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STATE AND FEDERAL TAXATION

Tax Problems of Formula Type of Marital Deduction Bequest

BYRON E. BRONSTON
Chicago, Ill.; Committee Chairman

I. PROBLEMS IN ADMINISTRATION OF ESTATE

A. Income During Administration

The common usage of formula clauses for the marital deduction has aggravated problems in the allocation of and accounting for income earned by the estate during the period of administration. Before the advent of the marital deduction it was held that where a pecuniary bequest is satisfied in property other than money, it is the same as if the property allocated in satisfaction of the bequest were sold, with capital gain or loss consequences. Thus, if the assets allocated to the pecuniary bequest have appreciated in value from the estate tax value a capital gain is realized by the executor and he must pay the tax on it.¹ The frequently used pecuniary type of marital deduction formula is treated in the same manner.² Of course, use of a fraction or percentage of residue type of marital deduction formula avoids this capital gains problem.³ Even with the pecuniary type of formula this problem can be avoided if the will provides that if the executor satisfies the marital bequest in kind the property allocated in satisfaction of this bequest shall be valued at its estate tax value; the "sale" price is thus made the same as its basis in the hands of the executor. But this gives a power and responsibility to the executor which he may not want and which many testators would not want him to have.⁴

Another type of problem that plagues executors in some jurisdictions is in connection with computing income on general pecuniary legacies in trust which are entitled to a proportionate share of the income earned on the whole estate from the date of death.⁵ A residuary trust is entitled, along with other resi-

duary beneficiaries, to receive any income actually earned by the estate during administration which is not otherwise disposed of, namely, as it has been called, the clear net residue income.⁶ The clear net residue rule can be applied with reasonable certainty. The difficulty lies in actually computing the income due the pecuniary legacy in trust.⁷ Statutes and case law have not provided guidance covering all situations.

More specifically, the problem consists in determining what is to be included in the "whole estate" and what is the "rate of return." What about real estate and its income? What is the value of the whole estate to be used in determining the rate of return?

The general rule in this country is that title to real estate passes immediately at death to the devisee or heirs at law subject, in most jurisdictions by statute,⁸ to the right of the personal representative of the estate to sell the real estate to pay debts, administration expenses, taxes or legacies which may be a charge upon it. Until the personal representative exercises this right he generally has no right to the income from the realty unless it is specifically devised to the executor⁹ or the will or statute gives him the right to such income for this purpose.¹⁰ Where the executor does not have the right to rents he cannot compel an heir or devisee who has received rents to return them for payment of debts or expenses.¹¹

Most marital deduction wills provide that the executor may select and assign the property (if qualified for the marital deduction) which is to satisfy the marital share. If the executor decides not to

allocate the realty to the marital share, then presumably the rents during administration belong to the residuary devisee or residuary trust. But if he decides to allocate the realty to the marital share; do the rents belong to the marital share? If a pecuniary type of formula is used, the usual rule is that a general pecuniary legacy in trust is entitled to income at the rate of return on the whole estate, or the average rate of return. If he had thought about it, the testator might have wanted the rents to go to the ultimate taker of the real estate.

These problems could probably be avoided or reduced if the will specifically designates where the realty is to go, or if a fraction or percentage of residue type of formula is used, and if there is a provision specifically dealing with the rents, such as that the executor is entitled to rents during administration for payment of debts and expenses, the same as income from personalty, and that the rents not so used belong to the ultimate taker of the realty.

The fraction of residue type of marital deduction formula helps here, because it avoids the computation of income due a pecuniary legacy in trust and puts the marital and nonmarital shares on an equal footing, i.e., both are residuary, sharing proportionately in the residuary income, including the rents. In addition, in states where he does not have the right by statute, the executor would be helped by being given the right to rents for payment of debts and expenses.

As to the value of the whole estate, the assets of the estate have a value at date of death, but changes occur during administration as assets are sold, debts, taxes, expenses and legacies are paid—all at various times. Market values change from day to day. Should these changes be taken into account? The New York practice does so by using the average daily balance of the estate in computing the average rate of return.¹² This method is very complicated and might not be usable in some other jurisdictions. A practical, less complicated method would be to use the date-of-death values of inventoried personal property and real estate devised to the executor.

¹*Suisman v. Eaton* 15 F. Supp. 113, aff'd. 83 F. 2d 1019 (C.C.A. 2, 1936), cert. den. 299 U. S. 573; *Kenan v. Commr.* 114 F. 2d 217 (C.C.A. 2, 1940); *Commr. v. Brinkerhoff*, 168 F. 2d 436 (C.C.A. 2, 1948).

²Rev. Rul. 56-270, 1956-1 C.B. 325.

³Rev. Rul. 55-117, 1955-1 C.B. 233.

⁴See Section I.I.B. of this report, dealing with such discretions of the executor.

⁵*Scott on Trusts*, (2d Edition, 1956), Sec. 234.2 *Webb v. Lines*, 77 Conn. 51, 58 Atl. 227 (1904) *State Bank v. Gross*, 344 Ill. 512, 176 N. E. 739 (1931).

⁶*Scott on Trusts*, (2d Edition, 1956), Sec. 234.3 *Clifford v. Davis*, 22 Ill. App. 316 (1887) *Waterman v. Aloan*, 42 Ill. App. 294 (1890).

⁷Mullen, "Problems of the Executor Arising Out of the Marital Deduction Law," p. 45, thesis submitted to Graduate School of Banking, American Bankers Association (1954).

⁸New York Surrogates Court Act, Sec. 234; *Illinois Revised Statutes* (1955), Ch. 3, Sec. 379.

⁹*Ellis v. King*, 336 Ill. App. 298, 83 N. E. 2d 367 (1949).

¹⁰Rodman, "Executor's Power to Allocate Property to Qualify for the Marital Deduction," 1955 Proceedings of Probate and Trust Law Divisions, Section of Real Property, Probate and Trust Law, American Bar Association, p. 32, n. 17, 94 TRUSTS AND ESTATES 801, 802, n. 17.

¹¹*Rauschkolb v. Ruediger*, 325 Ill. App. 342, 60 N. E. 2d 250 (1945).

¹²Dodge and Sullivan, *Estate Administration and Accounting*, (1940) pp. 423-431.

In some jurisdictions, income on assets sold to pay debts, taxes and expenses of administration is required to be capitalized.¹³ To determine the actual rate of return on the estate requires separate computations for different assets sold at different times.

Income in respect of a decedent, which is, in general, income accrued on his assets as of the date of his death and earnings from personal services payable after death, to the extent that it is received by the executor during administration, is, for income tax purposes, treated as income to the executor, retaining the same character in his hands as it would have had in the decedent's hands,¹⁴ and may be included in "distributable net income." If the executor distributes it in the taxable year of receipt he is allowed a deduction for the amount distributed and the beneficiary is taxable on it.¹⁵

But, for other than income tax purposes, such receipts are usually not income payable to those entitled to income, but are assets of the estate and constitute corpus. Such items are includible in the gross estate for estate tax purposes, and for estate accounting purposes under local law are to be added to corpus and distributed as such. Thus, a distributee of such items is in the position of being taxed for income tax purposes on items distributed to him as corpus under state law, with a deduction for the estate tax paid on them. The executor has to keep these items straight, and often has to decide where, as corpus, they are to be allocated.

While this is a problem whether or not marital deduction formulae are used, to the extent that income allocation and accounting problems are increased by use of the marital deduction formulae, this type of problem is similarly increased particularly where, as is the case in almost all marital deduction formula wills, the executor has the discretion as to allocating assets in kind in satisfying the marital bequest. Thus, if under the discretion granted by the will he allocates all of such items to the marital share and distributes them in the taxable year of receipt, the spouse or marital trust will be taxed with the income on them, whereas a corresponding value of assets which are not income in respect of a decedent, allocated to the nonmarital share, would not be so taxed. Here, again, is an area where the executor's discretion can be used to favor the spouse over the beneficiaries of the nonmarital share or *vice versa*.¹⁶

If partial distributions are made dur-

¹³Illinois Revised Statutes, 1955, Ch. 30, Sec. 163.

¹⁴I.R.C. (1954) Sec. 662(b).

¹⁵I.R.C. (1954) Secs. 661 and 662.

¹⁶See Section II B of this report.

ing the course of administration the executor has additional problems. For purposes of income accounting such distribution chops off income of the estate during administration as to the assets distributed and requires recomputations of income and, possibly, revaluation of the whole estate to cover this change in order to determine the rate of return on the whole estate as affected by the partial distribution. Also, under Sections 661-663 of the 1954 Code, partial distributions can result in unlooked for and undesirable income tax results. A distribution from an estate to a beneficiary, whether of income or corpus, is deemed for income tax purposes to be a distribution of current income of the estate to the extent that the estate has distributable net income. An exception to this is provided in Section 663(a)(1) in that a proper distribution of a gift or bequest of a specific sum of money or of specific property made, under the terms of the will, in not more than three installments is not to be deemed a distribution of estate income.

If a partial distribution is made either of 1) a specific sum of money or specific property in more than three installments, or 2) money or property not specifically bequeathed, the income attribution result attaches. This also applies to goods and chattels not specifically disposed of in the will and their advance distribution under the residuary clause of the will will be deemed income at their fair market value to the extent that there is distributable net income of the estate. Accordingly, goods and chattels should always be specifically disposed of by the will, to avoid application of this income attribution. However, payment of a widow's award or allowance is deductible by the estate, only to the extent of distributable net income, if it is payable out of and chargeable to income under the court order or decree making the allowance, or under local law.¹⁷

The problems of the types discussed are not handled in practice with too much uniformity even by corporate fiduciaries in the same state and there would appear to be a need for consistency under wills having or lacking the same provisions. Avoidance and amelioration of many of these problems is to a large extent within the power of the lawyer who drafts the will. Finally, the executor can avoid or reduce the impact of some of the problems by his awareness of them and by using to that end his discretions, powers, and the choices open to him.

