohio Supreme Court clearly held that the right of a widow to a year's allowance vests immediately upon the spouse's death and becomes a preferred and secured debt of the estate. Even though the widow dies within the period of twelve months after the death of her husband and such allowance has not been set off during her lifetime, the allowance must nevertheless be awarded, fixed, and determined on the

11. The effect of *Jackson* is that the marital gift is "overqualified," *i.e.*, too much property passes to the widow and the resulting estate tax on her estate is increased. If the gift to the widow is outright, the problem could be avoided by providing that any allowance paid to the spouse would be treated as an advance of a portion of her gift.

12. Estate of Proctor D. Rensenhouse, 31 T.C. 818 (1959), *acq.*, 1959-1 CUM. BULL. 5, *nonacq.*, 1964 INT. REV. BULL. No. 32, at 7

13. Estate of Margaret R. Gale, 35 T.C. 215 (1960) *acq.*, 1962-2 CUM. BULL. 4, *nonacq.*, 1964 INT. REV. BULL. No. 32, at 7

14. Estate of Michael G. Rudnick, 36 T.C. 1021 (1961) *acq.*, 1962-1 CUM. BULL. 4, *nonacq.*, 1964 INT. REV. BULL. No. 32, at 7

15. 1964 INT. REV. BULL. No. 32, at 7

16. United States v. Edmondson, 331 F.2d 676 (5th Cir. 1964)

basis of her reasonable support for twelve months and this survives as an asset of her estate.[17] Neither the Tax Court nor a federal district court has passed upon the question of the widow's allowance in Ohio.[18]

Property Exempt From Administration

The Commissioner has ruled that property set off as exempt from administration under state law qualifies as having passed from the decedent to the spouse, and will be treated as an inheritance which qualifies for the marital deduction.[19] Ohio property appears to come within this ruling. There has been no litigation with respect to such property qualifying as there has with the widow's allowance. However, one caution is necessary: the terminable interest rules are applicable, and if local law gives the minor children some type of survivorship right in such property, it may not qualify. In Ohio, minor children do have such a survivorship right in property set off in something other than money.[20] For that reason, it may be advisable to have the widow select cash rather than specific property.

Dower and Homestead Rights

Common law dower is generally considered to be a terminable interest and therefore the dower right as such would clearly not qualify for the marital deduction.[21] However, most states that have retained common law dower have adopted statutory provisions giving the widow the right to elect to take a commutation of her dower interest where the court finds that the dower interest may not be conveniently laid off and assigned in kind. The result is that after such order, the property is sold and the widow is paid in cash from the proceeds of the sale. It has been the Commissioner's contention that such proceeds, representing only a conversion of the dower interest, do not qualify for the marital deduction. It might be expected that the result here would be similar to the result in the widow's allowance cases, but surprisingly enough this

17. *In re* Estate of Croke, 155 Ohio St. 434, 99 N.E.2d 483 (1951); *accord, In re* Estate of Wreede, 106 Ohio App. 324, 154 N.E.2d 756 (1958)

18. An advance of funds by the widow herself to the estate in order to pay debts, including the allowance, will defeat the deductibility of the allowance since it is not paid by the estate. Estate of John H. Denman, 33 T.C. 361 (1959), *aff'd*, 287 F.2d 725 (6th Cir. 1961). If the widow elects to purchase property at its appraised value under Ohio Revised Code § 2113.38, the property will nevertheless be valued, where the alternate valuation is elected, as of the date of sale and a marital deduction will not be allowed for the difference between the values represented by market appreciation. Estate of Walter O. Critchfield, 32 T.C. 844 (1959). Neither of these cases, however, directly involved a determination on the deductibility of the widow's allowance itself.

19. Rev. Rul. 55-419, 1955-1 CUM. BULL. 458.

20. OHIO REV. CODE § 2115.13.

21. Rev. Rul. 279, 1953-2 CUM. BULL. 275.

has not been true. Although the issue has not as yet been presented to the Supreme Court, a number of circuit courts have seemingly applied a different test than that applied in the widow's allowance cases, holding that in effect the widow's right to dower is not a vested life estate until it is laid off and assigned to her.[22] The result is that when a federal court is faced with a state court finding that the interest was not susceptible of assignment, it holds that the interest which the widow has was never a life estate, but only a right to the commuted value of dower.

