MARITAL DEDUCTION FORMULAE—A PLANNER'S GUIDE

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The marital deduction formula bequest exists principally as a means of minimizing federal estate taxes. Considerations apart from the estate tax, however, have had a substantial effect upon the form of such clauses, and a 1964 pronouncement by the Internal Revenue Service has circumscribed their continued utility. The author examines the basic formula clauses, setting out the characteristics of each, the respects in which they differ, the objectives each is designed to secure, and the factors to be weighed by the draftsman who wishes to utilize a formula bequest to achieve a maximum federal estate tax marital deduction.

INTRODUCTION

JOHN NOWILL walks into the office of S. Tate Planner, attorney at law. After a lengthy conference, he departs, leaving Planner to formulate an estate plan to dispose of John's assets in accordance with his wishes at the lowest cost in administrative expenses and death taxes. After reviewing his notes of John's estate, Planner decides that the maximum marital deduction should be used[1] and that a formula clause should be inserted in John's will to assure that the maximum deduction will be available.[2] He then faces the problem of selecting the type of formula clause to be used.

No definite solution to this problem can be found until the draftsman has carefully analyzed the factual situation with which he is dealing, but neither can he choose among the marital deduction

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[1] The amount and scope of the marital deduction to be used is a complex question outside the scope of this article. For discussions of the factors to be considered, see, *e.g.*, LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES §§ 41.4-.10 (2d ed. 1962); Subcomm. on Estate Planning and the Marital Deduction of Comm. on Estate and Tax Planning, *Report*, 102 TRUSTS & ESTATES 934 (1963).

[2] Whether the amount of the marital deduction should be determined by use of a formula or by a non-formula consideration of individual assets is a question which will not be considered here. While most estate planners employ formula clauses, in certain factual situations a non-formula approach may be preferable. The classic debate between advocates of the formula and non-formula clauses is set out in Sargent, *A.B.C. and D. of Marital Deduction*, 92 TRUSTS & ESTATES 746 (1953); Sargent, *To Each His Own*, 93 TRUSTS & ESTATES 933 (1954); Trachtman, *Leaping in the Dark*, 93 TRUSTS & ESTATES 922 (1954).

formulae until he is acquainted with the basic types of formulae and their characteristics. This article will attempt to present in brief the advantages and disadvantages of the basic formulae.

EVOLUTION OF THE FORMULAE

A present understanding of marital deduction formulae requires some familiarity with their history. In 1948, Congress enacted the marital deduction provision of the estate tax statutes,[3] allowing a testator to pass up to one-half of his adjusted gross estate to his spouse free from the estate tax. Estate planners quickly realized the tremendous tax savings offered by this provision, and it became a key factor in many estate plans. Experience proved, however, that some provision was needed in the will which would automatically secure the maximum martial deduction for a testator, regardless of the changes which might take place in the composition of his estate after his will was drawn. To satisfy this need, the pecuniary formula was created.

The pecuniary formula gives to the surviving spouse a dollar amount sufficient to secure for the estate the maximum marital deduction to which it would be entitled under the statute. Soon after its appearance, however, the Internal Revenue Service ruled that the satisfaction of this dollar amount with assets which had appreciated from the values used on the estate tax return gave rise to a capital gain taxable to the estate.[4] To eliminate the possibility of these gains and to allow the spouse to share in the post-mortem appreciation of estate assets, draftsmen began using a clause designed to give the surviving spouse a fractional share of the estate. Since the surviving spouse would be entitled to an appropriate fractional share of each asset, there would be no capital gain upon distribution in kind, and the amount passing to the spouse reflects the post-mortem appreciation or depreciation of the estate assets.[5] Experience quickly revealed, however, that this "fractionalization" of assets was undesirable in many instances, especially where the estate contained stock in a closely held corporation or real property.

