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Michael D. Arri

Washington University School of Law

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NOTES

ESTATE PLANNING THROUGH MARITAL DEDUCTION EQUALIZATION CLAUSES

Since enactment of the federal estate tax marital deduction in 1948,¹ estate planners have explored numerous methods of utilizing the marital deduction to minimize married couples' estate taxes. Several commentators have advocated the use of marital deduction equalization clauses.² In three recent cases³ the Internal Revenue Service challenged marital bequests⁴ effected through such clauses, asserting that the interests created failed to satisfy the deductibility requirements of section 2056.⁵ The Tax Court, however, upheld the validity of each equalization clause bequest and thus allowed the claimed marital deduction. The Seventh Circuit affirmed the Tax Court judgment in the only case yet decided at the appellate level.⁶

Part I of this Note presents an overview of the estate tax marital deduction provisions, with special attention to the terminable interest limitations.⁷ Part II examines the judicial response to marital deduction equalization clauses,⁸ while Part III presents a critical analysis of that response.⁹ Part IV explores the effects of the Tax Reform Act of 1976 on the marital deduction equalization clause as a planning technique

1. Revenue Act of 1948, Pub. L. No. 471, 62 Stat. 110 (1948) (codified at I.R.C. § 2056).

2. See, e.g., A. CASNER, ESTATE PLANNING 1240 & n.128a (3d ed. 1961 & Supp. 1978); Barnes, *New Tax Court Decisions Broaden Estate Planning Potential of Marital Deduction*, 45 J. TAX. 292, 295 (1976); Kabaker, *Drafting Post-1976 Marital Deduction Formula Clauses*, in THE TWELFTH ANNUAL INSTITUTE ON ESTATE PLANNING ¶ 1210.1-3 (U. Miami 1978); Note, *Equalization Clauses with Alternate Valuation: An Emerging Option for Estate Planners*, 63 IOWA L. REV. 486, 502-03 (1977).

3. Estate of Laurin v. Commissioner, 38 T.C.M. (CCH) 644, *appeal docketed*, No. 79-1606 (6th Cir. Oct. 30, 1979); Estate of Meeske v. Commissioner, 72 T.C. 73, *appeal docketed*, No. 79-1615 (6th Cir. Oct. 31, 1979); Estate of Smith v. Commissioner, 66 T.C. 415 (1976) (nonacq. 1978-1 C.B. 3), *aff'd per curiam*, 565 F.2d 455 (7th Cir. 1977).

4. The term "marital bequest," as used in this Note, refers to any interspousal bequest intended to qualify for the marital deduction.

5. See I.R.C. § 2056; notes 11-27 *infra* and accompanying text.

6. Estate of Smith v. Commissioner, 565 F.2d 455 (7th Cir. 1977), *aff'g per curiam*, 66 T.C. 415 (1976), *nonacq.* 1978-1 C.B. 3.

7. See notes 11-34 *infra* and accompanying text.

8. See notes 35-73 *infra* and accompanying text.

9. See notes 74-99 *infra* and accompanying text.

and analyzes the alternatives available after the Revenue Act of 1978.¹⁰

I. MARITAL DEDUCTION: THE STATUTORY FRAMEWORK

Section 2056¹¹ of the Internal Revenue Code creates the estate tax marital deduction. Congress enacted the marital deduction provision in 1948¹² in an attempt to achieve uniform federal estate tax treatment of married individuals in community property and common-law jurisdictions.¹³ Section 2056, as amended by the Tax Reform Act of 1976,¹⁴ allows a deduction from a decedent's gross estate for the value of any interest in noncommunity property¹⁵ passing from the decedent to the decedent's surviving spouse.¹⁶ The deduction is limited to \$250,000 or one-half of the adjusted gross estate,¹⁷ whichever is greater.¹⁸ The in-

10. See notes 100-119 *infra* and accompanying text.

11. I.R.C. § 2056.

12. Pub. L. No. 471, 62 Stat. 110 (1948).

13. *Jackson v. United States*, 376 U.S. 503, 510 (1964); *United States v. Stapf*, 375 U.S. 118, 128 (1963); H.R. REP. NO. 1274, 80th Cong., 2d Sess. 24-26 (1948); S. REP. NO. 1013 (Part 1), 80th Cong., 2d Sess. 5, 26-29 (1948), *reprinted in* 1948-1 C.B. 288, 300-302.

Under a community property system only one-half of any community property is includible in the estate of a decedent spouse because outright ownership of the other half vests in the surviving spouse. Prior to enactment of the marital deduction provisions, estate tax burdens fell more heavily on married couples in common-law jurisdictions, given the existence of progressive estate tax rates and the fact that any property bequeathed by a decedent spouse to a surviving spouse would have been fully includible and hence taxable in the estates of both spouses. Through enactment of the marital deduction, Congress attempted to provide to couples in common-law jurisdictions the same "estate-splitting" possibilities automatically available to couples in community property jurisdictions. *United States v. Stapf*, 375 U.S. 118, 128 (1963).

14. Tax Reform Act of 1976, § 2002(a)(1), Pub. L. No. 94-455, 90 Stat. 1854 (1976).

15. I.R.C. §§ 2056(c)(1)(C), (c)(2)(B).

16. Determination of the requisite legal relationship qualifying an individual as a decedent's surviving spouse is sometimes a difficult matter, especially when one of the parties has received a divorce decree which is later declared invalid by a jurisdiction other than the one granting the original decree. *Compare* *Estate of Spalding v. Commissioner*, 537 F.2d 666 (2d Cir. 1976) *with* *Estate of Goldwater v. Commissioner*, 539 F.2d 878 (2d Cir.), *cert. denied*, 429 U.S. 1023 (1976) *and* *Estate of Steffke v. Commissioner*, 538 F.2d 730 (7th Cir.), *cert. denied*, 429 U.S. 1022 (1976). See generally S. REP. NO. 1013 (Part 2), 80th Cong., 2d Sess. 6-7 (1948), *reprinted in* 1948-1 C.B. 335. See also *Eccles v. Commissioner*, 19 T.C. 1049, 1053 (1953), *aff'd per curiam*, 208 F.2d 796 (4th Cir. 1953).

17. I.R.C. § 2056(c)(2) defines the adjusted gross estate as the gross estate less the deductions allowed by I.R.C. § 2053 (for funeral and administration expenses, and claims against the estate) and I.R.C. § 2054 (for certain losses from casualty and theft). The section also provides for an appropriate adjustment, in determining the amount of the adjusted gross estate, for the value of community property held by the decedent. I.R.C. § 2056(c)(2)(B).

18. I.R.C. § 2056(c)(1)(A). The Code also provides an adjustment to the limitations placed on the amount of the estate tax marital deduction, for the amount of any gift tax marital deduction claimed by the decedent for lifetime gifts made by the decedent to the spouse. *Id.* § 2056(c)(1)(B).

terest passing to the surviving spouse must be includible in the decedent's gross estate to qualify for the marital deduction.¹⁹

Section 2056(b), referred to as the "terminable interest rule,"²⁰ establishes another major limitation on the marital deduction. Section 2056(b)(1)²¹ denies the availability of the marital deduction for any interest passing to the surviving spouse if the interest may terminate or fail "on the lapse of time, on the occurrence of an event or contingency,

Notwithstanding this required adjustment, in certain instances appropriate planning for optimal use of the gift tax and estate tax marital deductions can reduce aggregate transfer taxes (i.e., gift taxes and estate taxes, combined) on transfers by an individual to his or her spouse. *See, e.g., Allington, How Interspousal Gifts, Marital Deductions Shape Estate Taxes on Successive Estates*, 48 J. TAX. 284 (1978).