B. Problems Resulting From Discretions And Elections Available to Executor, Involving Interests of Income Beneficiaries Versus Remaindermen

¹⁷Regulations Sec. 1.661(a)-2(e).

¹⁸Regulations Sec. 1.662(a)-3.

In the exercise of certain discretions and elections available to him, an executor may face substantial conflicts of interest between the surviving spouse and other beneficiaries or remaindermen.¹⁹ The existence of these conflicts has caused some eminent authorities to look with great disfavor upon any formula type of bequest, while it has prompted others, equally eminent, to limit their acquiescence only to the fractional-share-of-the-residue type of clause, or pecuniary formula bequest, with the assets valued at Federal estate tax value.²⁰ Still other experienced and capable authorities point to the comparative dearth of litigation arising from formula type clauses, since the origin of the marital deduction nearly a decade ago, as evidencing that the suggested problems of conflicts are more theoretical than real.

The function of this report is not to reargue the pros and cons of the formula type of marital deduction. Emphasis is placed here upon problems resulting from discretions and elections available to the executor. Inherent in these problems is the circumstance that a formula type provision represents an attempt in a single testamentary direction to dispose of a portion of an estate measured by a tax yard stick.

No experienced executor, or counsel for an estate, would attempt to point only to certain statutory provisions and say that those provisions plus any specific discretions granted in the will represent all the discretions and elections available to an executor. Innumerable situations arise during the course of the administration of an estate requiring the exercise of sound judgment by the fiduciary. The discretions and elections cover a wide range. They extend from the possibility of selecting the optional valuation date,²¹ or using administration expenses as an income tax deduction,²² to the selection, and possibly even the valuation, of assets to be distributed to the surviving spouse. The executor who undertakes administration of an estate under a will with a formula type marital deduction clause will find that in many instances the exercise of a discretion or election in a manner which is favorable to the surviving spouse will to some degree conflict with the interests of other beneficiaries, and vice versa.

1. Burden of Death Taxes

An analysis of the manner in which

¹⁹Cox, *Types of Marital Deduction Formula Clauses*, Proceedings N.Y.U. 15th Annual Institute on Federal Taxation.

²⁰Trachtman, *Leaping in the Dark*, Report of Proceedings of Probate and Trust Law Divisions, Section of Real Property, Probate and Trust Law, American Bar Association, 98, 93 TRUSTS AND ESTATES, 922, 926 (1954), and Sargent, *To Each His Own*, Same publication 117, 93 TRUSTS AND ESTATES 933 (1954), for expression of divergent views concerning formula clauses.

²¹I.R.C. (1954), Sec. 2032.

²²I.R.C. (1954), Secs. 162 and 212.

the burden of death taxes is affected by discretions and elections available to the executor discloses four principal areas of possible conflict: (1) the valuation of specific items included in the adjusted gross estate, (2) the selection of the optional valuation date, (3) the claiming of administration expenses as income tax deductions, and (4) the addition or exclusion of items such as inter vivos transfers. The extent to which the burden of death taxes may be affected by these considerations will depend upon the allocation or apportionment of those taxes.

(1) The valuation of specific items of property included in the adjusted gross estate often involves the exercise of considerable discretion. This observation, of course, does not apply to such items as cash on hand, or a bank account, or securities having a definite determinable market value. But as to improved real estate or stock in a closely held corporation, for example, an executor is called upon to exercise some degree of discretion. Having once exercised discretion in arriving at the valuation to be reported on the Federal estate tax return, the executor is often further called upon to exercise discretion in determining the extent to which he will resist a Revenue Agent's finding of a higher valuation.

The surviving spouse may have an interest as an income beneficiary in property passing under other provisions of the will than the formula clause for the marital deduction. Any variance in the valuation of specific items of property included in the adjusted gross estate may affect not only the amount of the bequest under the marital deduction formula clause but also the amount received under the residuary clause of the will, which in turn may affect other beneficiaries immediately, or as remaindermen upon termination of a trust or life estate from which the surviving spouse received income. The extent of the tax consequences will be determined by the extent of the variance in valuation and by application of directions of the will or provisions of case law or statute with respect to allocation or apportionment of such taxes.

(2) While it may be assumed that the optional valuation date is not likely to be selected if the total value of the adjusted gross estate is enhanced thereby, it may very well happen that some specific items of property are of a higher value on the optional valuation date than on the date of death. The sale, exchange or other disposition of property within one year after the decedent's death may be a factor in determining the election of the optional valuation date, just as, indeed, the possibility of electing the optional valuation date may have influenced the sale, exchange or disposition of such

property. Whatever circumstances may have prompted the election of the optional valuation date, the extent of the property passing under the marital deduction formula clause and the tax consequences upon beneficiaries of the estate obviously can be affected to a substantial degree by the election of the optional valuation date.

(3) Expenses incurred and claimed in administering property subject to claims is a deduction to be taken into account before arriving at the adjusted gross estate, by which is measured the maximum amount of the marital deduction. Since an executor has the election of treating certain administration expenses as income tax deductions, upon compliance with the provisions of the Code, the adjusted gross estate may be affected by whether such administration expenses are claimed as deductions on the Federal estate tax return or as income tax deductions. The manner in which this election is exercised may likewise affect the amount received by the surviving spouse under the formula clause with attendant death tax consequences. This same election may also affect the amount of net income after taxes distributable to the surviving spouse and other beneficiaries.

(4) Frequently an executor is confronted with the problem of excluding from the adjusted gross estate property not passing under the will. There may be questions of whether it can be shown that inter vivos transfers were not made in contemplation of death, whether life insurance proceeds are properly includible, or the extent of the contribution of the surviving joint tenant to property owned in joint tenancy. Initially the executor must determine how such items will be reported on the Federal estate tax

return. Frequently the executor will be called upon to exercise a discretion in determining the extent of his efforts to exclude such items, against a contrary position taken by the Revenue Agent. This may involve the question of payment and filing a claim for refund, or it may involve resistance in the Tax Court to a claimed deficiency in estate tax. Since the adjusted gross estate will be affected by the final determination of these items, so the amount passing to the surviving spouse under the formula clause will be affected, as well as the allocation or apportionment of the tax burden.

The way in which the burden of the Federal estate tax will be affected by the various matters observed will necessarily depend upon the manner in which such tax is allocated or apportioned. Where the total tax is to be paid from the residuary estate, obviously the more the surviving spouse receives under the marital bequest formula free from any tax burden the greater the benefit to the surviving spouse at the expense of other beneficiaries. Under apportionment acts in some states a part of the Federal estate tax may be apportioned to the surviving spouse. Under other apportionment acts there is specific provision requiring that allowance be made for any exemptions, including the marital deduction, in apportioning the tax, so that the burden of the tax falls upon those beneficiaries who receive property which contributed to the tax. It is within the province of the testator to make any direction he wishes with respect to the allocation of the Federal estate tax, but the difficulty is that it is a rare testator indeed who can accurately anticipate the value of his adjusted gross estate.

The fact that the Federal estate tax

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payable out of the property interest constituting the marital deduction must be deducted in determining the net value of the allowable marital deduction involves the necessary consequence that even though no part of the Federal estate tax may be allocated or apportioned against the surviving spouse herself, the amount of that tax is a material item in determining the amount of the marital deduction.

State death taxes may also be involved in various ways. The amount of such taxes payable out of property included in the marital deduction must be deducted in determining the amount of the marital deduction. Further, the amount of state inheritance taxes which may have to be paid will have a direct bearing upon the extent of the credit allowable for state death taxes. And the amount of such inheritance taxes will also have a bearing upon the extent to which, if any, the estate is liable for state estate taxes. The various discretions and elections exercisable by the executor may, therefore, very well have a bearing upon the amount of credit allowable for state death taxes, and at least so far as state estate taxes are concerned there may exist the same questions with respect to allocation and apportionment thereof among the different beneficiaries as exists with respect to the allocation or apportionment of the Federal estate tax. Further, in considering problems of allocation and apportionment among the beneficiaries of the estate, unless specifically eliminated by direction of the will or provisions of state statutes, there may be allocations or apportionments between income beneficiaries and remaindermen, the extent of which will be determined by the discretions and elections referred to above which are exercisable by the executor.

2. Burden of Income Taxes

The various discretions and elections available to an executor may have substantial income tax consequences, many of which are of particular significance under the formula type of marital deduction bequest.

Just as an election to claim administration expenses as an income tax deduction of the estate may enhance the burden of estate taxes so it will reduce the burden of income taxes. The extent to which the surviving spouse may benefit from such income tax saving will depend upon the extent of such spouse's interest in the net income of the estate. And if that net income is distributable net income, the income tax bracket of the respective recipients of distributable net income will have considerable bearing upon the real effect of claiming the income tax deduction.

The selection of the optional valuation date for estate tax purposes will also affect the basis upon which distributed assets, including those distributed to the surviving spouse, will be held, and will have a bearing upon the extent of capital gains or losses upon future sale.