Draftsmen then created a so-called "tax value clause" which they hoped would have all advantages of the pecuniary and the fractional

[3] INT. REV. CODE OF 1954, § 2056.
[4] Rev. Rul. 56-270, 1956-1 CUM. BULL. 325.
[5] See Treas. Reg. § 1.1014-4(a)(3) (1957); Rev. Rul. 60-87, 1960-1 CUM. BULL. 286.

share formulae with none of the attendant disadvantages. This formula[6] provides for a pecuniary bequest to the surviving spouse but allows the fiduciary to satisfy the bequest by distributing assets in kind at values as finally determined for estate tax purposes. Since it gives a dollar amount to the spouse, no splintering of assets is required, and since assets are to be valued at estate tax values, no capital gain can be realized. In addition to these benefits, this formula offered the executor an opportunity to engage in post-mortem tax planning. If the assets appreciated in value unequally, he could have, for example, distributed to the widow the assets with the least appreciation, and less than half the actual value of the estate would be subjected to a second tax upon her death. On the other hand, he could have funded the marital bequest with appreciated assets to give the surviving spouse additional property for her benefit. This flexibility led to the widespread adoption of this type of formula by draftsmen, but, as either predicted or precipitated by Professor Casner,[7] it also led to the promulgation of Revenue Procedure 64-19.

Revenue Procedure 64-19[8] denies the marital deduction to any estate or trust where the governing instrument allows or requires the fiduciary to "select assets in kind to satisfy the [marital deduction] bequest or transfer, but also provides that any assets distributed in kind shall be valued at their values as finally determined for Federal estate tax purposes."[9] The rationale of the Internal Revenue Service is that the amount of such a bequest may not be definitely determined at the date of the testator's death because of the inherent power in the fiduciary to vary the fair market value of assets passing to the surviving spouse. Such a power is seen as a power

[6] A typical example of a "tax value" clause for use in a power-of-appointment trust is as follows:

"*Marital Trust.* If my wife survives me, I give, devise, and bequeath to my Trustee, as a separate trust, *an amount* equal to the maximum estate tax marital deduction allowable in determining federal estate tax payable by reason of my death, diminished by the value for federal estate tax purposes of all items in my gross estate for federal estate tax purposes which qualify for said deduction and which pass or have passed to my wife under other provisions of this will, by operation of law, pursuant to contract or otherwise than under this bequest. In making the computations necessary to determine the amount of this gift, values as finally determined for federal estate tax purposes shall control. My Executor may, in setting aside this share, distribute assets in cash or in kind or partly in cash and partly in kind, *at values as determined for federal estate tax purposes*; provided, however, that no asset shall be allocated to this trust unless it qualifies for the marital deduction. [Italics added for emphasis.]

[7] CASNER, ESTATE PLANNING 815 (3d ed. 1961).

[8] 1964-1 (pt. 1) CUM. BULL. 682.

[9] Rev. Proc. 64-19, § 2.01, 1964-1 (pt. 1) CUM. BULL. at 683.

in another to appoint a portion of the bequest away from the spouse,[10] and, since that portion cannot be definitely determined, the entire bequest may be disallowed as a deduction.

The procedure does not apply to a pecuniary bequest where assets distributed in kind are valued at date-of-distribution values, nor to a fractional share bequest where the beneficiaries share proportionately in appreciation or depreciation of the estate.[11] In more general terms, it does not apply to bequests where the fiduciary "must distribute assets including cash having an aggregate fair market value at the date or dates of distribution amounting to no less than the amount of the pecuniary bequest or transfer as finally determined for Federal estate tax purposes,"[12] nor to bequests where he must "distribute assets, including cash, fairly representative of appreciation or depreciation in the value of all property thus available for distribution . . . ."[13] Taking advantage of the specific language of the procedure, estate planners have created two new marital deduction formulae resembling the tax value clause. One of these requires the fiduciary to distribute assets amounting to no less than the amount of the deduction claimed; the other requires distributions fairly representative of the appreciation or depreciation of estate assets.