Prior to amendment by the Tax Reform Act of 1976, § 2056(c) limited the maximum marital deduction to one-half of the adjusted gross estate. The 1976 amendment revising the limitation to the greater of \$250,000 or one-half of the adjusted gross estate affects only estates under \$500,000.

The 1976 Act also instituted the unified credit which provides for a credit against the estate tax of up to \$47,000 for estates of decedents dying after 1980. I.R.C. § 2010. The result of this provision is to make estates under \$175,625 completely nontaxable regardless of any bequest intended to qualify for the marital deduction. *See* notes 107-09 *infra* and accompanying text. Consequently, the effect of any pre-1976 clause providing for a bequest to the surviving spouse equal in amount to the maximum marital deduction should be carefully reconsidered in light of the 1976 changes.

19. I.R.C. § 2056(a) provides:

Allowance of Marital Deduction. For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsections (b) and (c), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

20. *See, e.g., Jackson v. United States*, 376 U.S. 503, 510 (1964); S. REP. No. 1013 (Part 2), 80th Cong., 2d Sess. 7 (1948), *reprinted in* 1948-1 C.B. 335.

21. I.R.C. § 2056(b)(1) states:

(b) *Limitation in the Case of Life Estate or Other Terminable Interest.*

(1) *General Rule.*—Where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction shall be allowed under this section with respect to such interest—

(A) if an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse); and

(B) if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse; and no deduction shall be allowed with respect to such interest (even if such deduction is not disallowed under subparagraphs (A) and (B))

(C) if such interest is to be acquired for the surviving spouse, pursuant to the directions of the decedent, by his executor or by the trustee of a trust. For purposes of this paragraph, an interest shall not be considered as an interest which will terminate or fail merely because it is the ownership of a bond, note, or similar contractual obligation, the discharge of which would not have the effect of an annuity for life or for a term.

or on the failure of an event or contingency to occur."²² This limitation applies, however, only if upon that termination or failure the interest in the property passes from the decedent to a person other than the surviving spouse, and as a result that person thereafter possesses or enjoys any part of the property.²³

The terminable interest rule is subject to several exceptions, the most pertinent being section 2056(b)(5).²⁴ That section provides that if an interest in property passes from the decedent, and the surviving spouse is entitled to all the income from that interest for life and receives a general power of appointment over the interest, then the interest shall be considered as passing to the surviving spouse and not to any other

22. *Id.*

23. *Id.* A few examples may help to illustrate the operation of the terminable interest rule. Perhaps the most common form of terminable interest is the life estate in the surviving spouse. In such a case the surviving spouse's life estate and hence her interest in the property necessarily terminate on her death, and the remaindermen thereafter possess or enjoy the property. (If coupled with a grant to the surviving spouse of a general power of appointment over the property, the bequest of a life estate to a surviving spouse may nonetheless qualify for the marital deduction under § 2056(b)(5). See notes 24-27 *infra* and accompanying text.)

Additional examples of terminable interests are bequests in the form "to my wife for a specified term of years," "to my wife until she remarries," or "to my husband until he reaches age sixty-five," with remainders over to others upon the occurrence of the contingency. S. REP. NO. 1013 (Part 2), 80th Cong., 2d Sess. 7 (1948), *reprinted in* 1948-1 C.B. 335.

A bequest of an interest in property such as a patent is not a nondeductible terminable interest within the meaning of § 2056(b)(1). Even though the patent itself, and hence the surviving spouse's interest therein, must necessarily terminate with the lapse of time, the interest in the patent does not thereafter pass from the decedent to someone other than the surviving spouse.

If the decedent directs the executor to purchase a patent or a similar interest for distribution to the surviving spouse, however, the interest will not qualify for the marital deduction. I.R.C. § 2056(b)(1)(C). See note 21 *supra*.

24. I.R.C. § 2056(b)(5) states:

(5) *Life Estate with Power of Appointment in Surviving Spouse.*—In the case of an interest in property passing from the decedent, if his surviving spouse is entitled for life to all the income from the entire interest, or all the income from a specific portion thereof, payable annually or at more frequent intervals, with power in the surviving spouse to appoint the entire interest, or such specific portion (exercisable in favor of such surviving spouse, or of the estate of such surviving spouse, or in favor of either, whether or not in each case the power is exercisable in favor of others), and with no power in any other person to appoint any part of the interest, or such specific portion, to any person other than the surviving spouse—

(A) the interest or such portion thereof so passing shall, for purposes of subsection (a), be considered as passing to the surviving spouse, and

(B) no part of the interest so passing shall, for purposes of paragraph (1)(A), be considered as passing to any person other than the surviving spouse. This Paragraph shall apply only if such power in the surviving spouse to appoint the entire interest, or such specific portion thereof, whether exercisable by will or during life, is exercisable by such spouse alone and in all events.

person.²⁵ Thus, although every life estate is inherently terminable,²⁶ the effect of section 2056(b)(5) is to allow the marital deduction for certain qualifying life estates by removing them from the operation of the terminable interest rule.²⁷

Estate planners often can integrate married couples' dispositive wishes with appropriate marital deduction planning to achieve significant estate tax savings. A primary goal of marital deduction planning is to prevent double estate taxation of property held by a married couple. Marital deduction property, if not consumed prior to death, is includible in the estate of the surviving spouse. Therefore, estate planners have developed numerous highly complex drafting arrangements to insure that the surviving spouse receives no more than the amount of property required to utilize the desired marital deduction.²⁸ Any marital bequest in excess of this amount is subject to double estate taxation because the property ultimately will be includible in both spouses' estates without a deduction in either.²⁹

The foremost technique employed by estate planners in providing for the appropriate marital deduction bequest is the formula bequest. The amount of property transferred to the surviving spouse under this technique is determined by a formula clause in the decedent's will.³⁰ Prior

25. *Id.*

26. See S. REP. NO. 1013 (Part 2), 80th Cong., 2d Sess. 9, 11 (1948), reprinted in 1948-1 C.B. 337, 338.

27. The other two exceptions to the terminable interest rule are set forth in I.R.C. §§ 2056(b)(3) and 2056(b)(6).

Section 2056(b)(3) states that an interest passing to the surviving spouse shall not be considered a terminable interest—and thus will qualify for the marital deduction—when the terminating condition specified in the testamentary instrument is the death of the surviving spouse within six months of the decedent's death, and the surviving spouse does not die within that period. For example, a bequest to a surviving spouse which is made conditional on that spouse's surviving decedent's death by a specified period will qualify for the marital deduction, provided the specified survival period does not exceed six months and the surviving spouse in fact lives the required time.

Under § 2056(b)(6), if the interest in property passing from the decedent consists of the proceeds of a life insurance, endowment, or annuity contract, and those proceeds are payable to the surviving spouse throughout her life, the interest will qualify for the marital deduction provided the spouse also has a general power to appoint all amounts remaining to be paid (either after her death, or merely after the exercise of the power).

28. *U.S. Treasury Dept. House Ways and Means Comm. and Senate Finance Comm., 91st Cong., 1st Sess., Tax Reform Studies and Proposals 357-58* (Comm. Print 1969).