If under the particular type of marital deduction bequest the executor has discretion to distribute property in kind in satisfaction of the marital bequest, extensive consequences may follow in the area of the future income tax burden of the surviving spouse as well as of other beneficiaries. Aside from the question of the basis of the property distributed, the nature of the property has significance. Distribution of improved real estate upon which a tenant under a long-term lease has made the improvements might result in a situation where the recipient of the improved real estate was unable to take depreciation or amortize the lease. Distribution of municipal bonds could result in receipt of tax-exempt income. In some situations the distribution of stocks from which the recipient would be entitled to have a dividends received credit would be a significant item in connection with the state income tax liability of the beneficiaries.

Under the pecuniary formula type of clause, sometimes known as the "dollar legacy type of bequest," unless the amount of the marital deduction is measured by valuation at Federal estate tax values, a distribution in kind of assets which have appreciated in value

will result in taxable gain to the estate, as distinguished from the effect of a distribution of the identical assets under a fractional-share-of-the-residue type of clause.²³ This is true whether the distribution is directly to the surviving spouse or to a trustee under a marital deduction trust for the benefit of the surviving spouse. Conversely, losses on account of depreciation in the value of assets may thus be realized by an estate, which losses may be offset against gains.

Among the discretions frequently assumed to be available to an executor is that of making partial distributions. Unless distribution pursuant to a formula type of clause is made all at once, or at least in not more than three installments, it would seem that the distribution was of distributable net income, with the resulting tax consequence of possible income tax liability upon the recipient. This observation seems to apply even in the case of distribution to a trustee.²⁴

C. Treatment of Income Tax — Allocations and Adjustments

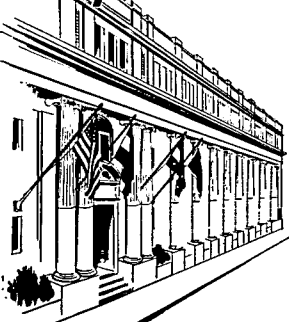
Executors are free to withhold or pay out income as may be to the income tax advantage of the estate and the beneficiaries.²⁵ The amount to be distributed by the estate to the beneficiaries in the taxable year therefore depends upon an analysis of the tax brackets of the beneficiaries and of the estate, considering also the type of income of each and the income tax deductions of each.

Generally speaking and in the absence of a will provision requiring current distribution, there is no mandatory current distribution in the case of an estate and it is proper to say that the extent of the deduction by the estate and the taxation of income to the beneficiary will be the income "which is properly paid or credited to beneficiaries during the taxable year."

To establish the maximum amount which can be deducted by the estate and taxed to the beneficiaries and to enable amounts distributed to retain their character as gross income, tax-exempt income, capital gain, etc., a new standard known as "distributable net income" has been introduced. This term is defined in Section 643(a) as the taxable income of the estate or trust with certain modifications.

In order to compute the taxable income of an estate or trust certain adjustments must be made. Thus an estate or trust is allowed the credit for partially tax-exempt interest only to the extent that the credit does not relate to interest properly allocable to beneficiaries.²⁶ The

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²³Rev. Rul. 56-270.

²⁴Stevens, *Troublesome Will Provisions*, 34, *Taxes*, 809, 817, (1956).

²⁵I.R.C. (1954), Secs. 665-668.

²⁶I.R.C. (1954), Sec. 642(a)(1).

credit for foreign taxes is similarly limited.²⁷ Likewise the dividends received credit is allowed to the estate or trust only for so much of the dividends as are not properly allocable to beneficiaries.²⁸ The time of receipt of dividends allocable to beneficiaries is deemed to be the dates on which the dividends were received by the estate or trust.

An estate is allowed an unlimited deduction for contributions paid or permanently set aside out of its gross income for charitable or similar purposes, where made pursuant to the terms of the governing instrument;²⁹ but the deduction is limited to contributions of income that enter into the gross income of the estate or trust.

The deduction for depreciation and depletion is, as under the 1939 Code, allowed only to the extent not allowed to the beneficiaries.³⁰ Amounts allowable as deductions for estate tax purposes under Sections 2053 or 2054 are not allowed as a deduction in computing the taxable income of the decedent's estate unless waived as estate tax deductions.³¹

In order to determine the distributable net income of an estate or trust other adjustments must be made. Certain types of income that are nontaxable to the estate or trust but available for distribution to beneficiaries must be included in taxable income. These include: (1) tax-exempt interest on governmental obligations specified in Section 103 reduced by any nondeductible disbursements allocable to such interest; (2) in the case of a foreign trust, income from sources without the United States with the same reduction; and (3) dividends excluded from gross income under Section 116.³²

Capital gains are excluded from distributable net income to the extent that such gains are allocated to corpus and are not paid, credited or required to be distributed to beneficiaries or to a charity or similar organization. This provision taxes capital gains to the estate unless paid or set aside to a beneficiary or for a charitable or similar purpose. Capital losses are excluded except to the extent that distributed or distributable capital gains are reduced thereby.³³

Subpart C³⁴ contains the rules for estates and for trusts accumulating income or distributing corpus. The first determination is the deduction that may be taken by the estate or trust on account of distributions to beneficiaries.

²⁷I.R.C. (1954), Sec. 642(a)(2).

²⁸I.R.C. (1954), Sec. 642(a)(3).

²⁹I.R.C. (1954), Sec. 642(c).

³⁰I.R.C. (1954), Sec. 642(e).

³¹I.R.C. (1954), Sec. 642(f).

³²I.R.C. (1954), Sec. 643(a), (5), (6) and (7).

³³I.R.C. (1954), Sec. 643(a)(3).

³⁴I.R.C. (1954), Secs. 661-663.

This deduction consists of the sum of (1) the amount of income for the year required to be distributed currently and (2) any other amounts that are properly paid, credited or required to be distributed for the year. As mentioned earlier, the deduction for an estate will usually be the amount actually "paid or credited" to the beneficiary. The deduction cannot exceed distributable net income. Thus where the entire net income of an estate is paid over to a single beneficiary, the estate deducts and the beneficiary reports the total distributable net income less the amount of tax-exempt interest and excluded dividends.³⁵

Where only part of the distributable net income of the estate is to be disbursed to a single beneficiary, it is necessary to allocate taxable and exempt income and any included capital gain between the estate and the beneficiary. Code Sections 661(b) and 662(b) provide that the amount distributed shall be treated as consisting of the same proportion of each class of income as the total of that class bears to the total distributable net income, in the absence of a provision regarding such allocation in the will or trust instrument. In applying the foregoing rule the items of deductions, including the charitable deduction, entering into distributable net income shall be allocated among the various types of income in accordance with the Regulations.³⁶

Where there are distributions to multiple beneficiaries, each beneficiary will be considered to have received a pro rata portion of each type of income, unless the testator's will provides for a specific allocation.³⁷ These distribution rules can, as indicated, be changed by an appropriate provision in the will, such as a direction that tax-exempt income shall be distributed to a certain beneficiary in a high individual income tax bracket or that certain classes of taxable income be distributed to charities.

³⁵I.R.C. (1954), Secs. 661(a) and 662(a).

³⁶Regulations, Secs. 1.661(b) and 1.662(b).

³⁷I.R.C. (1954), Sec. 662(b).

Where the beneficiaries receive income in excess of distributable net income, each reports only a portion of the amount received. This portion consists of the ratio which the amount paid to him bears to the total amount, less income currently distributable, paid to all beneficiaries.³⁸

Under Section 663(a) any amount which, under the governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or credited all at once or in not more than three installments is excluded from estate distributions that are deductible by the estate or taxable to the beneficiary.

Where the will of a testator contains a marital deduction formula clause, the surviving spouse's share of the estate is not capable of exact determination until the Federal estate tax proceedings are completed. However, the surviving spouse is entitled to the income attributable to her share from the date of the testator's death. The executor may decide to withhold distribution of any portion of her share of the income until all phases of the estate administration are over. Such a decision would depend upon the income tax bracket of the estate, the individual income tax bracket of the surviving spouse and other factors. If the income attributable to the share of the surviving spouse is accumulated, the estate will include all items of taxable income in its gross income, take its deductions and pay income tax on the net taxable income. Having been taxed to the estate, such income is tax-free when it is subsequently distributed to the spouse. This will obviously be advantageous to a surviving spouse who is already in a high individual income tax bracket and substantial tax savings can be accomplished through prolonging the administration of the estate.

As a general rule, the administration of an estate does not end until the

³⁸I.R.C. (1954), Sec. 662(a)(2).



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Federal and state estate tax audits have been closed, the debts, expenses and bequests have been paid and the accounting of the executor has been approved by the court. Where all or any portion of the income allocable to the bequest to the surviving spouse is accumulated in the estate and reported as taxable income by the estate, the estate has paid income taxes on income that is to be distributed to the spouse at a later date. This will occur to some extent in practically all estates where the gift to the spouse is under a formula since the amount of the gift cannot be determined until the Federal estate tax return is closed. So that the widow will pay her correct share of the tax burden, it is proper to charge her share of the income with a pro rated portion of the income taxes paid by the estate. Since presumably there is a spread between the income tax bracket of the estate and that of the surviving spouse under these circumstances, the spouse has received a tax advantage by virtue of the income accumulation.

In any estate where the surviving spouse has little or no income from other sources, it is usually necessary for the executor to distribute to her a portion of the estate income. Where partial distributions are thus made to the spouse during the period of administration, the estate will deduct and the surviving spouse will report the income actually "paid or credited" to her during the tax-

able year in accordance with the rules previously discussed.