With the addition of these new clauses, the draftsman has four basic formula clauses, each of which gives to the estate the maximum marital deduction.[14] These formulae are: (1) The true pecuniary

[10] See Rogovin, *The Sound and the Fury, Official Views on Revenue Procedure 64-19,* 104 TRUSTS & ESTATES 432, 433 (1965). See also INT. REV. CODE OF 1954, § 2056 (b) (5); Treas. Reg. § 20.2056 (b)-5 (j) (1958).

[11] Rev. Proc. 64-19, §§ 4.01 (1), (3), 1964-1 (pt. 1) CUM. BULL. at 684.

[12] Rev. Proc. 64-19, § 2.02, 1964-1 (pt. 1) CUM. BULL. at 683.

[13] *Ibid.*

[14] Each of these formulae also possesses one undesirable characteristic. Section 662 of the Internal Revenue Code provides that a distribution from an estate or complex trust carries with it a proportionate part of the distributable net income of the trust or estate. Under § 663, a bequest of a specific sum of money or of specific property is excluded from this rule if payable in not more than three installments. The regulations provide, however, that a marital deduction bequest under a formula clause does not qualify under this exclusion because "the identity of the property and the amount of money specified in the preceding sentence are dependent both on the exercise of the executor's discretion and on the payment of administration expenses and other charges, neither of which are facts existing on the date of the decedent's death." Treas. Reg. § 1.663 (a)-1 (b) (1) (1956). Thus, any distribution in satisfaction of such a bequest carries its proportionate share of the distributable net income, and this added income to the beneficiary must be considered in planning distributions. Its effects are mitigated to some extent, however, by the fact that, to the extent income is realized by the beneficiary, the basis of property distributed in kind acquires a stepped-up basis *without* realization of capital gain. See Treas. Reg. § 1.661 (a)-2 (f) (3) (1956); Kelly, *Fiduciary Tax Planning with Revenue Code Section 661,* 105 TRUSTS & ESTATES 945 (1966).

clause; (2) The clause requiring distribution of no less than the amount of the marital bequest (the no-less-than clause); (3) The fractional share clause; and (4) The clause requiring a distribution fairly representing fluctuations in market values (the ratable sharing clause).[15]

CHARACTERISTICS OF THE "SET AMOUNT" FORMULAE

A. *True Pecuniary Formula*

This formula gives to the surviving spouse that dollar amount necessary to secure the maximum marital deduction for the estate, after taking into consideration property passing to the spouse from the decedent in any manner other than under the formula clause. While every draftsman will have his own preferred version,[16] the following language is typical:

> *Marital Trust.* If my wife survives me, I give, devise, and bequeath to my Trustee, as a separate trust, *an amount* equal to the maximum estate tax marital deduction allowable in determining the federal estate tax payable by reason of my death, diminished by the value for federal estate tax purposes of all items in my gross estate for federal estate tax purposes which qualify for said deduction and which pass or have passed to my wife under other provisions of this will, by operation of law, pursuant to contract or otherwise than under this devise and bequest. In making the computations necessary to determine the amount of this devise and bequest, values as finally determined for federal estate tax purposes shall control. My Executor may, in setting aside this share, distribute assets in cash or in kind or partly in cash and partly in kind; provided, however, that no asset shall be allocated to this trust unless it qualifies for the marital deduction. *In setting aside any share or making any distribution, my Executor shall use*

[15] These basic clauses may be modified and combined to form innumerable formulae having somewhat uncertain characteristics. See, *e.g.*, Keydel, *Revocable Trusts and the Marital Deduction—A Two-Step Formula*, 104 TRUSTS & ESTATES 1215 (1965) (tax value clause plus "no-less-than" formula). In the vast majority of instances, however, it is felt that one of the basic formulae will best fill the draftsman's need.

[16] All examples of marital deduction formulae herein discussed must, of necessity, reflect the drafting techniques of the author. As with any forms, there should be careful examination to see that they are suitable to the particular circumstances with which the draftsman is confronted. See generally CASNER, *op. cit. supra* note 7, at 793-94; COVEY, THE MARITAL DEDUCTION AND THE USE OF FORMULA PROVISIONS (1966); LOWNDES & KRAMER, *op. cit. supra* note 1, §§ 41.4-.10; Polasky, *Marital Deduction Formula Clauses in Estate Planning—Estate and Income Tax Considerations*, 63 MICH. L. REV. 809 (1965).