29. *Id.*; R. COVEY, THE MARITAL DEDUCTION AND THE USE OF FORMULA PROVISIONS 1-3 (2d ed. 1978); ESTATE AND GIFT TAX AFTER TAX REFORM 125-27 (M. Weinberger ed. 1977).

30. A result generally equivalent to the use of a formula clause in a will can be achieved through creation of a revocable inter vivos trust providing for division of the trust assets, on the

to the Tax Reform Act of 1976, these formulae normally transferred to the surviving spouse property equal to fifty percent of the decedent's adjusted gross estate, which at that time represented the maximum marital deduction.³¹ If the surviving spouse possessed a substantial independent estate, however, a formula providing for the maximum marital deduction bequest potentially caused the couple's aggregate estate taxes to be greater than necessary,³² due to the progressive nature of estate tax rates.³³ In these circumstances, aggregate estate taxes might be reduced through a formula clause providing for a marital bequest equal only to the amount required to equalize the two estates.³⁴

II. JUDICIAL RESPONSE TO EQUALIZATION CLAUSES

In *Estate of Smith v. Commissioner*³⁵ the Tax Court undertook its first consideration of the validity of an equalization clause for estate tax marital deduction purposes. The decedent in *Smith* had created a revocable inter vivos trust which, at his death, contained the bulk of his assets.³⁶ The trust instrument provided that if the decedent's wife survived him, upon his death the trust corpus was to be divided into two portions, the "marital portion" and the "residual portion." The instrument directed that the surviving spouse receive a life income interest in and general testamentary power of appointment over the marital por-

settlor's death, according to the terms of a formula clause contained in the trust. See, e.g., *Estate of Smith v. Commissioner*, 66 T.C. 415, 417-18 (1976) (nonacq. 1978-1 C.B. 3), *aff'd per curiam*, 565 F.2d 455 (7th Cir. 1977).

31. See note 18 *supra* and accompanying text.

32. See A. CASNER, *ESTATE PLANNING UNDER THE TAX REFORM ACT OF 1976* 131-33 (2d ed. 1978).

33. See I.R.C. § 2001(c); note 34 *infra*.

34. Mathematically, estate equalization is a relatively simple procedure. The amount of the marital bequest required to equalize the estates of a husband and wife is equal to one-half of the difference between the values of the two estates. For example, assume husband has an adjusted gross estate of \$1,200,000 and wife has an adjusted gross estate of only \$800,000. The difference between the two estates is \$400,000, so that the amount of the marital bequest by husband (the party with the larger estate) necessary to equalize the two estates—at \$1,000,000 each—is \$200,000.

In this example, the amount of the maximum marital deduction available to husband's estate is \$600,000 (50% of \$1,200,000). If husband had made the maximum marital deduction bequest his taxable estate would have been reduced to \$600,000, while wife's estate would have been increased to \$1,400,000.

35. 66 T.C. 415 (1976) (nonacq. 1978-1 C.B. 3), *aff'd per curiam*, 565 F.2d 455 (7th Cir. 1977). Judge Drennen authored the Tax Court opinion, which was reviewed by the full court. Judge Irwin dissented, and Judge Tannenwald did not participate in the review.

36. 66 T.C. at 417.

tion.³⁷

The decedent's trust directed the trustee to allocate sufficient assets to the marital portion to equalize the estates of decedent and his spouse. To determine the size of the surviving spouse's estate, the trustee was to assume that decedent's spouse died after him, but on the date of his death. For the purpose of determining the amount of the equalization bequest, the trust instrument directed the trustee to value both estates as of the same date, that date being either the date of death or the statutory alternate valuation date,³⁸ whichever would result in the lowest hypothetical estate tax on the estates of both decedent and his wife.³⁹

37. *Id.* at 427.

38. At the time of the decedent's death in *Smith* (June 7, 1970), the estate tax alternate valuation date was one year after the date of death. The alternate valuation date has since been changed to six months after the date of death. Pub. L. No. 91-614, § 101(a), 84 Stat. 1836 (1970) (amending I.R.C. § 2032).

The "estate" of the surviving spouse used in the equalization clause formula represented merely the hypothetical estate of the surviving spouse, assuming she had died on the same date as decedent. Consequently, any action actually taken by the surviving spouse after the date of decedent's death with respect to the assets which she held individually could not affect the amount of the marital bequest to be made through decedent's equalization clause. Even if the trustee elected to use alternate valuation date values for the "estates" of decedent and surviving spouse, all the assets comprising those estates on the date of death would have been included in the overall valuation, regardless of any intervening changes in the actual composition of the estates.

39. 66 T.C. at 418. On the alternate valuation date the values of the estates of decedent and his surviving spouse were both higher than their respective values on the date of decedent's death. Consequently, in accordance with the trust instrument the trustee used the date of death values for federal estate tax purposes, as well as for determining the amount of the marital bequest to be made pursuant to the marital deduction equalization clause. *Id.* at 420.

The actual clause read as follows:

Article IV
Distribution

On Settlor's Death—Upon the death of Settlor, if his wife, *Alice M. Smith*, survives him, corpus (including additions, but excluding property added to or allocated to a separate asset account by reason of having been added by one other than Settlor, or for any other reason) shall be divided into portions, one of which shall be called the Marital Portion and the other of which shall be called the Residual Portion.

(a) There shall first be allocated to the Residual Portion any asset or the proceeds of any asset (or interest therein) with respect to which the marital deduction would not be allowed if allocated to the Marital Portion.

(b) There shall then be allocated to the Marital Portion that percentage interest in the balance of the assets constituting the trust estate which shall when taken together with all other interests and property that qualify for the marital deduction and that pass or shall have passed to Settlor's said wife under other provisions of this trust or otherwise, obtain for Settlor's estate a marital deduction which would result in the lowest Federal estate taxes in Settlor's estate and Settlor's wife's estate, on the assumption Settlor's wife died after him, but on the date of his death and that her estate were valued as

The Commissioner disallowed the marital deduction in *Smith* on the ground that the interest created was a terminable interest, nondeductible under section 2056(b)(1). The Commissioner argued that if the trustee elected alternate valuation and the value of the survivor's estate on that date equalled or exceeded the value of decedent's estate, then the surviving spouse's interest in the trust estate would terminate because no trust assets would be allocated to the marital portion.⁴⁰ Rather, the entire trust corpus would pass to the residual portion of the trust and thereafter would be possessed or enjoyed by the residual beneficiaries. Consequently, the surviving spouse's interest was a nondeductible terminable interest under the terms of section 2056(b)(1).⁴¹

In an opinion by Judge Drennen, the Tax Court rejected the Commissioner's arguments and allowed the marital deduction for the assets that actually passed into the marital trust under the equalization clause. Judge Drennen reasoned that the surviving spouse received an interest in the marital trust that vested indefeasibly on decedent's death. The inability to value the interest at that particular time did not render it terminable, because no subsequent event could divest the surviving

of the date on (and in the manner in) which Settlor's estate is valued for Federal estate tax purposes; Settlor's purpose is to equalize, insofar as possible, his estate and her estate for Federal estate tax purposes, based upon said assumptions.

(c) There shall finally be allocated to the Residual Portion the remaining percentage interest in the balance of the assets constituting Settlor's estate.