Where the gift to the surviving spouse is a pecuniary legacy in trust or a portion of the residuary estate in trust, consideration should be given to setting up the trust, at least in part, early in the administration of the estate. Where the estate income is large, payment of a portion of the income to the trust will shift the tax on such income to the surviving spouse to the extent that the trust makes distribution to her. This could be advantageous where the spouse was in need of the income and was in a lower tax bracket than the estate. The advantages of setting up additional taxpayers in the form of trusts at an early date are, of course, more apparent where the will also provides trusts for minor children.³⁹

D. Treatment of Estate Tax

The Federal estate tax in most instances is a tax on the whole estate and not a tax on the distributive shares, except where there is a state statute to the contrary. However, Sections 2206 and 2207 of the 1954 Code carry forward the provisions that life insurance and property transferred by the exercise of a power of appointment shall bear their pro rata portion of the Federal estate tax unless the decedent directs otherwise in his will.

It has been held in a large number of cases that, in the absence of statute or testamentary provision, the burden of the tax falls on the residue without any right of apportionment.⁴⁰ To alleviate possible hardship, a number of states have provided that each distributive share of the estate shall bear its proportionate part of the Federal estate tax and the state estate tax if any. Some states provide only for apportionment of the Federal estate tax.⁴¹

Where a state apportionment statute is in effect, the testator can direct against apportionment by the terms of his will, but care must be exercised to specifically provide, if such a result is desired, that all estate, inheritance, transfer and succession taxes imposed upon property passing under the will and property passing outside of the will shall be paid out of the general estate. If the clause in the will does not specifically provide that its terms shall apply to the entire taxable estate, the courts are likely to construe it as limited in application to property actually pass-

ing under the will.⁴² A clause similar to the following is suggested to place the entire burden of estate and inheritance taxes on the residuary estate in all states, whether an apportionment statute is operative or not:

"My executors shall pay out of my general estate, as if they were my debts, all estate and inheritance taxes by whatever name called (including interest and penalties, if any) that may become payable because of my death in respect of all property comprising my gross estate for death tax purposes whether or not such property passes under this Will."⁴³

A clear direction against apportionment of the estate tax becomes essential in situations where it is desirable to give to the surviving spouse an amount equal to the maximum marital deduction. This is due to the provisions of Section 2056 (b) (4) stating that the marital deduction shall be reduced by the amount of any death taxes applicable to it.

In achieving the maximum marital deduction, it has been found by a large number of draftsmen that a formula clause is the answer. Where the gift to the surviving spouse is to take the form of an outright bequest, legal life estate or pecuniary legacy in trust, a clause similar to the following is employed:

"An amount equal to the maximum estate tax marital deduction (allowable in determining the Federal estate tax on my gross estate) diminished by the value for Federal estate tax purposes of all other items in my said gross estate which qualify for said deduction and which pass or have passed to my wife under other provisions of this will or otherwise. In making the computations necessary to determine the amount of this gift, the final determination in the Federal estate tax proceedings shall control."⁴⁴

Under such a formula clause and where the will provides for the payment of death taxes out of the residue, the share of the surviving spouse will pass to her undiluted by any portion of the death taxes payable by the estate.

Where any portion of the Federal estate tax is payable from property passing to the surviving spouse, the Federal estate tax cannot be computed without knowing the amount of the marital deduction, and the amount of the marital deduction cannot be ascertained without knowing the amount of the Federal estate tax.⁴⁵ Obviously this mathematical problem contains two unknown and mutually dependent sums and can only be solved by an algebraic formula or by lengthy trial and error computations. Aside from the mathematical complexities involved in computing the Federal estate tax, the

³⁹Stern, *The Income Tax Problems of Estates*, Proceedings, N. Y. U. 13th Annual Institute on Federal Taxation pp. 157-158 (1955).

⁴⁰McCarthy, *Apportionment of Estate and Inheritance Taxes*, Proceedings, N. Y. U. 9th Annual Institute on Federal Taxation, p. 58, and cases cited therein, (1951).

⁴¹Tennessee, California and Maryland.

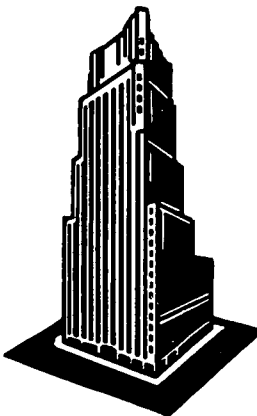
⁴²*Carpenter et al. v. Carpenter*, (Mo. 1954), C. C. H. Inheritance Tax Rep. Par. 18,179.

⁴³Trachtman, *Estate Planning*, p. 52, (1951 Edition), published by Practising Law Institute.

⁴⁴Casner, *Estate Planning*, (2d Edition 1956), p. 641.

⁴⁵Trachtman, *op. cit.*, p. 53.

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amount of the marital deduction has been reduced which in turn increases the Federal estate tax payable. These problems can be avoided where the will directs that the share of the surviving spouse shall pass free of death taxes.

Where the surviving spouse is simply given a portion of the residuary estate and the will provides for payment of all death taxes out of the residuary estate, then even in the states having apportionment statutes, the Federal and state death taxes will have to be paid from the residuary estate and again the computation of mutually dependent sums will be necessary.⁴⁶ To avoid this problem and the consequent reduction of the marital deduction, it is desirable to provide that the residue from which the marital share is given is the residue before payment of estate and inheritance taxes. An additional provision that such taxes are to be paid from the nonqualifying share of the residue should also be included.

E. Problems in Redemption of Corporate Stock Under Section 303

Section 303 of the Internal Revenue Code of 1954 permits a disproportionate redemption of certain corporate stock in order to pay death taxes, without classifying such a redemption as a dividend. Because of the requirement that such stock must equal at least 35% of the decedent's gross estate or 50% of the decedent's taxable estate, this section normally has application to a decedent who held a majority interest in a closely held corporation. The maximum use of the marital deduction is of assistance in meeting the "50 per cent of the taxable estate" test.

The testator whose principal asset is stock in a closely held corporation may feel confident that his estate will have sufficient liquidity due to the redemption provisions of Section 303, but an indiscriminate use of the popular marital deduction formula language, i.e., "one-half of my adjusted gross estate as finally determined for Federal estate tax purposes," in bequeathing property to his surviving spouse may lead to severe complications.

In many cases, the testator will wish to have his stock interest in the closely held corporation pass to his widow, at least for her life. If such life interest is coupled with a power of appointment, a bequest of such stock will qualify for the marital deduction. In order to fulfill the testator's wishes, the draftsman normally would plan to provide specifically that the bequest of the maximum marital deduction to the surviving spouse include the stock of the corporation. However, if the draftsman also uses the customary "taxes out of resi-

due" provision, the executor may be confronted with an impossible task of marshaling sufficient liquid assets to provide for the payment of death taxes since such taxes cannot be paid out of the specific bequest to the spouse.

An equally serious problem may confront the draftsman if he decides not to specifically refer to the stock in the formula marital deduction bequest and if that formula is worded so as to create a pecuniary obligation. Cf. Rev. Rul. 55-117. Under Revenue Ruling 56-270, the payment by the executor of a pecuniary bequest sufficient to utilize the maximum marital deduction would probably result in the inapplicability of the favorable provisions of Section 303 upon a subsequent redemption of the stock by the surviving spouse. That ruling provides that gain will be recognized by the estate to the extent that the fair market value of the stock on the date of distribution in satisfaction of the bequest exceeded the basis which it had acquired in the hands of the estate. Since there is recognition of gain, the surviving spouse will take over the stock at a new basis, thus disqualifying herself from the use of Section 303 (See Subsection 303(c)).

The only safe thing to do would be to have the executor redeem the stock prior to satisfying the spouse's specific bequest, but this might be contrary to the testator's intentions in some situations. In addition to this rather technical basis problem, if no mention of the closely held stock is made in the specific bequest of the maximum marital deduction, local law may require the executor to distribute the stock one-half to the surviving spouse and one-half to the residuary legatees. This could easily result in unsatisfactory intracorporate strife.

As a partial solution to these problems, it might be advisable at least to consider a bequest to the surviving spouse out of the residue of the estate of her maximum marital deduction and specifically include in her share such stock of the closely held corporation as is not redeemed under Section 303. This would give the spouse the option to continue holding the stock without impairing her right to a favorable redemption of the stock within the percentage and time limitations of Section 303.

F. Problems Involving Real Estate Subject to Marital Deduction Formula

1. Unwieldy Fractional Interests — Title Complications

In a majority of cases where the testator owns the family residence in his own name, it is his wish that his wife and family continue to live there. Therefore, the draftsman often provides that the surviving spouse is specifically de-

vised and bequeathed property "equivalent in value to one-half of my adjusted gross estate as finally determined for Federal estate tax purposes including real property and improvements thereon situated at _____" (or, "including such real property and improvements thereon as may be occupied by me as my principal residence at the time of my death.")

Unless the draftsman has carefully calculated the tax effect of these words, the widow may find herself in a temporarily, if not permanently, difficult position. In appraising the property for estate tax purposes, it is usually advisable to have a high value placed on the property since a subsequent sale by the devisees will result in the realization of a smaller gain. This is especially true in small estates where the estate tax bracket is less than the devisees' income tax brackets applicable to the capital gains. The surviving spouse who is entitled to receive only the maximum marital deduction may, therefore, in an estate consisting of an overappraised \$80,000 residence and \$80,000 worth of securities, find herself receiving from the estate only the family residence. Naturally, unless she has funds of her own, it is impossible for the spouse to continue to live in the residence, and often times she would not want to live there even if she could afford to do so. Deprived of any source of income until

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⁴⁶Trachtman, *op. cit.*, p. 54.

the residence can be disposed of, the spouse finds herself a victim of circumstances which she cannot control. Often the residence must be disposed of at a price far less than its true market value.