All formula clauses presented here are designed for use in a testamentary power-of-appointment trust. If some other method is being used to qualify the bequest for the marital deduction, appropriate changes should be made.

values to be determined at the date of distribution. [Italics added for emphasis.]

Advantages:

Definite amount to spouse. Under this formula, the surviving spouse is entitled to receive only the set amount determined by its operation. Where the assets of the estate increase in value after the date of death (or the alternate valuation date if the executor so elects), the appreciation passes to the nonmarital share. For planning purposes, the most significant effect of this result is that the appreciation escapes taxation in the estate of the surviving spouse, although she will often benefit from the appreciation as an income beneficiary of the nonmarital, or family, share.

Post-mortem planning. While no variation is permitted in the *amount* of the marital bequest, the executor may exercise some discretion in choosing the *assets* to be used to satisfy it, *if* the will grants him authority to make distributions in kind.[17] Thus, for example, assets subject to rapid appreciation may be allocated to the residue, to escape taxation in the spouse's estate, while assets producing the larger income may be allocated to the marital share for the spouse's current benefit.

Ease of administration. This formula avoids many of the administrative problems created by use of the fractional or ratable sharing formulae. In particular, treatment of partial distributions of principal are simplified. Any partial distribution to the surviving spouse or to a trust for her benefit is simply valued at date of distribution values and credited against the total amount due, whereas any such non-pro-rata distribution under either of the "sharing" formulae would necessitate a revaluation of all estate assets and, in the fractional share clause, a recomputation of the appropriate fraction.

Disadvantages:

Pecuniary bequest. Since this formula makes a pecuniary bequest, it is generally entitled under state law to preference in order of payment, and if not paid within a short time (generally one year

[17] It should be pointed out, however, that many fiduciaries regard this flexibility as a disadvantage, since any inequality of treatment between marital and nonmarital shares gives beneficiaries cause for question. See Golden, *Rev. Proc. 64-19, Implications for Attorneys and Fiduciaries,* 103 TRUSTS & ESTATES 536, 538 (1964).

from death), interest must be paid by the estate.[18] Quite frequently the amount of this bequest will be a large dollar amount, forcing the executor to administer the estate so that sufficient cash will be available to satisfy the bequest. Thus, unless the power to distribute in kind is given to the executor, the cash requirements of the estate are increased at the time when the debts, taxes, and administration expenses are normally paid.

May favor spouse. Just as this formula passes post-mortem appreciation to the residue, post-mortem depreciation is, in effect, allocated to the residue. The surviving spouse will receive one-half of the adjusted gross estate as determined for federal estate tax purposes, even though that amount may represent the larger part, or even all, of the estate when valued at date of distribution. There is no guarantee as to the actual portion of the estate passing to the nonmarital beneficiaries; indeed, there is no guarantee that they will participate at all. However, the problem of decreasing values can be alleviated somewhat by electing to value the estate as of the alternate valuation date when the value of the gross estate would be lower and the marital deduction bequest reduced.

Second valuation. The formula provides that the distributed assets are to be valued at date-of-distribution values, requiring a second valuation when any assets are distributed. Such revaluation may well be a difficult administrative task, especially where stock in a closely held corporation is being distributed. This revaluation is, however, limited to the assets distributed in satisfaction of this bequest, since the residuary legatees receive the balance of the estate regardless of its fair market value on the date of distribution.[19]

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[18] *E.g.*, State Bank of Chicago v. Gross, 344 Ill. 512, 176 N.E. 739 (1939); CAL. PROB. CODE § 162; PA. STAT. ANN. tit. 20, § 320.753 (1950).