It might have been expected that after the *Jackson* decision, the trend in the dower cases would be reversed. However, in the one case decided since *Jackson*, which the Government relied on heavily, the court distinguished the situations by stating that the dower right is one vested as of the date of the decedent's death, whereas the right to a widow's allowance does not become a vested right until the order is made granting it to the widow.[23] It is submitted that the dower right is no more "vested" in states where that right exists than is the right to the widow's allowance. If the widow dies before an order is entered finding that the dower interest cannot be assigned to her, it is usually held that her estate does not retain any asset referable to that interest.[24] For that reason, it may very well be that the result in the dower cases will be overturned when that issue reaches the Supreme Court.

Election to Take Against the Will

The regulations state that any property taken by the widow under a statute giving her the right to elect against the will and take her intestate share in lieu thereof qualifies as having passed from the decedent to the spouse.[25] If the possibilities of the marital deduction were not adequately considered at the time the will was prepared, it may be possible to save a substantial amount of federal estate tax and still achieve the testator's desires by counseling the widow to elect against the will.[26] In so doing, however, it is necessary to keep in mind the applicable state law rules governing apportionment of taxes in such a situation.[27]

In order for the interest passing to the spouse under the election to qualify for the marital deduction, the spouse must in fact make a valid election, and the interest must pass to her by virtue of having so made

22. Dougherty v. United States, 292 F.2d 331 (6th Cir. 1961); United States v. Crosby, 257 F.2d 515 (5th Cir. 1958); United States v. Traders Nat'l Bank, 248 F.2d 667 (8th Cir. 1957).

23. First Nat'l Exch. Bank v. United States, 64-2 U.S. Tax Cas. 12253 (4th Cir. 1964)

24. *Cf.* 28 C.J.S. *Dower* § 71 (1941), and cases cited therein.

25. Reg. § 20.2056(c)-2(c) (1958).

26. See Estate of Jaeger v. Commissioner, 252 F.2d 790 (6th Cir. 1958), *affirming*, 27 T.C. 863 (1957).

27 Edwards, *Marital Deduction Pitfalls — Methods of Losing the Marital Deduction*, 16 W RES. L. REV. 253 (1965).

an election.[28] Payments made by other beneficiaries in order to forestall the election may not qualify as having passed from the surviving spouse for purposes of section 2056.[29] In one case, the widow received only a life estate under her deceased husband's will, and the trustees of his estate were given discretion to make payments of principal to the widow. In order to forestall the election, which would have forced the estate to dispose of some closely-held stock, the trustees entered into an agreement which the court held to be binding on them to exercise their discretion to pay her principal. The court found that what the widow took was still a terminable interest.[30]

Amounts Arising out of Will Controversies

An amount which is paid or transferred to the widow as a result of a controversy involving her interest in the estate, as an heir, is deemed to have passed to the widow and therefore qualifies for the marital deduction if the transfer was in bona fide recognition of an enforceable right. This determination must, of course, be made by the Tax Court or federal district court under applicable state law. This is a result of the *Jackson* case which held that courts must inquire into a widow's rights under state law in a widow's allowance situation. Assuming that a court is fortunate enough to find some state law authorities on the question, there still remains some doubt as to the binding effect of such authority for federal tax purposes.[31] In many other situations there will be no applicable state law at all.

Although the Commissioner has generally required that the enforceable right must have arisen out of an adversary proceeding,[32] the courts have been more lenient and have permitted the deduction where the amount was paid as a result of an "arm's-length" settlement.[33] It is difficult to harmonize those decisions with decisions such as *Estate of Hyman Kleinman*[34] and *Estate of Charles Elson*[35] which involved payments made to forestall an election under the will. It is submitted that the Supreme Court's rejection of the "intent of Congress" argument in the *Jackson* case may affect the results in this area as well.

28. Estate of Charles Elson, 28 T.C. 442 (1957); Estate of Hyman Kleinman, 25 T.C. 1245 (1956), *aff'd per curiam*, 245 F.2d 235 (6th Cir. 1957)

29. Estate of Hyman Kleinman, *supra* note 28.

30. *Ibid.*

31. Estate of Charles Elson, 28 T.C. 442 (1957); Teschner, *State Court Decisions, Federal Taxation, and the Commissioner's Wonderland: The Need for Preliminary Characterization*, 41 TAXES 98 (1963), and cases cited therein.