A more difficult situation arises where the same language is used but the appraised value of the family residence exceeds the value of the surviving spouse's "maximum marital deduction." If the residuary estate is to pass to others, the spouse will then find herself at the mercy of the residuary legatees. Under some local laws, the spouse and remaindermen would own the property as joint tenants and, accordingly, due to the terminable interest rule, the devise of the family residence would probably not even qualify for the maximum marital deduction. But even in states where the spouse and residuary legatees would own the property as tenants in common, the residuary legatees would be necessary parties to any conveyancing unless, of course, the surviving spouse undertook to have the property partitioned prior to disposing of it.

2. Who Receives Rental Income

Although conveyancing is difficult under such circumstances, administering the property becomes even more complex. With unwieldy fractional interests involved, the allocation of rent, depreciation and other miscellaneous income and expense charges on the property

may present expensive accounting problems.

Furthermore, the problem of rent can be an additional thorn in the side of the surviving spouse. If she intends to remain on the property and has sufficient income from other sources to furnish her ordinary living expenses, she nevertheless may be required by the other owners of the property to pay them a rent proportionate to their interests which she cannot afford to pay.

Worst of all is the residuary legatee-tenant in common who, when the property is to be sold, holds out for a higher price than the fair market value of the property. He can effectively bar the sale of the property by the surviving spouse unless and until there can be some amicable settlement, which settlement deprives the spouse of her just proceeds from the sale of the residence.

To eliminate the foregoing problems, some draftsmen have come to the conclusion that residential property and, indeed, other real property, should, wherever possible, be devised to a trust. With legal title in the trustee, conveyancing problems are minimized. The trust provisions can be so worded that the trust will qualify for the marital deduction and within that framework the widow can be given the right to live on the property, so long as it remains an asset of the trust or for the rest of her life. If the only asset of the trust is residential property, the trust can provide that the widow is to receive all of the trust income for the rest of her life, thus obviating the need for any possible payments of rent. At her death, the trust can also provide that one-half or all of the property is subject to a power of appointment, depending on how the marital deduction provisions are worded.

II. DISTRIBUTION PROBLEMS

A. Valuation Problems

The ordinary rule as to valuation of assets distributed in kind is that they are valued for purposes of distribution on the date of distribution.⁴⁷ However, the rule became established that the distribution of securities or other assets in satisfaction of a pecuniary legacy is a taxable transaction involving gain or loss. This is the so-called Suisman rule.⁴⁸

It was suggested that perhaps the Suisman rule should not apply to the pecuniary bequest type of marital deduction on the theory that it was not really pecuniary.⁴⁹ However, in 1956 this question seems to have been settled

⁴⁷*Boston Safe Deposit & Trust Co. v. Reed*, 229 Mass. 267; 118 N. E. 333.

⁴⁸*Suisman v. Eaton*, 15 F. Supp. 113; aff'd. 83 F. 2 1019 (CA2); *Kenan v. Commissioner*, 114 F. 2 217 (CA2); *Commissioner v. Brinckerhoff*, 168 F. 2 436 (CA2).

⁴⁹Smith, *Marital Deduction in Estate Planning*, 32 *Taxes* 15, 18 (1954).

by Revenue Ruling 56-270, holding that a bequest in an amount sufficient to utilize the maximum marital deduction was a bequest of a definite fixed dollar amount and capital gain was realized by the estate to the extent that the value on the date of distribution exceeded the estate tax valuation, citing the Suisman and Kenan cases. This difficulty may be minimized by the selection of assets of stable value for transfer to the widow's share; but certainly in every case some variation is to be expected between the estate tax value and the value at distribution unless distribution is made within the first year after the death of the decedent and the optional valuation date is selected.⁵⁰

In this connection attention is called to Code Section 267, disallowing loss in transactions between related persons. Subparagraph (c) attributes to the beneficiaries of an estate stock owned by the estate but only for the purpose of applying sub-section (b) defining the relationships of persons as to whose transactions the loss is disallowed. This list does not include transactions between estates and beneficiaries. On principle, such losses should not be disallowed because they are not of a purely voluntary nature, the kind at which this section is aimed.⁵¹

In order to avoid these income tax problems, draftsmen of wills containing the pecuniary formula began to provide that in making distributions in kind the executor should distribute the property at the estate tax valuation. This did not, however, avoid all income tax problems. Most distributions are usually made before final determination of the estate tax valuations. Any distribution before then might subject the estate to gain or loss on the transaction, depending upon whether the price at which the property was transferred proved to be the estate tax valuation finally determined. As a practical matter also it makes distributions prior to one year after the death of the decedent troublesome because at the time of transfer it is not known whether the optional valuation date will be elected; if the property is transferred at the value on the date of death, that valuation usually would be the wrong value if the optional valuation is selected, since Section 2032 requires the value at date of distribution to be taken. Also the terms of the will which requires the estate tax valuation to be used will be violated.

Giving the executor direction to distribute at the estate tax valuation is frequently adopted so as to give more opportunity for post mortem estate planning; if the values at distribution

⁵⁰I.R.C. 1954, Sec. 2032(a)(1).

⁵¹Price, *Post Mortem Estate Planning*, Proceedings N. Y. U. 15th Annual Institute on Federal Taxation, 1029, 1048 (1957).

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are substantially different from the estate tax values or if some assets have decreased in value while others have increased, or if there is a wide variation between the amount of increase or decrease in different classes of assets, the executor's discretion may be a very important power. The executor can decide at the date of distribution whether to distribute the appreciated property to the marital trust and the depreciated property to the other interests or vice versa, or whether to distribute the appreciated and depreciated assets proportionately, bearing in mind that the marital trust, if not consumed during the widow's life, will be subject to tax at the widow's death and will receive no credit as property previously taxed if she dies within ten years. Thus there may be a real tax advantage in favoring the non-marital share.

For a discussion of these questions of post mortem estate planning, see also the articles listed in footnote 52.

The possibilities of post mortem estate planning may impose great responsibilities upon the executor since there will usually be a conflict of interest between the widow and the other beneficiaries, usually the children, which is considerably aggravated if one or more of the sons is executor or co-executor and personally interested in his decisions. A few illustrations will demonstrate these problems.

Suppose some of the property has enhanced in value since the tax date and other property has not. It is necessary for the executors to sell some of the property to pay the estate tax; the marital bequest is under the pecuniary formula and the tax values are to be used as a basis of distribution. Shall the executor sell the enhanced securities and thus obtain the cash necessary to pay the taxes by the sale of a minimum amount, or shall he sell those that have not advanced or perhaps declined in value? In the latter case he will have the appreciated assets to distribute to the widow and she will thereby benefit.

Assume that a substantial part of the estate consists of the stock of a family corporation in which the son is also interested and this stock enhances materially in value after the tax date largely as a result of the son's management, but it is not specifically bequeathed to the son. The son is executor and his step-mother is the widow. Perhaps she is interested not only in obtaining her distribution in enhanced assets

⁵³Cox, *Types of Marital Deduction Formula Clauses*, *Proceedings N. Y. U. 15th Annual Institute on Federal Taxation*, 909, 932 (1957); Smith, *Marital Deduction in Estate Planning*, 32 *Taxes* 15, 17 (1954); Lovell, *Administering the Marital Deduction*, 92 *TRUSTS AND ESTATES*, 812, 813 (1953); Smith, Furman, *How to Provide for Changes in Marital Deduction Values Between Tax Date and Final Distribution*, 90 *TRUSTS AND ESTATES*, 16 (1951).

but also in obtaining an interest in, if not control of, the family business; perhaps she has a son by the testator who is coming along whose future she would like thereby to assure. What should the executor do? For further discussion of the problems of conflicting interests see footnote 53.

Where there are substantial changes between the tax date values and distribution date values and the executor is authorized to distribute on the basis of the tax date values, he has power to vary the value of the widow's marital share as actually received by her. Take an example where a \$50,000 marital bequest is reduced to \$25,000 in value at the time of distribution. It might be argued that only the lower amount passes from the husband to the widow and that the rest of the original marital deduction passes to the residuary legatees by reason of the executor's power to distribute to them the appreciated assets. If the marital deduction is by way of a qualified trust with a power in the widow to appoint the principal, it might be questioned whether the executor has been given power to appoint some part of the dollar bequest. The regulations require that none of the widow's interest in the trust may be subject to a power in any other person to appoint any part thereof.⁵⁴ Putting it differently, would it affect the marital deduction if all the enhancement went to the residue?⁵⁵

The other marital deduction formula giving a percentage of the residue to the widow avoids many of these problems. It means that the widow will share proportionately in the increases and decreases in value of the assets. Thus many of the conflict of interest problems referred to above are eliminated. Also, since her bequest will be a percentage of the residue and not a dollar amount, no taxable gain or loss occurs to the estate by the transfer to her of assets in kind in satisfaction of the marital bequest.⁵⁶ Thus no income tax problem will arise on the distributions to her.

Even when the percentage of the residue formula is used and when value

⁵³Cox, *Types of Marital Deduction Formula Clauses*, *Proceedings N. Y. U. 15th Annual Institute on Federal Taxation* 909, 942 (1957); Edmonds, *Administrative Problems under Marital Deduction Clauses*, 89 *TRUSTS AND ESTATES*, 380, 381 (1950); Smith, Furman, *How to Provide for Changes in Marital Deduction Values*, 90 *TRUSTS AND ESTATES*, 16 (1951); Kiley and Golden, *The Residue Formula*, 89 *TRUSTS AND ESTATES*, 744, 746 (1950); and 90 *TRUSTS AND ESTATES*, 824, 868 (1951).