In North Carolina, for example, the legacy must be paid within one year after the date of death of the testator, and, if not paid by that date, it bears interest thereafter. See Branch Banking & Trust Co. v. Whitfield, 238 N.C. 69, 76 S.E.2d 334 (1953); Shepard v. Bryan, 195 N.C. 822, 143 S.E. 835 (1928); Hart v. Williams, 77 N.C. 426 (1877). See generally 6 PAGE, WILLS § 59.11 (New Rev. Treatise 1962); THOMPSON, WILLS § 542 (3d ed. 1947).

[19] To the extent that the composition of the estate and the circumstances likely to be present during its administration can be foreseen, the second valuation problem can be minimized by using the formula clause as a "back-up" for specific bequests made to the spouse in antecedent paragraphs of the instrument. The formula bequest thus prevents underqualification of assets caused, for example, by unexpected accretions to the estate prior to death. Of course, the formula would have no effect if the amount of the specific bequests exceeded the amount of allowable marital deduction. See Polasky, *supra* note 16, at 888-89.

Realization of capital gain. In Revenue Ruling 56-270,[20] the Internal Revenue Service ruled that distribution of appreciated property in satisfaction of a "fixed and definite 'dollar amount'" bequeathed to a spouse by means of a pecuniary formula was the equivalent of a sale or exchange by the estate and that the realized gain was taxable.[21] Thus, the executor faces realization of capital gain when he funds the marital trust with assets which have appreciated from date-of-death values. This problem can be alleviated, however, by funding the marital trust as soon after the decedent's death as possible and by careful selection of assets with which to fund it.

B. *No-Less-Than Formula*

This formula, like the true pecuniary, gives to the surviving spouse a dollar amount sufficient to secure the maximum marital deduction for the estate. To meet the requirements of Revenue Procedure 64-19, however, the formula directs the executor to transfer to the surviving spouse assets having a date-of-distribution value not less than the amount of the marital deduction claimed. Typical language would be as follows:

> *Marital Trust.* If my wife survives me, I give, devise, and bequeath to my Trustee, as a separate trust, an *amount* equal to the maximum estate tax marital deduction allowable in determining the federal estate tax payable by reason of my death, diminished by the value for federal estate tax purposes of all items in my gross estate for federal estate tax purposes which qualify for said deduction and which pass or have passed to my wife under other provisions of this will, by operation of law, pursuant to contract or otherwise than under this devise and bequest. In making the com-

[20] 1956-1 CUM. BULL. 325. See also Treas. Reg. § 1.1014-4(a)(3) (1957); Rev. Rul. 60-87, 1960-1 CUM. BULL. 286.

[21] This rationale is based upon Suisman v. Eaton, 15 F. Supp. 113 (D. Conn. 1935), *aff'd*, 83 F.2d 1019 (2d Cir.), *cert. denied*, 299 U.S. 573 (1936), and Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940), wherein the Second Circuit held that satisfaction of a pecuniary bequest with appreciated property was the equivalent of a sale and that any gains realized were taxable.

A corollary of this position is that satisfaction of the pecuniary bequest with depreciated property creates a capital loss which may be deducted by the estate. In the case of a trust, however, the loss will not be deductible since INT. REV. CODE OF 1954, § 267 denies deduction of losses incurred on a "sale" between trustee and beneficiary of a trust or between two trustees where both trusts are created by the same grantor. Thus, losses would be disallowed on transfers from an inter vivos trust to the surviving spouse or to a marital deduction trust and on transfers from a testamentary trust to the spouse.

putations necessary to determine the amount of this devise and bequest, values as finally determined for federal estate tax purposes shall control. My Executor may, in setting aside this share, distribute assets in cash or in kind or partly in cash and partly in kind; provided, however, that no asset shall be allocated to this trust unless it qualifies for the marital deduction.

My Executor, in order to satisfy this devise and bequest shall distribute to my Trustee assets, including cash, having an aggregate fair market value at the date or dates of distribution amounting to no less than the amount of this devise and bequest as finally determined for federal estate tax purposes. [Italics added for emphasis.]