(d) The percentage interest of the Marital and Residual portions shall be determined and fixed by using asset values for all such purposes as finally established for Federal estate tax purposes. In selecting a valuation date for the purpose of the Federal estate tax, Settlor directs Trustee to select the date which will result in the greatest tax benefit to Settlor's wife's and Settlor's estates, regardless of the effect this selection may have on the amount provided by this Article for Settlor's wife.

Id. at 417-18.

40. The Commissioner's terminable interest argument is applicable only with respect to an equalization clause allowing for alternate valuation of both estates in determining the amount of the marital bequest. The potential for substantial variation in the value of the assets comprising decedent's estate and the estate of the surviving spouse between date of death and the alternate valuation date is the real contingency which opens up the possibility that the surviving spouse may receive nothing whatsoever through the equalization clause bequests. It is this very contingency that lies at the heart of the Commissioner's 2056(b)(1) argument. 66 T.C. at 427-28. If the equalization clause had not conditioned the calculation of the marital bequest on potential alternate valuation date values, both the Commissioner and the Tax Court apparently would agree that no terminable interest had been created.

41. 66 T.C. at 421, 427-28. See also Covey, *Estate, Gift and Income Taxation—1974 Developments*, in THE TWELFTH ANNUAL INSTITUTE ON ESTATE PLANNING ¶ 145 (U. Miami 1975) (full reprint of I.R.S. National Office Technical Advice Memorandum issued with regard to the *Smith* estate); *Shop Talk: I.R.S. Explains Why Equalization Clause Bars Marital Deduction*, 42 J. TAX. 254-55 (1975) (partial reprint of same I.R.S. National Office Technical Advice Memorandum).

spouse of her interest in the marital portion of the trust.⁴² Trustee discretion played no part in determination of the interest's value because no subsequent event could alter the basic components of the formula creating the marital bequest.⁴³

Judge Drennen also noted that the Internal Revenue Service had never opposed a deduction for a formula bequest on the ground that it created a nondeductible terminable interest.⁴⁴ He initially reasoned, therefore, that an equalization clause bequest, being but one form of formula bequest, likewise did not create a terminable interest.⁴⁵ Furthermore, alternate valuation is a statutory prerogative⁴⁶ that does not result in a normal formula bequest being considered a nondeductible terminable interest. This result occurs even though alternate valuation may affect the amount of the marital deduction⁴⁷ and, consequently, the amount of the marital bequest actually passing to the surviving spouse under the formula bequest. Finally, because the surviving spouse received a life income interest in the marital portion of the trust with a general testamentary power of appointment over the corpus, Judge Drennen concluded that the interest created must qualify under 2056(b)(5) for the marital deduction.⁴⁸ Choosing to rely solely on the

42. 66 T.C. at 428.

43. *Id.* at 430.

44. *Id.* at 425. In several instances the Internal Revenue Service has implicitly accepted formula bequests (though not equalization clause bequests) as qualifying for the marital deduction. *See, e.g.,* Empire Trust Co. v. United States, 226 F. Supp. 623 (S.D.N.Y. 1963); Rev. Rul. 74-42, 1974-1 C.B. 281; Rev. Rul. 55-643, 1955-2 C.B. 386.

The Internal Revenue Service also has indicated that it will disallow the marital deduction with respect to pecuniary formula bequests when either the dispositive instrument or applicable state law allows the trustee or executor to fund the bequest with assets not fairly representative of the general appreciation or depreciation of all estate assets occurring between the date of valuation for federal estate tax purposes and the date of distribution (i.e., date of actual funding of the bequest). *See* Rev. Proc. 64-19, 1964-1 C.B. 682. *See also* Estate of Hamelsky v. Commissioner, 58 T.C. 741 (1972), *nonacq.* 1973-1 C.B. 2. In both Rev. Proc. 64-19 and *Hamelsky* the Internal Revenue Service argued that a pecuniary formula bequest may constitute a nondeductible terminable interest, and thus fail to qualify for the marital deduction, if the discretion afforded the fiduciary to distribute depreciated assets to the surviving spouse may diminish or defeat the marital bequest. The Tax Court agreed with the Commissioner's assertions in *Hamelsky*, but found them inapposite in that case. Even though the trust instrument did not prohibit the trustee from distributing depreciated assets to the spouse only, the court found that under state law the trustee did not have discretion to do so.

45. 66 T.C. at 425.

46. I.R.C. § 2032.

47. Treas. Reg. § 20.2056(b)-4 (1958).

48. 66 T.C. at 427, 429.

terminable interest argument,⁴⁹ the Commissioner apparently failed to contest the apparent applicability of 2056(b)(5).⁵⁰

The Seventh Circuit Court of Appeals affirmed the Tax Court judgment in *Smith*.⁵¹ The appellate court decision disregarded Judge Drennen's reasoning that the surviving spouse's interest in the marital portion of the trust qualified for the marital deduction because it fell squarely within the protective provisions of section 2056(b)(5). Instead, the Seventh Circuit opinion focused on the basic policies underlying the marital deduction, and upheld the *Smith* marital bequest as consistent with the fundamental purposes of that provision. Quoting from *Northeastern Pennsylvania Bank & Trust Co. v. United States*,⁵² the court noted that it was "Congress' intent to afford a liberal 'estate-splitting' possibility to married couples."⁵³ Furthermore, any assets ultimately allocable to the marital portion of the trust eventually would be taxable in the survivor's estate.⁵⁴ The court concluded, therefore, that the equalization clause bequest qualified for the marital deduction even if the statutory language of 2056(b)(1) could be read to indicate otherwise.⁵⁵

Relying on the Tax Court theory that the potential terminable value of an interest in a portion of a trust does not constitute a terminable interest, the appellate court also found the *Smith* interest nonterminable under the literal language of section 2056(b)(1).⁵⁶ The court declared inapplicable Justice White's statement in *Jackson v. United States*⁵⁷ that "there is no provision in the Code for deducting all terminable interests which become nonterminable at a later date and therefore taxable in the estate of the surviving spouse if not consumed or

49. See notes 40-41 *supra* and accompanying text.

50. 66 T.C. at 427.

51. 565 F.2d 455 (7th Cir. 1977), *aff'g per curiam*, 66 T.C. 415 (1976), *nonacq.* 1978-1 C.B. 3.

52. 387 U.S. 213 (1967).

53. *Id.* at 221.

54. 565 F.2d at 458-59.

55. *Id.* at 459.

56. *Id.*

57. 376 U.S. 503 (1964). In *Jackson* the Supreme Court addressed the question of whether the monthly allowance provided by California law for support of a widow during the administration of her husband's estate (and payable out of that estate) is a terminable interest. Under applicable state law, the right to the allowance was not vested, but accrued only on the court order providing for the payments. Furthermore, the widow's rights to ordered payments abated on her death or remarriage. *Id.* at 506-07. Even though the estate had actually paid the widow \$72,000, the Court found that the widow's allowance constituted a nondeductible terminable interest.

transferred,"⁵⁸ on the ground that *Jackson* applied only where state law had clearly declared an interest to be terminable.⁵⁹ In *Smith* state courts had never considered the nature of the interest at issue. Because the interest had not been declared either terminable or nonvested at the date of settlor's death,⁶⁰ "no vagary of state law"⁶¹ precluded a federal court from granting the marital deduction with respect to that interest.⁶²

In two recent cases, *Estate of Meeske v. Commissioner*⁶³ and *Estate of Laurin v. Commissioner*,⁶⁴ the Internal Revenue Service again challenged marital deduction equalization clauses virtually identical to the one in *Smith*. Relying entirely on *Smith*, the Tax Court again rejected the Commissioner's section 2056(b)(1) objections.⁶⁵

The Commissioner also asserted a new ground for disallowance of the *Meeske* marital deduction, which had not been presented in *Smith*, claiming that the marital trust failed to meet all the requirements of 2056(b)(5).⁶⁶ In particular, the Commissioner argued that the surviving spouse did not have a right to income from or a power of appointment over a "specific portion" of the decedent's revocable trust estate.⁶⁷ Furthermore, the Commissioner asserted that the surviving spouse lacked the ability to effectively exercise her general testamentary power of ap-

58. *Id.* at 509-10.