⁵⁴Regs. 105, Sec. 81.47a(c)(5); Proposed Regs. Sec. 20.2056(b) 5(a)(5).

⁵⁵Cox, *Types of Marital Deduction Formula Clauses*, *Proceedings N. Y. U. 15th Annual Institute on Federal Taxation*, 909, 931 (1957); Edmonds, *Administrative Problems under Marital Deduction Clauses*, 89 *TRUSTS AND ESTATES*, 380, 381.

⁵⁶Rev. Rul. 55-117.

at distribution is used under the pecuniary formula the executor must still select which assets to distribute to each of the different interests. Some of the assets may have enhanced in value and some declined since the tax date and thus may have lower or higher cost bases for income tax purposes; the executor must make the allocations.

The necessity of post mortem planning is not entirely eliminated either. The estate may contain diverse types of assets; for example, it is usually wise planning to assign depreciable assets to the marital share and also assets not likely to subsequently appreciate greatly in value.

Problems also will arise under either formula where, as is usually the case, partial distributions are made. Under either formula the total value of the marital deduction cannot be finally determined even after the valuation date has been selected, until the estate tax valuations have been finally determined either by audit or litigation. Care must be exercised not to distribute too much to the widow's share.

One way to be sure that the widow and the other beneficiaries receive their exact proportions is to divide each asset into the proper proportions and distribute to the widow her exact proportion of each asset. If this is possible it will make no difference when the distri-

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bution or distributions are made. It will not be possible if any part of the assets consists of non-qualifying assets, since some of the marital deduction would be lost. Another way is to wait until the estate tax value is finally determined and thus the share of the widow finally determined, and distribute the entire estate at that time, dividing the assets according to their then value. Neither of the last two mentioned methods is likely to be followed.

If, as is usually done, partial distributions are made during the administration, and it is not possible or convenient to divide the assets specifically in kind in the required proportions, the difficulty can be minimized by making distributions of assets having proportionate values to all the beneficiaries of the residue, including the widow, making the best guess possible as to what the widow's percentage will finally be and making final adjustment between the widow and the other beneficiaries at the time of final distribution.

If partial distributions are made to the widow alone other than her share of each asset distributed, and subsequent changes in value of the remaining assets occur, the ultimate adjustment in final distribution may result in the receipt by the widow and by the other beneficiaries of a substantially different proportion of the specific assets because of changes in the value after partial distributions to the widow alone.

So the executor, even under the percentage of the residue formula has considerable discretion and power in any event and not all problems are solved by avoiding the pecuniary formula.

A consideration of the foregoing problems of valuation points to the conclusion that the pecuniary formula gives rise to more tax problems or problems of conflicting interest than the percentage of the residue formula and, unless the testator desires the widow to be certain of the dollar amount without regard to subsequent enhancement or decline in value of his assets, and unless his family situation is likely to be har-

monious after his death, he may well conclude that the percentage of the residue formula is safer. Indeed, further consideration of all the problems may lead the testator or his counsel to the conclusion not to use either of the formulae.

B. Qualification of Spouse's Award or Widow's Allowance For Marital Deduction

In most States provision has been made by statute for payment to the surviving spouse from the general estate of a decedent. Such benefits are generally considered as providing for the needs of the family during the period of administration.⁵⁷

If such an award, sometimes called a "widow's allowance," could be granted as a part, or in lieu, of dower or curtesy there would be no problem about qualification for the marital deduction. The estate tax law has a clear and affirmative provision permitting it.⁵⁸ However, normally this type of "support" allowance, to which either surviving spouse is entitled in many States, is entirely distinct from any interest which he or she may inherit by way of intestacy or under a will, or to which the survivor may be entitled by way of dower, curtesy, statutory thirds or similar right.

The nature of the award and how it is calculated, and whether it is automatic or only granted after the institution of some kind of a proceeding, means that perhaps the qualification *vel non* for the marital deduction may well vary from State to State depending upon the specific statutory provisions under which the spouse's award is created.

When the marital deduction was created by the Revenue Act of 1948, there was no problem in many States as to whether or not a spouse's award would qualify. It was not necessary. Section 812(b)(5) of the 1939 Code provided that for tax purposes there were deductible from the value of the gross estate all amounts "reasonably re-

quired and actually expended for the support during the settlement of the estate of those dependent upon the decedent." But it was soon found that this provision benefited inequitably estates in those States where generous allowances were made. An appealing widow and a sympathetic judge could considerably disturb the presumed equal impact of taxes on estates of equal size.

To correct this situation a new section was inserted in the Revenue Act of 1950 to eliminate the spouse's award, as such, as a deductible item from gross estate for federal estate taxes. But then the question was immediately raised as to whether or not it could still be deductible by qualifying for the marital deduction, which is described in the statute in general terms⁵⁹ as "any interest in property which passes or has passed from the decedent to his surviving spouse," provided that it is not a terminable interest.

It became apparent that the answer would thereafter depend upon how the two absolute conditions to the qualification for the marital deduction could be satisfied, namely, that the interest must not be a "terminable interest," and it must be an interest "which passes or has passed from the decedent to his surviving spouse." The Congressional Committees⁶⁰ contemplated that at least some types of spouse's awards would qualify for the marital deduction "subject to the conditions and limitations of section 812(e)" (now Section 2056).

Not necessarily a terminable interest.

A 1953 Revenue Ruling explains that the nature and effect of spouse's awards vary in different States. In some, any allowance to which the surviving spouse may be entitled will terminate in the event of the spouse's death or remarriage during the period of the settlement of the estate. In such a case the allowance amounts to no more than an annuity payable out of the estate assets for a limited period, and therefore constitutes a "terminable interest." In other States the spouse's right becomes fixed and will survive death or remarriage. In such a case the spouse's award could qualify, *Rev. Rul. 83* stating:⁶¹

"In order to qualify under this subparagraph, any right of a widow to an allowance in her husband's estate must be a vested right of property which is not terminated by her death or other contingency. * * * Whether any interest thus taken by a widow satisfies the statutory requirements in this respect is to be determined in the light of the applicable provisions of the State statutes, as inter-

⁵⁷21 *Am. Jur.*, p. 560.

⁵⁸I.R.C. (1954), Sec. 2056(e)(3).

⁵⁹I.R.C. (1954), Sec. 2056(a) (Sec. 812(e)(1) (A) of the 1939 Code.)

⁶⁰Report of House Committee on Ways and Means, C. B. 1950-2, p. 380 at page 478; Report of Senate Committee on Finance, C. B. 1950-2, p. 483 at page 576.

⁶¹C.B. 1953-1, p. 395.



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preted by the local courts. * * * (But it must) constitute a vested right of property such as will, in the event of her death as of any moment or time following the decedent's death, survive as an asset of her estate."

The holding in *Rev. Rul. 83* was reaffirmed in 1956 in *Rev. Rul. 56-26*.⁶²

Passing from decedent to surviving spouse.

One of the first words on the subject of whether or not a spouse's award should be considered as "passing from the decedent to the surviving spouse" was given in the Report of the Senate Committee on Finance at the time the Revenue Act of 1948 was being considered:⁶³

"An interest in property does not pass to the surviving spouse from the decedent * * * by reason of a claim against the estate * * *. Neither the payments made in satisfaction of such a claim or debt nor the amounts expended in accordance with the local law for support of such surviving spouse during the settlement of the estate pass to such surviving spouse from the decedent within the meaning of section 812(e) (3)" (now Section 2056(e)).

But, as explained above, at that time the spouse's award was deductible from the gross estate. Since the Revenue Act of 1950 repealed that provision, the earlier language of the Committee Report seemed to have denied the validity of the above-mentioned Revenue Rulings relating to "terminable interests."

The problem was presented by Section 2056(e) of the 1954 Code (Sec. 812(e) (3) of the 1939 Code), the one mentioned specifically in the foregoing Committee Report, which provides that for purposes of the marital deduction an interest in property shall be considered as passing from the decedent to any person *only if* it is bequeathed or devised to such person by the decedent or if it is inherited by such person from the decedent. It is true that there are five other specified tests which would permit an interest to be considered as "passing from the decedent to his surviving spouse" but they are all irrelevant to this discussion. The closest one, which permits qualification if the interest is a dower or curtesy interest (or statutory interest in lieu thereof), is eliminated from consideration here since the spouse's award discussed in this paper is by definition an award made *in addition to* dower or curtesy.

However, as in the case of the "terminable interest" problem, the Commissioner has again taken a position in writing which acknowledges the possibility that at least some types of spouse's awards can be considered as "passing" and therefore qualifying for the marital deduction. In the Proposed Estate Tax

Regulations which were issued on October 16, 1956, it is stated:⁶⁴

"An allowance or award paid to a surviving spouse pursuant to local law for her support during the administration of the decedent's estate constitutes a property interest passing from the decedent to his surviving spouse if the executor or administrator of the surviving spouse's estate could under local law have caused the allowance or award to be paid to her estate in the event of her death immediately after the decedent's death."

Without taking a position until faced with each specific situation the Commissioner seems to be saying that there might well be a little different treatment for a spouse's award which is automatic and is a fixed amount to which the spouse is entitled immediately upon the death of the decedent, from that given an award which is made only after the survivor has had the opportunity to employ a lawyer to file a petition, have a hearing thereon, and then obtain a decision of the court fixing a certain amount either as the sum that should be paid periodically during the administration of the estate, or an aggregate sum which should be paid to the widow in a single fixed amount regardless of how long the administration might take.