Advantages:

Post-mortem planning. As with the true pecuniary clause, the executor may exercise some discretion in choosing assets to fund this bequest where the will gives him the power to make distributions in kind.[22]

Possibility of no capital gain. While this formula initially gives the surviving spouse a definite dollar amount, it provides that the executor shall satisfy the bequest by distributing assets having a date-of-distribution value not less than the amount of the marital deduction claimed by the estate. It has been suggested that the amount finally distributed to the spouse is not a "fixed and definite dollar amount" within the meaning of Revenue Ruling 56-270,[23] since the minimum amount passing to the spouse is fixed, but the maximum is not. If this interpretation is adopted by the Internal Revenue Service, no capital gain should result upon distribution of appreciated assets.[24]

Ease of administration. Like the true pecuniary clause, this formula avoids the complexities of a fractional share, which changes with each non-pro-rata distribution of principal.

Disadvantages:

Second valuation. When any distribution is made, the assets distributed must be revalued to determine their date-of-distribution

[22] This discretion may be considered a disadvantage by some. See note 17 *supra.*

[23] 1956-1 CUM. BULL. 325. See text accompanying notes 20-21 *supra.*

[24] See CASNER, *op. cit. supra* note 7, at 550 (Supp. 1966); Polasky, *supra* note 16, at 867-68. *But see* Covey, *Statutory Panacea for 64-19?*, 104 TRUSTS & ESTATES 69, 70 (1965).

value. This revaluation is limited, however, to the assets distributed in satisfaction of the marital bequest.[25]

Cash need; time of payment. As a pecuniary bequest, the share passing to the surviving spouse is subject to the general requirement of rapid payment plus interest after one year,[26] with the resultant drain on the cash of the estate.

Uncertainty as to maximum. The amount passing to the surviving spouse has a minimum value set forth in the formula, but not a maximum. While this characteristic may circumvent the capital gain problem of the true pecuniary formula, it creates, in turn, its own problem. It is clear, indeed it is mandatory, that the spouse receive no less than the amount of the marital deduction claimed. What is not clear, however, is the maximum amount which the testator intends to pass to her. At least one court has held that a variation of this formula required the widow to share in any appreciation of the estate.[27] In the will in that case a pecuniary clause was used, and the executor was directed to distribute assets at the lower of the date-of-death or date-of-distribution value. In interpreting this provision, the court said:

> [W]here a will permits the executor or trustee, in satisfying the marital deduction bequest, to distribute assets in kind at date of death values, the testator is presumed to have intended that the surviving spouse share in any appreciation.[28]

The court found the provision in question to reflect a corresponding concern that the wife be protected against depreciation as well.[29]

Effect on charitable remainder. Before an estate is entitled to a charitable deduction, the interest passing to charity must be capable of being valued.[30] Since the non-less-than formula is indefinite as to the maximum amount passing to the surviving spouse, the Service may contend that value of the charitable interest is unascertainable and therefore nondeductible.[31]

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[25] See note 19 *supra.*
[26] See note 18 *supra* and accompanying text.
[27] *In re* McDonnell's Will, 45 Misc. 2d 57, 256 N.Y.S.2d 149 (Surr. Ct. 1965).
[28] *Id.* at 58, 256 N.Y.S.2d at 151.
[29] *Id.* at 59, 256 N.Y.S.2d at 152.
[30] Commissioner v. Sternberger's Estate, 348 U.S. 187 (1955).
[31] See Covey, *Statutory Panacea for 64-19?*, 104 TRUSTS & ESTATES 69, 70 (1965).

CHARACTERISTICS OF "SHARING" FORMULAE

A. *Fractional Share Formula*

The fractional share formula gives to the surviving spouse the right to receive a fractional share of each asset in the estate.[32] It may be expressed in either simple or complex form, as exemplified in the following clauses:

> [Simple]
>
> *Marital Trust.* If my wife survives me, I give, devise, and bequeath to my Trustee, as a separate trust, *that fractional share of my residuary estate* required to obtain for my estate a marital deduction equal to the maximum marital deduction allowable for federal estate tax purposes, less the aggregate value for federal estate tax purposes of all interests in property which pass to my wife under other provisions of this will, by operation of law, by contract or otherwise, but only to the extent that such interests are included in determining my gross estate and are allowable as a marital deduction for federal estate tax purposes. In making those computations necessary to determine such fractional share, values used in the final determination of the federal estate tax upon my estate shall control. No asset shall be allocated to the marital trust unless it qualifies for the marital deduction allowable in determining the federal estate tax.