59. 565 F.2d at 460.

60. *Id.*

61. *Id.*

62. *Id.* The Seventh Circuit's reliance on the absence of any state law determination of the nature of the interest involved is highly questionable at best, especially in view of the Supreme Court directive in *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967). In that case the Supreme Court directed that when federal tax results turn on state law, federal courts themselves must decide the proper application of pertinent state law, absent a decision on the point by the state's highest court.

The basis of the Seventh Circuit's decision in *Smith* (as well as the basis of the Tax Court decision in the same regard) with respect to the vested and indefeasible character of the surviving spouse's interest in the marital portion of the trust is unclear. The Seventh Circuit may be deciding implicitly that, if presented with the question, the highest court of the state of the trust administration (Michigan) would declare the interest to be indefeasibly vested at decedent's death. With greater likelihood, the court may be declaring that, at least in the instant case, determination of the characterization of the interest under state law is simply irrelevant for purposes of § 2056(b)(1). See 565 F.2d at 458 n.5.

63. 72 T.C. 73, *appeal docketed*, No. 79-1615 (6th Cir. Oct. 31, 1979).

64. 38 T.C.M. (CCH) 644, *appeal docketed*, No. 79-1606 (6th Cir. Oct. 30, 1979).

65. 38 T.C.M. (CCH) at 645-46; 72 T.C. at 77.

66. 72 T.C. at 77-80. See notes 48-50 *supra* and accompanying text.

67. 72 T.C. at 79. See I.R.C. § 2056(b)(5).

pointment before the trust assets had been allocated to the marital portion. The trust, therefore, failed to comply with the section 2056(b)(5) requirement that the power be exercisable in all events.⁶⁸

The Tax Court rejected both arguments, holding that the trust did meet the 2056(b)(5) prerequisites and thus qualified for the marital deduction. The court found that the surviving spouse had a life income interest in and a power of appointment over a "specific portion" of the decedent's trust estate, although the fractional amount of that portion could not be determined absolutely until the alternate valuation date. The court also found the surviving spouse's testamentary power of appointment to be exercisable in all events, beginning immediately upon decedent's death. Even though the survivor might not know the value of the interest over which she had the power, any testamentary exercise of the power prior to the arrival of the alternate valuation date would be effective as to the entire amount allocable to the marital trust.⁶⁹

The decedent in *Estate of Laurin v. Commissioner*⁷⁰ also created a revocable inter vivos trust that included a marital deduction equalization clause. The clause was virtually identical to the clause utilized in *Smith*, but the disposition of the marital portion of the trust estate differed significantly from that of either *Smith* or *Meeske*. In each of the latter cases the trust instrument provided the surviving spouse with a life interest in and general testamentary power of appointment over the marital portion. In *Laurin*, however, the trust instrument directed the trustee to distribute the assets comprising the marital portion to a revocable trust created by the surviving spouse.⁷¹

In a cryptic memorandum opinion based completely on *Smith*, the Tax Court found that the *Laurin* bequest also created a qualifying interest, nonterminable under the provisions of section 2056(b)(1).⁷² The court reached this result without well-reasoned analysis, even though the outright bequest in *Laurin* differed significantly from the 2056(b)(5) trust of *Smith*.⁷³

68. 72 T.C. at 80.

69. *Id.* at 79-80.

70. 38 T.C.M. (CCH) 644, *appeal docketed*, No. 79-1606 (6th Cir. Oct. 30, 1979).

71. *Id.* at 645.

72. *Id.* at 646.

73. Because *Laurin* involved an interest equivalent to an outright bequest rather than a bequest into a 2056(b)(5) trust, the factual setting of the case presented an excellent opportunity for the court to review its *Smith* decision on the 2056(b)(1) terminability issues, uninhibited by any

III. JUDICIAL RESPONSE: A CRITIQUE

The three equalization clause cases illustrate that equalization clause bequests present potential questions of nondeductibility under the provisions of both sections 2056(b)(1) and 2056(b)(5). The 2056(b)(5) issues may be examined by a review of the *Meeske* decision, and the 2056(b)(1) issues will be analyzed thereafter.⁷⁴

The marital trust in *Meeske*, once funded, undoubtedly complied with the requirements of section 2056(b)(5). The Tax Court found the surviving spouse's general testamentary power of appointment to be exercisable in all events,⁷⁵ and the trust instrument itself imposed no limitations on the exercise of the power.⁷⁶ Furthermore, even though the widow may not know the value of the trust estate to be received and though any disposition by the survivor may be delayed during the period of administration of the decedent's estate, these factors alone do not indicate that the power is not exercisable in all events.⁷⁷

Similarly, the survivor's income interest and general power of appointment over the marital trust in *Meeske* appear to meet the "specific portion" requirement of the statute⁷⁸ because the decedent's trust instrument prescribes absolutely and with specificity the method of determining the spouse's portion. Consequently, the Tax Court in *Meeske* correctly concluded that, once funded, the trust met the requirements

potential § 2056(b)(5) confusion which may have been present in *Smith* and *Meeske*. See notes 81-86 *infra* and accompanying text.

The stance taken by the parties in *Laurin*, however, arguably repressed complete review of *Smith*. *Meeske* and *Laurin* were companion cases, and the same counsel represented the parties in both cases. 38 T.C.M. (CCH) at 646 n.2. Notwithstanding the material differences between the two cases (see text accompanying notes 70-73 *supra*) the parties submitted briefs for *Laurin* identical to those for *Meeske*, including 2056(b)(5) arguments. Failing to find a 2056(b)(5) trust in *Laurin*, the court ordered additional briefs. In response, the parties merely stipulated that the *Laurin* distribution was equivalent to an outright bequest, apparently without further briefing of the varying issues thereby presented. 38 T.C.M. (CCH) at 646 n.2.

74. See notes 80-99 *infra* and accompanying text.

75. The fact that the surviving spouse could exercise the general power of appointment only by will did not prevent the power from being exercisable in all events, because I.R.C. § 2056(b)(5) applies to general powers of appointment "whether exercisable by will or during life." I.R.C. § 2056(b)(5). See also *Mittleman's Estate v. Commissioner*, 522 F.2d 132 (D.D.C. 1975); Treas. Reg. § 20.2056(b)-5(g)(1) (1958).