32. Reg. § 20.2056(e)-2(d)(2) (1958).

33. Lyeth v. Hoey, 305 U.S. 188 (1938); Indiana Nat'l Bank v. United States, 191 F. Supp. 73 (S.D. Ind. 1961); Estate of Gertrude P. Barrett, 22 T.C. 606 (1954).

34. 25 T.C. 1245 (1956), *aff'd per curiam*, 245 F.2d 235 (6th Cir. 1957).

35. 28 T.C. 442 (1957).

JOINTLY-OWNED PROPERTY

Property owned jointly by the decedent and his wife will normally qualify for the marital deduction.[36] However, it is important to distinguish between jointly-owned property and property which the decedent devises or bequeaths to his spouse and another as joint tenants. In the latter case, the devise of such property will not qualify because it is by its very nature a terminable interest.

PROPERTY SUBJECT TO ENCUMBRANCE

Where the property which is devised or bequeathed to the spouse is subject to an encumbrance, such as a mortgage, the value of the marital bequest is reduced accordingly.[37] Although this rule is clear, there may be some difficulty in applying it. For example, in *Estate of D Byrd Gwinn*[38] the decedent pledged a policy of insurance as collateral security for a personal loan. Upon his death, the insurance proceeds were payable to his wife as beneficiary, but subject of course to any unpaid amount of the loan. The decedent's indebtedness to the insurance company was in fact paid by the estate and the estate claimed the full marital deduction for the insurance proceeds delivered to the wife. The estate's position was upheld against the Commissioner's objections that the value of the proceeds should be reduced by the amount of the debt.

Another problem area with respect to the gift or bequest of property subject to an encumbrance is that of foreign property which will be subject to foreign death taxes. This has become an area of added importance in estate planning since foreign real estate has been only recently included in the gross estate for federal estate tax purposes.[39] The bequest of such property to the spouse can result in the loss of all or a portion of the foreign death tax credit. This result occurs because of a limitation on the foreign death tax credit.[40] Section 20.2014-3 of the regulations spells out in detail the procedure and the steps necessary to calculate the credit where a marital bequest of foreign property is involved. The effect of the computations is that in applying the limiting fraction to the federal estate tax, both the numerator and the denominator of that fraction are reduced by any property which qualifies for the marital deduction. If the property bequeathed to the spouse is the only property subject to foreign death taxes, the elimination of such bequest from both the numerator and denominator results in the limitation

36. CODE § 2056(e)(5)

37 CODE § 2056(b)(4)(B).

38. 25 T.C. 31 (1955)

39. CODE § 2031 was amended with respect to the estates of decedents dying after October 16, 1962, to delete the prior exclusion of foreign real estate.

40. CODE § 2014(b)(2)

becoming zero, and the foreign death tax credit is lost entirely. It is desirable, therefore, to qualify the marital bequest by specifically excluding property which may be subject to a foreign tax credit. Although there are many forms of doing this, the following language should prove satisfactory: The gift to my wife herein shall not be satisfied by the distribution to her of assets with respect to which a foreign death tax credit is allowable under the provisions of the Internal Revenue Code.

THE MARITAL DEDUCTION AND SECTION 691

Section 691(c) permits the estate or the beneficiary of the estate, depending upon who in fact receives the property, to take a deduction for income tax purposes for that portion of the estate tax resulting from the inclusion of section 691 property in the gross estate. Section 691 property is generally income which the decedent earned or had a right to during his lifetime, but which was in fact not received until after his death. In order to determine the advisability of including such property in the marital bequest, careful estate planning is required with attention to a comparison of the relative burdens of the income and estate tax.

The argument has been advanced that where a portion of the income in respect of a decedent passes to the surviving spouse, and the part of the income which qualifies for the marital deduction does not exceed fifty percent of the adjusted gross estate, the section 691 property must be eliminated from both the gross estate and the marital deduction in making the computation of the estate tax, with the income in respect of a decedent eliminated — the so-called "second computation." The effect of this is that there would be no change in the estate tax and therefore no income tax deduction under section 691(c) [41] There are no regulations or rulings on this question and the Commissioner was unsuccessful in the only reported case on the question.[42] However, the issue has not been foreclosed, and where such income may be significant, it may be advisable to consider eliminating it from the marital bequest.