> [Complex]
>
> *Marital Trust.* If my wife survives me, I give, devise, and bequeath to my Trustee, as a separate trust, *that fraction of my residuary estate,* which shall have as its
>
> *Numerator,* the maximum estate tax marital deduction allowable in computing the federal estate tax payable by reason of my death, undiminished by any taxes, but diminished by the

[32] The authorities are in general agreement on this point. See, *e.g.*, COVEY, THE MARITAL DEDUCTION AND THE USE OF FORMULA PROVISIONS 29-32 (1966); Butula, *Administrative Problems Involving Marital Deduction Gifts,* 16 W. RES. L. REV. 290, 293-97 (1965); Casner, *How to Use Fractional Share Marital Deduction Gifts,* 99 TRUSTS & ESTATES 190 (1960); Durbin, *Marital Deduction Formula Revisited,* 102 TRUSTS & ESTATES 545 (1963); Keydel, *supra* note 15, at 1215 n.1; Polasky, *supra* note 16, at 845; Stevens, *How to Draft Marital Deduction Formula Clauses Under New Rev. Proc. 64-19,* 20 J. TAXATION 352, 356 (1964); Weinstock, *The Marital Deduction—Problems and Answers Under Revenue Procedure 64-19,* 43 TAXES 340, 343 (1965). It appears, however, that there are no reported decisions supporting this conclusion.

Some authorities have suggested that this formula also requires the executor to distribute the basis of estate assets in accordance with the fraction. In most instances, this distribution would also require fractionalization of estate assets. See Keydel, *supra* note 15, at 1215 n.1; Roberts & Muller, *Constructive Receipt of Income by Estates and Trusts Through Distributions in Kind to Beneficiaries,* 4 TAX L. REV. 372, 377 (1949).

> value as finally determined for federal estate tax purposes of all other property in my gross taxable estate which qualifies for the marital deduction under the Internal Revenue Code of 1954, as amended, which passes or has passed to my wife outright under other provisions of this will or outside this will by contract, operation of law or otherwise, including, but not limited to, insurance and property held as tenants by the entireties,

and as its

> *Denominator,* the value of my residuary estate determined with values used in the final determination of the federal estate tax upon my estate, with no value ascribed to anything not includible in my gross estate for federal estate tax purposes.

My executor may, in setting aside this share, distribute assets in cash or in kind or partly in cash and partly in kind; provided, however, no asset shall be allocated in any division to the Marital Trust unless it qualifies for the said marital deduction. [Italics added for emphasis.]

Advantages:

No capital gain. Under this formula, the surviving spouse is entitled to receive an appropriate fractional share of each asset falling into the residuary estate.[33] Upon distribution in kind by the fiduciary in satisfaction of this bequest, no capital gain is realized since the spouse simply receives the exact property bequeathed to her by the will.[34]

Spouse shares in appreciation and depreciation. Since the surviving spouse is entitled to a fractional share of each asset, the total value of her bequest rises and falls with the value of those assets. It also insures that the residuary legatees cannot be completely excluded from participating in the estate.

No second valuation. Because the marital bequest is entitled to a fractional share of each asset, the date-of-distribution values of the assets are irrelevant. The need for a second valuation of any asset is therefore eliminated.