At this point it would be well to review two recent cases.

In *Proctor D. Rensenhouse*⁶⁵ testator explained in his will that he had made adequate provision for his wife through an insurance program and that, therefore, he was making only a limited provision for her in his will. The widow filed a petition for an award or allowance under the Michigan law. The court granted \$10,000 a year to be paid in monthly instalments, for a period of one year. The Tax Court held that the award did not constitute an interest which "passed from the decedent to his spouse." The Court said "that the widow received the widow's allowance not as a legatee, heir or beneficiary of the es-

tate, but as the widow of the decedent and by virtue of the statute." It concluded that a widow's allowance under the Michigan law amounted to no more than a cost of administration, and since that had been repealed as a proper deduction by the Revenue Act of 1950, and the allowance could not be considered as having passed from the decedent to his surviving spouse under the provisions of the existing statute, the spouse's award could not qualify for the marital deduction. The case is now on appeal to the Court of Appeals for the Sixth Circuit.

Although the opinion in *Rensenhouse* was filed six days after the Proposed Estate Tax Regulations were issued, it did not mention them. One month and five days after the filing of *Rensenhouse* the opinion in *King v. Wiseman*⁶⁶ was published. Pending the settlement of the decedent's estate the local probate court had ordered the executor to pay \$1,250 per month to the widow for her support and maintenance. The U. S. District Court held that the entire amount could qualify for the marital deduction, and then went one step further. It held that under the Oklahoma statutes the spouse's award was "not even part of the gross estate subject to administration and federal estate taxes." The conclusion of the Court, quite contrary to that promulgated earlier by the majority in *Rensenhouse*, was reached without reference to that case or to the Proposed Regulations, or even to any of the supporting Committee Reports or Revenue Rulings.

Reconciliation of authorities.

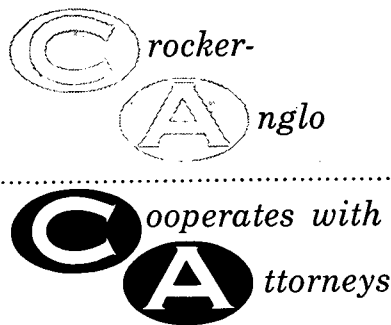
In trying to reconcile the foregoing authorities one thing stands out. Although both the Tax Court and the Proposed Regulations turn on the importance of the phrase "passing from the decedent to the surviving spouse," precisely the same factors seem to be involved in considering whether the spouse's award can pass the "terminable interest" test.

The 1950 Committee Reports, speaking

⁶⁴Proposed Regs. Par. 20.2056(e)-2(a).

⁶⁵*Proctor D. Rensenhouse*, 27 T. C.—, No. 10 (1956).

⁶⁶147 F. Supp. 156 (W. D. Okla.-1956).



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⁶²C.B. 1956-1, p. 447.

⁶³C.B. 1948-1, p. 331 at page 333.

of qualification for the marital deduction in general, mention that qualification is contemplated "subject to the conditions and limitations of section 812(e)" (now Section 2056). The focus is then sharpened by the two Revenue Rulings in 1953 and 1956 under the heading of "terminable interest." It is there said that in order to qualify, the surviving spouse must have a vested right which will not terminate because of death or other contingency.

But suppose the interest of the spouse depends on something being done after the decedent's death, before it even comes into existence. Is there an unavoidable lapse of time during which there is no interest in being? If the surviving spouse should die then, would the interest ever come into existence? Is it not then a "terminable interest," for it would indeed have terminated if the surviving spouse did not live long enough to have the right to the award born? Or would it be more correct to say instead that such an interest simply does not "pass from the decedent to the surviving spouse" since there is no bridge to carry it over that empty period before the petition is filed and the court makes its finding?

Perhaps this is what the Revenue Rulings had in mind when they added that in order to qualify and avoid the "terminable interest" pitfall the right must survive as an asset of the survivor's estate in the event of death "as of any moment or time following the decedent's death" — what the Proposed Regulations meant in connection with "passing from the decedent" when they mentioned that, to qualify, the interest must be payable to the survivor's estate in the event of the survivor's death "immediately after the decedent's death."

The award which by statute is a fixed amount that is automatically determined upon the death of the first to die, and is then collectible by the estate of the survivor if he or she dies immediately thereafter, should surely qualify. As for awards under other types of statutes, there is a question.

If the foregoing is correct then so perhaps is *Rensenhouse*, although not so the Oklahoma decision, unless it can be distinguished on the second ground that somehow the allowance was "not even part of the gross estate" to begin with. In his allegations of error in *Rensenhouse* the petitioner contends that under Michigan law a spouse's award "when approved and authorized by the Probate Court" becomes a vested and absolute right. If that is correct then there is that area of time when there is no interest actually in existence; so that if the survivor died at that instant there never would be an interest; it would have been terminable.

There is no indication in the opinion as

to what the Michigan law is on that point. But by the same token the interest, if it must wait for the petition and order, without any sustenance in the meantime, might then be truly said to have been born from or arrived with the court order as its first breath, rather than having "passed" from the decedent. Under the circumstances the chain would have been broken.

C. Presumption that Non-Qualifying Assets Are Included in Satisfying Marital Deduction

Section 2056(b)(2) provides that where assets are of such a character that they would not qualify for the marital deduction if left directly to the widow, such as a terminable interest, then the allowable marital deduction will be reduced by the amount of the value of such non-qualifying assets, whether or not the executor uses them to satisfy any marital gift to the wife, if they could be so used.

Thus, if there is a non-qualifying interest valued at \$10,000 in an estate of \$200,000, and the husband uses a formula clause in leaving the maximum marital deduction to his wife, and if there is nothing in the will to prevent the executor from using the terminable interest to satisfy the gift, it will be presumed that the executor does use the non-qualifying interest for marital deduction purposes. As a result, although the size of the gift to the wife will not be affected, the allowable deduction will be reduced by \$10,000 to \$90,000.⁶⁷

Under such circumstances it would be advisable always to provide affirmatively in a will where a formula type clause is used that if the decedent should own such an asset at the time of his death such asset is not to be used to satisfy any interest bequeathed to the surviving spouse. The Proposed Regulations recognize this precautionary measure and permit the use of it to preserve for the estate the full amount of the marital deduction, saying:⁶⁸ "If the decedent's will provided that his wife's bequest could not be satisfied with a non-deductible interest, the entire bequest is a deductible interest."

D. Abatement of Marital Deduction Bequest

Because the amount allowed as a marital deduction cannot exceed the amount actually passing to the surviving spouse from the decedent, any abatement in such a bequest will reduce the allowable marital deduction unless the abated amount that actually passes to the surviving spouse exceeds the maximum allowable marital deduction, that is, one half of the adjusted gross estate.

Thus, in the *Estate of Wheeler v.*

⁶⁷See Proposed Regs. Par. 20.2056(b)-1(c)(ii).

⁶⁸Proposed Regs. Par. 20.2056(b)-2(d).

*Comm.*⁶⁹ the marital deduction bequest of a residuary estate was denied because after the payment of administration expenses, debts, and taxes nothing remained in the residuary estate for distribution to the surviving spouse. Since residuary bequests generally abate before general and specific legacies,⁷⁰ it would appear advisable to establish an order of abatement in the decedent's will that would result in the abatement of the marital deduction bequest last. This is particularly true if any anticipated abatement would reduce the amount actually received by the surviving spouse below the maximum allowable deduction.

Appropriate draftsmanship may also minimize or avoid a reduction in the allowable marital deduction by the amount of the death taxes attributable thereto. Unless the marital deduction bequest passing to the surviving spouse is exonerated from the payment of the death taxes attributable thereto either by the terms of the decedent's will or by local law, the allowable marital deduction will be reduced by the amount thereof.⁷¹ For an annotation relating to the effect of various will provisions upon the death tax burden, see 37 ALR 2d 13. See also 37 ALR 2d 202 for an annotation relating to the effect of a tax apportionment statute upon the tax burden and 37 ALR 2d 169 for an annotation relating to the imposition thereof in the absence of a statutory or will provision.

Since the exoneration of a bequest from the payment of taxes is ineffective in the event that the fund designated for their payment is insufficient,⁷² provision should be made to insure that the marital deduction bequest will abate last in order to provide for their payment. In this manner, maximum advantage may be obtained from the marital deduction bequest in the case of an insufficiency of the decedent's assets.

III. COMMUNITY PROPERTY PROBLEMS

Not all property owned by married residents of community property states is their community property. "Separate property" includes not only property of which one spouse is the sole owner, but also property held by the spouses in other forms of cotenancy, such as joint tenancy, tenancy in common, and tenancy in partnership. It therefore becomes necessary for lawyers in community property states to be thoroughly familiar with the marital deduction, as well as with the treatment of community

⁶⁹26 T. C. 466 (1956). See also, *Estate of Herman Hohensee, Sr. v. Commissioner*, 25 T. C. 1258 (1955).

⁷⁰57 Am. Jur. Wills, Sec. 1458, p. 979-980.

⁷¹I.R.C. (1954) Sec. 2056(b)(4); see, *Estate of Rose G. Jaeger*, 27 T. C. No. 105 (1957); *Estate of Charles Juster*, 25 T. C. 669 (1955); cf. *Estate of Rosalie Cahn Morrison*, 24 T. C. 965 (1955).