76. See 72 T.C. at 76.

77. See *Estate of Benjamin v. Commissioner*, 44 T.C. 598 (1965); Treas. Reg. § 20.2056(b)-5(g)(4) (1958).

78. I.R.C. § 2056(b)(5).

of section 2056(b)(5).⁷⁹

A bequest into a trust which by its terms meets the requirements of section 2056(b)(5) may nonetheless fail to qualify for the estate tax marital deduction.⁸⁰ If the trust corpus, for example, consists of property interests that are themselves terminable under section 2056(b)(1),⁸¹ then the bequest of those interests into the 2056(b)(1) trust is nondeductible.⁸² Furthermore, if a decedent has made a bequest intended to fund a 2056(b)(5) trust, even though the asset bequeathed is not inherently terminable, a proper interpretation of section 2056(b)(1) mandates a conclusion that the bequest still may fail to qualify for the marital deduction. This result occurs if the surviving spouse's interest in that asset is potentially terminable under section 2056(b)(1), according to the manner in which that interest is created and restricted by the terms of the decedent spouse's dispositive instrument.⁸³

79. By implication, therefore, the Tax Court in *Smith* also correctly reasoned that the marital trust in that case, with terms basically identical to those of the *Meeske* trust, complied with the 2056(b)(5) requirements. The *Smith* court apparently reached that conclusion without benefit of briefs or argument by the parties on that point. 66 T.C. at 427.

80. See S. REP. NO. 1013 (Part 2), 80th Cong., 2d Sess. 16-18, reprinted in 1948-1 C.B. 342-43, which states,

[Paragraph (5) of section 2056(b)] also provides an exception to the terminable interest provisions of [2056(b)(1)]. This exception is for the purpose of allowing the marital deduction in the case of certain trusts where the surviving spouse has a power of appointment. *The other provisions of section [2056] are still applicable generally to interests passing to the surviving spouse in trust.*

Even though a trust meets all the tests of [2056(b)(5)], the provisions of [2056(b)(1) and (2)] may disallow the marital deduction where the trust corpus consists, in whole or in part, of terminable interests.

(emphasis added).

81. See S. REP. NO. 1013 (Part 2), 80th Cong., 2d Sess. 9-10, reprinted in 1948-1 C.B. 337-38 (Examples 1 & 2).

82. *Id.* The draftsmen of the *Smith* and *Meeske* marital trusts certainly recognized this fact, providing that any of decedent's assets which of themselves would fail to qualify for the marital deduction (presumably referring to assets which represent interests inherently terminable, see notes 21-23 *supra* and accompanying text) must be allocated to the residual portion of the trust. See note 39 *supra*. Thus, the only assets available for allocation to the marital trusts were those which were not inherently terminable.

83. From a statutory viewpoint the need for a provision like 2056(b)(5) arises solely because of the inherent terminability of life estates. Congress nevertheless wanted to allow the marital deduction for bequests in trust when the surviving spouse receives a life income interest and a general power of appointment over the trust corpus. In such a case, the spouse is the virtual owner of the trust assets, entitled to all the income therefrom during life and freely able to direct their disposition on death. See S. REP. NO. 1013 (Part 2), 80th Cong., 2d Sess. 16, reprinted in 1948-1 C.B. 342.

The only reason such an arrangement would not qualify for the marital deduction is that the

The primary issue, therefore, is whether the Tax Court and the Seventh Circuit rendered the proper decision in *Smith*, holding the interest to be nonterminable under section 2056(b)(1), wholly apart from any 2056(b)(5) considerations. The principal Tax Court error in *Smith* was its failure to recognize the absolute separability of the 2056(b)(1) and 2056(b)(5) issues. The Tax Court proceeded from the correct assumption that the marital trust in *Smith* fulfilled the requirements of section 2056(b)(5), to the incorrect conclusion that the surviving spouse's interest in that trust therefore qualified for the marital deduction.⁸⁴ As previously noted, the Code provides a marital deduction for interests in property, not interests in trust. Where the interest in property is to be held in a 2056(b)(5) trust that may never be funded, then the interest in property may never pass to the surviving spouse. Furthermore, should the contingency occur which would result in nonfunding of the marital trust,⁸⁵ the assets potentially allocable to the marital trust would instead pass into the residual trust to be enjoyed by the residual beneficiaries, thereby meeting all the 2056(b)(1) tests of a nondeductible terminable interest.⁸⁶

spouse's life income interest necessarily must terminate on death, and thereafter the property will be possessed and enjoyed by persons other than the surviving spouse. Thus, because the sole need and reason for the existence of § 2056(b)(5) arose because of the inherent terminability of all life estates, § 2056(b)(5) should apply to protect only those interests that are terminable solely because they are life estates. If an interest in trust is potentially terminable for any reason other than its character as a life estate, then 2056(b)(5) should not apply to preserve its deductibility in that regard. Rather, the interest must be subjected to critical examination as to terminability under § 2056(b)(1). See also note 80 *supra* and accompanying text.

84. See 66 T.C. at 427, 429.

85. In the *Smith* and *Meeske* cases the contingency which would result in nonfunding of the marital trust would occur if: (1) On the alternate valuation date the value of the surviving spouse's "estate" exceeded that of decedent's, and (2) alternate valuation were chosen for federal estate tax purposes, in accordance with the terms of the trust instruments involved.

86. A close reading of the Tax Court opinion in *Smith* reveals the extent of the court's erroneous reliance, in deciding the 2056(b)(1) issues, on the fact that the marital portion of the trust met the requirements of § 2056(b)(5). The court found significant the fact that the form of the arrangement in *Smith* was a revocable inter vivos trust that was to be divided according to the equalization clause into a marital portion and a residual portion. In an attempt to assist the court in focusing on the 2056(b)(1) terminability issue rather than the 2056(b)(5) nature of the marital trust, the Commissioner urged the Tax Court to analyze the transaction as though the equalization clause created an outright bequest. 66 T.C. at 431-32. The Tax Court refused this suggestion, noting that both the court and the Commissioner have recognized "a distinction between the division of a trust into two parts and the termination of one trust followed by the creation of another." *Id.* at 432.

Although such a distinction may be appropriate in other circumstances, the distinction is inappropriate when deciding the terminability of an interest to be placed into a trust. Regardless of

Because the interest created in *Smith* fulfills the 2056(b)(1) requirements for terminability, all the remaining arguments advanced by the Tax Court for allowing the marital deduction are inapposite. The Court's characterization of the interest as vested and indefeasible is not only irrelevant but also highly questionable. Although several courts have applied the term "indefeasibly vested" to nonterminable interests,⁸⁷ the only relevant question is whether the interest is terminable within the definition provided by section 2056(b)(1).⁸⁸

The Tax Court's distinction between the terminable value of an interest in a trust and the interest's terminable character⁸⁹ fails to recognize that section 2056 allows a deduction only for interests in property, not mere interests in a trust that may or may not hold any assets.⁹⁰ Undoubtedly an interest in property is not terminable merely because the value of the property may fall to zero, making the property worthless. In such a case the survivor's interest in the property does not terminate, but continues. In the *Smith* case, however, the survivor's entire interest in the underlying trust property could terminate if, in accord-

whether a trust—already containing assets—is to be divided into two distinct portions or two different trusts, the interest of the surviving spouse in the underlying assets is the same. To hold otherwise clearly is an elevation of form over substance.

The *Smith* court's refusal to analyze the transaction as an outright bequest similarly demonstrates the inappropriate reliance on *Smith* by the Tax Court in *Laurin*, a case involving an outright bequest made through an equalization clause. Even if *Smith* had been correctly decided, this unreasoning extension of its holding is unfortunate. See notes 71-74 *supra* and accompanying text.