Another aspect of the section 691 problem in connection with the marital deduction is present in almost every estate where a self-adjusting formula is used. The elimination of each dollar of income in respect of a decedent, when making the second computation of the estate tax to determine the section 691(c) deduction, results in a reduction of one dollar in the adjusted gross estate, but reduces the marital deduction by only fifty cents, so that the estate tax attributable to the elimination would be only half of what might otherwise be expected. If, on the other hand, such income is bequeathed to someone other than the spouse

41. 2 LASSER, ESTATE TAX TECHNIQUES, 2058 (1961). See also Findlay v. Commissioner, 64-2 U.S. Tax Cas. 9532 (2d Cir. 1964).

42. Estate of Thomas A. Desmond, 13 C.C.H. Tax Ct. Mem. 889 (1954).

and if that which qualifies for the marital deduction does not exceed fifty percent of the adjusted gross estate, then the marital deduction for estate tax does not reduce the section 691(c) deduction. It may even be advisable in certain cases to forego the maximum marital deduction in order to increase the section 691(c) deduction. This would be true where the section 691 property is substantial and where the recipient's income tax bracket is materially higher than the federal estate tax bracket of the estate. For example, assume an adjusted gross estate of $1,000,000 with $300,000 of section 691 income:

(a) *If the Maximum Marital Deduction Formula Clause is Used.*	
Adjusted gross estate	$1,000,000
Marital deduction	500,000
Taxable estate	500,000
Tax	126,500
Second computation:	
Adjusted gross estate	700,000
Marital deduction	350,000
Taxable estate	350,000
Tax	78,500
Section 691(c) deduction: ($126,500 − $78,500) (or ½ of tax rate of 32% x $300,000)	$ 48,000
(b) *If Wife Gets $250,000, but None of § 691 Property:*	
Adjusted gross estate	$1,000,000
Marital deduction	250,000
Taxable estate	750,000
Tax	212,200
Second computation:	
Adjusted gross estate	$ 700,000
Marital deduction	250,000
Taxable estate	450,000
Tax	110,500
Section 691(c) deduction: ($212,200 − $110,500)	$ 101,700
Total taxes (a).	
Estate tax on husband's estate	$ 126,500
Estate tax on wife's estate	126,500
Income tax on $300,000 less $48,800	161,890
	$ 414,890

Total taxes (b):

Estate tax on husband's estate	$ 212,200
Estate tax on wife's estate	47,700
Income tax on $300,000 less $101,700	124,300
	$ 384,200

The resultant savings to the family amount to $30,690. Such saving is due to the fact that the income tax rate is higher than the estate tax rate. If the estate is large and section 691 income is small, or where it is spread among a number of separate taxpayers, the result would be quite different. This emphasizes the necessity for careful planning where section 691 property is involved.

SUMMARY

This discussion of particular kinds of property and property rights and the marital deduction highlights once more the increasingly difficult task of the estate planner. If it is the draftsman's aim to obtain for his client the maximum marital deduction allowable for estate tax purposes, he must take the time to inquire in detail of his client regarding the kinds of property which the client owns. A failure to obtain information about foreign property or section 691 property can, as has been shown, prove quite costly.

In drafting his client's will, the planner must be currently informed on the legal incidence of certain types of property and the nature of rights which the surviving spouse or others may have with respect to the estate under applicable state law. The effect of state law is such that the client should in all cases be warned that a change of domicile calls for a review of the will. Lawyers are many times prone to regard the question of domicile as having only to do with the validity of the execution of the will; but, it has been shown that the substantive results are dramatically different for such things as the widow's allowance and dower and homestead rights.

The draftsman must once again bend his talents toward accomplishing what Congress intended in enacting the marital deduction, and which the courts have once again thwarted. Good drafting can still accomplish the desired result and avoid time consuming and costly arguments with the Government. The interrelationship between state law property rights and the marital deduction leaves no room for the careless lawyer.