⁷²37 A.L.R. 2d 126.

property under the Internal Revenue Code.

The first problem of estate planning in community property states is to determine whether there is any separate property. Property owned before marriage or subsequently acquired by gift, descent, devise or bequest is separate property, as is also property derived therefrom; but the laws of community property states differ as to whether income from separate property is separate or community. Thus, income during marriage from the separate property of a resident of Texas is community property,⁷³ whereas income from separate property of a California resident is always separate property.⁷⁴ There are other differences between the community property laws of the eight states within the community property group, and it would be very difficult to plan the estate of a person domiciled in any one of these states, or owning real property located therein, without the active participation of a member of the bar of that particular state.

Of course, if in your particular case all property of the testator is community property, no thought need be given to the marital deduction. Section 2056(c) (2) (B) of the Internal Revenue Code provides that in computing the adjusted gross estate all community property must be deducted from the gross estate. If the entire gross estate consists of community property, the adjusted gross estate will be zero, and the marital deduction will also be zero. On the other hand, it is inaccurate to say that community property does not "qualify" for the marital deduction. If the gross estate includes both community and separate property, a marital deduction will be allowed for community property passing to the surviving spouse, so long as the value thereof does not exceed one-half the adjusted gross estate — that is, one-half the value of the separate property.

It is only rarely, however, that community property is used for the purpose of obtaining the marital deduction. The reason is easy to understand. Only one-half of the community property will be subjected to estate tax however it may be devised or bequeathed.⁷⁵ A favored practice is to leave it in trust to pay the income to the surviving spouse for life, remainder to children or others. If such a trust were intended to qualify for the marital deduction it would be necessary to give the surviving spouse a general power of appointment, thus putting it in his or her power to disinherit the intended remainderman. Where,

⁷³W. T. Carter, Jr., 36 B.T.A. 853 (1937).

⁷⁴California Civil Code, Secs. 162, 163.

⁷⁵An exception should be noted for California community property acquired before July 29, 1927, in the absence of an agreement specifying equal shares.

therefore, the estate contains both community and separate property, the testator usually prefers to subject only one-half of the separate property, and none of the community property, to such a general power of appointment.

A special rule is established for separate property acquired with community funds. Under subsection 2(C) of Section 2056(c) of the Code such separate property is treated as community property for purposes of computing the adjusted gross estate, unless it was acquired before 1942.⁷⁶ If it was acquired before 1942 the taxpayer gets a break. Assume, for example, that community funds are used in 1940 to acquire property in the names of the spouses as joint tenants. Although only the decedent's one-half interest is included in the gross estate, it is not treated as community property in computing the adjusted gross estate, and a marital deduction is therefore allowed, with the result that only one-fourth of the entire value of the joint tenancy property is subjected to the tax.

The laws of the community property states vary as to the extent to which such property is liable for the separate debts of the spouses, as distinct from those of the marital community. This of course affects the computation of the adjusted gross estate and of the maximum marital deduction, but if and to the extent that a marital deduction is allowable, it may be taken by any form of devise or bequest which satisfies the requirements of Section 2056. The use of the formula type of bequest, there-

⁷⁶Before the enactment of the 1954 Code, an exception was also made for separate property acquired with community funds between Jan. 1, 1943 and April 2, 1948. Sec. 812(e) (2) (C) of the 1939 Code.

fore, presents precisely the same problems as in the common law states.

IV. PRACTICAL CONSIDERATIONS IN USING MARITAL DEDUCTION CLAUSES

From the foregoing sections of this report we may conclude that legal and practical considerations will sometimes dictate a use of less than the maximum marital deduction and the accomplishment of marital deduction objectives by means other than by use of formula clauses. Some situations where less than the maximum marital deduction may be desirable are discussed below.

Increase of death taxes on successive estates.

Effective estate planning requires that the incidence of tax savings be where such savings best serve the testator's objectives in providing for his beneficiaries. For example, the testator may desire to minimize taxes on his death to provide a maximum amount of assets for his surviving spouse. Such an objective calls for a use of the maximum marital deduction. On the other hand, the testator may wish to minimize the death tax take on successive estates of husband and wife thereby leaving a greater amount of assets for succeeding generations.

This latter objective may be defeated by using the maximum marital deduction where the spouse has property in addition to that passing to her from the testator. If the property of the spouse is so substantial as to cause the marital deduction property received by her to be taxed in her estate at rates substantially greater than the rates applicable to the testator's estate, then an overall death tax saving may be accomplished

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by using less than the maximum marital deduction in the testator's estate. Mathematically, equalization of estates usually results in the least amount of total taxes on the two estates.⁷⁷

However, the following important factors in the use of a maximum or near maximum marital deduction to save taxes on the death of the first of the spouses to die should be considered.

- (a) The burden of raising cash for taxes in the testator's estate is lightened. This could have such important results as saving the family business from liquidation to pay taxes.
- (b) More assets remain available for the surviving spouse during her life. Particularly where the spouse has a long life expectancy, those assets may increase in value and produce substantial income over the years for her benefit.
- (c) Death taxes may not be increased on the death of the surviving spouse because:
 - (1) Where desirable, the surviving spouse may use up the marital deduction assets for her support and enjoyment or otherwise take steps to remove them from her taxable estate, as by making gifts or investing in foreign real estate.
 - (2) The fact that the effective estate tax rate for taxable estates between \$120,000 to slightly over \$1,000,000 ranges between 27.2% and 32.2% means that the marital deduction property, if it remains to be taxed in the spouse's estate, usually will not be taxed at a rate substantially greater than the rate at which such property would have been taxed in the testator's estate had it not qualified for the marital deduction.

Simplicity may be preferred.

Use of a maximum marital deduction usually implies the use of formula clauses which have a further objective of saving taxes on the death of the surviving spouse by preventing all property not needed for a maximum marital deduction from becoming a part of the taxable estate of the surviving spouse. Such formula clauses are seldom understood by testators for they must be comprehensive enough to take into account not only probate assets but also non-probate assets such as joint tenancies, various types of trusts and insurance, and many other factors. At the risk of achieving less than a maximum marital deduction, or of having too much property taxed on the death of the surviving spouse, many testators will understand and prefer to use a simple marital deduction bequest to their spouses of one-half of the decedent's separate property rather than formula clauses which they cannot understand.⁷⁸

⁷⁷Particular care should be exercised in taking into account the effect of State death tax computations which may make such a generalization false.

⁷⁸For a discussion of this and other problems concerning the drafting of wills with marital deduction provisions, see Harry M. Halstead,

However, such non-formula clauses put a tremendous burden, at the time the will is prepared, on accurate analysis of the nature and value of a testator's property. Inaccuracies in such things as estimating probable value at death of non-probate assets may have unfortunate death tax results which could be avoided by use of a formula clause which automatically adjusts the amount of the marital deduction legacy, taking into account the value of probate and non-probate property as it exists at the time the will is put into effect.

Testator's objectives. Power to alienate.

If property is to qualify for the marital deduction, it must pass to the surviving spouse in some manner that will permit her at some time to dispose of it as she sees fit. Certain permissible technical limitations, such as requiring specific reference in the spouse's will to a power of appointment in the testator's will,⁷⁹ may not satisfy a testator who desires assurance that his property ultimately will descend to his issue.

Section 2056(b)(4) requires that in valuing the interest in property passing to the surviving spouse there must be taken into account the effect of State and Federal death taxes and any encumbrances on marital deduction property interests and the effect of obligations imposed on the surviving spouse with respect to the passing of such property to her. However, such reasons as a preponderance of non-liquid assets may make it desirable during probate to make income available to meet administration expenses and to have property passing to the surviving spouse bear a proportionate part of the death taxes.⁸⁰

In addition to the four problem areas just discussed, there are many other matters to consider in using the marital deduction wisely — whether to use estate trusts or power of appointment trusts, clauses favoring survivorship of the testator or of the spouse, pecuniary bequests or share of residue bequests, are but a few. However, no problem is more complex than that of whether to use maximum marital deduction formula clauses or take one's chances on receiving too much or too small a marital deduction through non-formula clauses. Some criticisms, in addition to those already mentioned, of maximum marital deduction formula clauses are that:

- (a) Pecuniary-type formula clauses may create income tax problems at the time of distribution of the marital deduction legacy.⁸¹

Drafting Tax Clauses in a Will—Marital Deduction Clauses, 1957 Southern California Tax Institute 505.

⁷⁹*Ibid.*, p. 544.

⁸⁰*Ibid.*, p. 523; Where power of appointment trusts are used to qualify for the marital deduction, restrictions on income during probate should be avoided.

⁸¹*Ibid.*, p. 532; Rev. Rul. 56-270, 1956-1C. B. 325.

- (b) The spouse's share of the estate will depend on the outcome of the Federal estate tax proceedings, possibly causing much uncertainty and anguish to some widows unable to comprehend such matters.
- (c) Distribution of a substantial part of the probate estate may be delayed as much as several years pending final determination of the Federal estate tax and the exact amount of the marital deduction.
- (d) The executor under formula clauses often has the problem of selecting assets to distribute in satisfaction of the marital deduction legacy, thus giving the executor the power to determine which assets the widow is to receive.

Regardless of the many legal and practical problems engendered by the use of maximum deduction formula clauses, the facts remain that they are widely used and that relatively few of the difficulties that *might* arise ever really do arise. Certainly the executor's task can be more difficult because of the use of formula clauses in wills. However, if maximum death tax savings in the testator's estate outweigh other considerations, use of formula clauses often will be the only satisfactory answer.

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