87. See, e.g., *Jackson v. United States*, 376 U.S. 503 (1964); *United States v. Mappes*, 318 F.2d 508 (10th Cir. 1963); *Berger v. United States*, 285 F. Supp. 92 (E.D. Pa. 1968); *Estate of Gardner v. United States*, 220 F. Supp. 196 (E.D. Mo. 1963); *Estate of Reynolds v. United States*, 189 F. Supp. 548 (E.D. Mich. 1960); *Estate of Landers v. Commissioner*, 38 T.C. 828 (1962).

88. See S. REP. NO. 1013 (Part 2), 80th Cong., 2d Sess. 7, reprinted in 1948-1 C.B. 336 ("[I]t is immaterial whether the interest passing to the surviving spouse is considered as a vested interest subject to divestment or as a contingent interest. [Section 2056(b)(1)] applies whether the terms of the instrument or the theory of their application are conceived as creating a future interest which may fail to ripen or vest or as creating a present interest which may terminate . . ."); notes 60-62 *supra* and accompanying text.

In *Jackson v. United States*, 376 U.S. 503, 506 (1964), the Supreme Court noted that under California law the interest at issue was not vested. See note 57 *supra*. The Court also stated that the interest was not indefeasible. Although the Court's use of the terms "vested" and "indefeasible" may have misled later courts in applying § 2056(b)(1), the *Jackson* Court based its decision of nondeductibility squarely on the requirements of § 2056(b)(1), and not on the terminology attached to the interest by state courts. Furthermore, nothing in the opinion indicates that mere characterization of an interest as vested and indefeasible will suffice to render the interest nonterminable under the federal statute.

89. 66 T.C. at 428.

90. See I.R.C. § 2056(a).

ance with the mandates of the equalization clause, no trust property whatsoever is allocated to the marital portion of the trust. Consequently, there might have been a termination not only of the value of the spouse's interest in the marital trust, but also of her entire interest in the underlying trust property. Section 2056 makes interests in property the only relevant interests, thus requiring a conclusion as to terminability contrary to that reached by the Tax Court.

Finally, the mere fact that alternate valuation is a statutory prerogative⁹¹ does not imply that use of an equalization clause employing alternate valuation of both spouses' "estates" is likewise a prerogative.⁹² Section 2032 allows alternate valuation, but only with respect to property included in the decedent's gross estate.⁹³ Although alternate valuation by its very nature may cause an adjustment in the amount of the marital deduction allowed,⁹⁴ adjustments based on factors other than variation in the value of the decedent's gross estate fall outside the purview of the alternate valuation prerogative.⁹⁵

The practical effect of allowing equalization based on alternate valuation also undermines the Seventh Circuit's policy arguments in favor of its *Smith* affirmance.⁹⁶ The primary congressional purpose behind the marital deduction provisions was to provide uniform estate tax treatment for married couples in both community property and common-law jurisdictions.⁹⁷ In community property states, the community property division is based on date of death values without provision for readjustment at a later date.⁹⁸ In a common-law jurisdiction, under *Smith's* validation of equalization with alternate valuation a married

91. *Id.* § 2032.

92. See S. REP. NO. 1013 (Part 2), 80th Cong., 2d Sess. 9-10, reprinted in 1948-1 C.B. 338, stating:

In determining whether an interest in property is a terminable interest . . . , the situation is viewed as of the date of decedent's death. . . .

The election of the executor to determine the value of the gross estate as of a date subsequent to the decedent's death, as provided in section [2032] of the Code, does not extend to such later date the time for determining the character of the interest passing to the surviving spouse and its deductibility under [section 2056(b)(1)].

93. *Id.*

94. Because the maximum marital deduction in estates larger than \$500,000 is limited to 50% of the adjusted gross estate, any variation in the adjusted gross estate will effect the amount of the maximum marital deduction. Treas. Reg. § 20.2032-1(g), T.D. 7238, 1973-1 C.B. 544, 549-50.

95. See *id.*, which states, "[N]o such adjustment may take into account any difference in value due to . . . the occurrence or non-occurrence of a contingency."

96. See notes 51-55 *supra* and accompanying text.

97. See notes 12-13 *supra* and accompanying text.

98. Of course, for federal estate tax purposes the value of the decedent's share of community

couple may accomplish the property division based on either date of death valuation or alternate valuation, whichever is more beneficial. Even assuming that Congress intended to afford a liberal estate splitting possibility to married couples in common-law states,⁹⁹ there is no indication whatsoever that Congress intended to increase the relative advantage of common-law estate splitting over that available to couples in community property states.

IV. PLANNING CONSIDERATIONS

Various commentators have advocated the use of the marital deduction equalization clause as an excellent estate planning tool.¹⁰⁰ Several factors indicate, however, that the risks associated with the marital deduction equalization clause greatly exceed the tax benefits available.

Even though three cases have upheld the validity of the marital deduction equalization clause, the statutory arguments against allowance of the marital deduction in those cases are persuasive. The Commissioner has issued a nonacquiescence to the *Smith* decision¹⁰¹ and thus will continue to challenge the allowance of a marital deduction when the bequest is generated through an equalization clause providing for possible alternate valuation.¹⁰²

The estate and gift tax changes generated by the Tax Reform Act of 1976¹⁰³ make estate planning through marital deduction equalization clauses much more complicated. The 1976 Act provided for unification of lifetime gifts and testamentary transfers into a single, unified transfer tax base, subject to a unified progressive tax rate schedule.¹⁰⁴ Furthermore, the Act also provided for the possibility that a decedent's estate and hence the overall transfer tax base may be increased for purposes of section 2056 by the amount of certain generation-skipping trans-

property may be determined either at the date of death or the alternate valuation date, under § 2032.

99. *Northeastern Pa. Bank & Trust Co. v. United States*, 387 U.S. 213, 221 (1967).

100. See generally A. CASNER, *ESTATE PLANNING* 1240 & n.128a (3d ed. 1961 & Supp. 1978); Barnes, *supra* note 2, at 295; Kabaker, *supra* note 2, at ¶ 1210.1-3; Note, *Equalization Clauses with Alternate Valuation: An Emerging Option for Estate Planners*, 63 IOWA L. REV. 486, 502-03 (1977).

101. 1978-1 C.B. 3.

102. The Commissioner has filed appeals to the *Meeske* and *Laurin* decisions, both in the Sixth Circuit Court of Appeals. Given his nonacquiescence to *Smith*, and his pursuit of appellate review of *Meeske* and *Laurin*, the Commissioner probably will continue to aggressively challenge equalization clauses with alternate valuation.

103. Pub. L. No. 94-455, 90 Stat. 1846 (1976).

104. Pub. L. No. 94-455, § 2001(a)(1), 90 Stat. 1846 (1976) (amending I.R.C. § 2001).

fers.¹⁰⁵ Thus, to equalize the tax rates applicable to the decedent's and surviving spouse's estates, the calculation of the marital bequest must necessarily include the values of the respective estates and the amount of any lifetime gifts and generation-skipping transfers included in the transfer tax base. Although drafting an equalization clause providing appropriately for all of the foregoing disparate factors is not impossible, the task is certainly more complicated than prior to the Tax Reform Act of 1976.

Even if a workable clause is conceived, careful consideration of the actual tax results that occur through equalization indicates that absolute equalization may result in no tax savings whatsoever, and might even cause increased transfer taxes.¹⁰⁶ The Tax Reform Act of 1976 provided a unified credit against estate taxes of \$47,000 for decedents dying after 1980.¹⁰⁷ This credit provides an "exemption equivalent"¹⁰⁸ of \$175,625, transferable completely free of tax without use of any marital deduction.¹⁰⁹ Equalization of a married couple's estates or transfer tax bases may cause the under-utilization of the available unified credit and result in aggregate transfer taxes higher than necessary.

Even where estate equalization does not prevent full utilization of the available unified credit, absolute equalization nevertheless may fail to achieve any overall tax or economic benefits. Several factors can cause this result. For example, in taxable estates over \$250,000 the narrowest tax rate bracket is \$250,000 in amount.¹¹⁰ Given the broad width of these brackets, in many instances the first spouse to die can leave the survivor the maximum amount qualifying for the marital deduction, rather than only the amount necessary to equalize their tax

105. Pub. L. No. 94-455, § 2006(a), 90 Stat. 1879, 1880 (1976) (adding I.R.C. § 2602(c)(5)(A)). For a general explanation of the generation-skipping transfer tax, see A. CASNER, *supra* note 32, at 29-40.

106. See Allington, *How Interspousal Gifts, Marital Deductions Shape Estate Taxes on Successive Estates*, 48 J. TAX. 284 (1978); Thomas, Esperti & Katz, *New Variable Marital Deduction Technique Eliminates Uncertainty in Estate Plans*, 47 J. TAX. 194 (1977). See also Brode, *Not Maximizing the Marital Deduction in Certain Estates May Produce Higher Savings*, 48 J. TAX. 148 (1978); Schnee, *An Analysis of the Optimum Marital Deduction*, 5 TAX ADVISOR 222 (1974).

107. Pub. L. No. 94-455, § 2001(a)(2), 90 Stat. 1848 (1976) (adding I.R.C. § 2010).

108. The term "exemption equivalent" refers to the maximum dollar value that can be transferred without tax, due to the allowance of the credit with respect to the tax otherwise payable.

109. The \$175,625 exemption equivalent is the estate value necessary to generate a pre-credit tax of \$47,000, assuming the decedent has made no taxable lifetime gifts. See generally I.R.C. § 2001(c).

110. I.R.C. § 2001(c).

bases, and not thrust the survivor's estate into a higher bracket than the decedent's.¹¹¹

Even if a higher bracket results, absolute equalization still may not present the most beneficial alternative. If the surviving spouse's life expectancy is great, substantial economic benefits may be achieved by making a maximum marital deduction bequest, thereby reducing to a minimum the estate taxes payable on the death of the first spouse to die. The interest earned on the deferred taxes may more than compensate for the increased taxes payable at the survivor's death. Additionally, if the surviving spouse is expected to consume a significant portion of the assets received from the decedent spouse, through living expenses, annual gifts of less than \$3,000 each among several donees,¹¹² or otherwise, then a maximum marital deduction bequest may also be warranted.

Given the multiplicity and complexity of the foregoing factors, each of which should be thoughtfully considered in any responsible estate plan, the equalization clause generally is an unattractive estate planning alternative.¹¹³ After the Tax Reform Act of 1976, as clarified by the Revenue Act of 1978,¹¹⁴ estate planners possess a more flexible tool; the disclaimer.

Section 2045¹¹⁵ provides that a person may make a valid disclaimer of any interest in property within nine months of the transfer creating the interest.¹¹⁶ As clarified by the Revenue Act of 1978, section 2045(b)(4) indicates that to qualify as a valid disclaimer, the interest refused must pass without direction on the part of the person making the disclaimer. The interest may pass to the decedent's spouse, however, even though the spouse is the person making the disclaimer.¹¹⁷

Estate planners can achieve great flexibility in marital deduction planning by coupling a maximum marital deduction bequest with a provision directing the disposition of any portion of the bequest that is validly disclaimed by the surviving spouse.¹¹⁸ The decedent's will may

111. See A. CASNER, *supra* note 32, at 130-33.

112. See I.R.C. § 2503.

113. See Thomas, Esperti & Katz, *supra* note 106, at 195.

114. Pub. L. No. 95-600, § 702(m)(1), 92 Stat. 2763, 2935 (1978) (amending I.R.C. § 2045).

115. I.R.C. § 2045.

116. *Id.*

117. *Id.* See Revenue Act of 1978, Pub. L. No. 95-600, § 702(m), 92 Stat. 2935 (1978) (section entitled "Disclaimer by Surviving Spouse Where Interest Passes to Such Spouse").

118. Prior to enactment of § 2045, § 2056(d) governed the effect of disclaimers on the marital

even direct that the amount disclaimed be placed in trust, giving the surviving spouse a life income interest and a special power of appointment over the corpus.¹¹⁹ This estate plan allows the decedent to fully provide for the economic sufficiency of the bequest to the surviving spouse.

Furthermore, the marital bequest amount can reflect variables such as the existing "estate" of the surviving spouse, the potential impact of generation-skipping transfers, lifetime gifts, the unified credit, transfer tax rate brackets, the life expectancy and economic needs of the surviving spouse, and the deferral value of estate taxes otherwise payable currently. Through consideration of the situation existing at the decedent's death, optimal use of the marital deduction may be accomplished. Upon determination of the optimal marital deduction amount, the desired results can be easily achieved through an appropriate disclaimer by the surviving spouse in accordance with the provisions of section 2045.

V. CONCLUSION

Despite judicial approval of equalization clauses with alternate valuation, numerous factors indicate that estate planners should avoid the equalization clause as a marital deduction planning technique. From the single aspect of flexibility, the maximum bequest-disclaimer tool constitutes an exceptionally attractive alternative. Furthermore, the legal risks associated with the equalization clause are very great. The Commissioner's nonacquiescence to *Smith* erects a significant practical

deduction. The federal tax consequences of an attempted disclaimer depended primarily on the disclaimer's effectiveness under local law. Congress enacted the new disclaimer provisions to provide greater uniformity of treatment for purposes of the federal estate, gift, and generation-skipping transfer taxes. H. REP. NO. 94-1380, 94th Cong., 2d Sess. 66-67 (1976), *reprinted in* 1976-3 C.B. 800-01.

With the states' disparate treatment of disclaimers under prior law, estate planners devised unusual testamentary provisions to allow the post-mortem marital deduction planning now possible under the federal disclaimer rules. The judicial response to these unusual arrangements, often involving the potential terminability of the interests created, injected substantial uncertainty into their use. *Compare* Estate of Neugass v. Commissioner, 555 F.2d 322 (2d Cir. 1977) *with* Estate of Mackie v. Commissioner, 64 T.C. 308 (1975).

119. In general, a special power of appointment is a power exercisable in favor of a defined class that does not include the surviving spouse, or the estate or creditors of the surviving spouse. *See* Treas. Reg. § 20.2041-1(c)(1) (1958). The income interest obviously benefits the surviving spouse financially, while the limitation of the power to a special power insures that the bequest does not qualify for the marital deduction in the decedent's estate (*see* I.R.C. § 2056(b)(5)) and also is not includible in the surviving spouse's estate (*see* I.R.C. § 2041(a)).

barrier to effective use of the equalization clause, as the Commissioner is likely to challenge any marital deduction generated by such a clause. Finally, persuasive statutory and policy arguments support the conclusion that equalization clause bequests are terminable interests under section 2056(b)(1), so that rejection of the *Smith* line of cases not only is warranted, but also presents a serious possibility.

Michael D. Arri