Post-mortem planning. Since the surviving spouse receives a fractional share only of the assets falling into the residue, to the extent that the fiduciary can determine the composition of the residue, he can determine the assets passing to the spouse. Normally,

[33] See note 32 *supra.*

[34] Rev. Rul. 55-117, 1955-1 CUM. BULL. 233; Treas. Reg. § 1.1014-4 (a) (3) (1957).

the residuary estate consists of all assets passing under the will, less those used to satisfy any specific or pecuniary bequests. The fiduciary, by choosing the assets used to satisfy any pecuniary bequests, can exercise some control over the composition of the residue. Further control can be given the fiduciary if the draftsman defines the residue as all items of the estate after payment of specific and pecuniary legacies and payment of administrative and/or death taxes.[35]

Disadvantages:

Fractional share of each asset. There is general agreement among the authorities that this formula gives the surviving spouse the right to receive the appropriate fractional share of each asset in the estate.[36] Where an estate is comprised primarily of fungible assets, such as listed corporate securities, this requirement poses no great problem. Where the estate contains closely held corporate stock or real property, however, the resulting "fractionalization" often will not be in keeping with the desires of the testator.

Possibilities of capital gain to the estate. When using the fractional share formula, many draftsmen authorize the fiduciary to apply the fraction obtained from the formula to the estate as a whole, seeking to avoid the pro rata distribution of each asset.[37] Such a provision seems to give the surviving spouse a claim upon the estate for a fixed and definite amount determined by the value of her fractional interest at date of death or alternate valuation date, as the case may be. When this claim is satisfied by distribution of appreciated property, capital gain may result to the estate, just as in the case of the pecuniary clause.[38]

Possibilities of capital gain to the surviving spouse. In many cases, the legatees under a fractional share formula may request the fiduciary to make distribution of the assets in some manner other than the fractional one required by the formula. It has been sug-

[35] See Casner, *How to Use Fractional Share Marital Deduction Gifts*, 99 TRUSTS & ESTATES 190, 191 (1960). To the extent that the residue is narrowly defined, the fractional share of the surviving spouse becomes larger, with the danger in some cases that there will be insufficient assets to obtain the maximum marital deduction.

[36] See note 32 *supra* and accompanying text.

[37] A typical clause might read as follows: "My Executor shall apply the fraction so determined to the residuary estate as a whole and not to individual assets therein."

[38] See Casner, *How to Use Fractional Share Marital Deduction Gifts*, 99 TRUSTS & ESTATES 190, 277 (1960); Keydel, *supra* note 15, at 1218; Polasky, *supra* note 16, at 863-65. See also text accompanying note 42 *infra*.

gested that this is a taxable exchange of property by the beneficiaries, who give up vested interests in certain assets in exchange for other assets.[39] Each party to the distribution would be treated as if he exchanged the property to which he would have been entitled for the property which he received, and any gain or loss would be recognized.

Complexity of partial distributions. Since the fractional share of the surviving spouse is defined with reference to the residue of the estate, non-pro-rata distributions from the residue require that the fraction be recomputed in order that income and principal may be correctly apportioned in the future. Such a recomputation requires the revaluation of all assets in the estate and presents a sizable administrative burden where the estate contains assets other than cash and traded securities.

Application of fraction to income and principal. Although the precise fraction under the formula cannot be determined until the final acceptance of the estate tax return for the estate, the fraction must be applied to income earned after the date of decedent's death, as well as to each item of principal in the estate at the time of any distribution. The fiduciary who distributes income and principal before final audit of the estate tax return faces the prospect of being required to revise those distributions in the event the audit changes the fraction substantially.

B. *Ratable Sharing Formula*

The ratable sharing formula represents the second type of marital bequest based upon the specific language of Revenue Procedure 64-19. Like the pecuniary and the no-less-than formulae, it gives to the surviving spouse the exact dollar amount necessary to ensure the maximum marital deduction for the estate but provides that the executor shall satisfy the amount so determined by distributing assets which are fairly representative of the appreciation or depreciation of estate assets since the date of death. Its language, set forth below, generally incorporates the exact words of Revenue Procedure 64-19.[40]

[39] Casner, *How to Use Fractional Share Marital Deduction Gifts*, 99 TRUSTS & ESTATES 190, 277 (1960); *cf.* Rouse v. Commissioner, 159 F.2d 706 (5th Cir. 1947). However, if the interests exchanged are undivided interests in real estate, the parties may be regarded as having exchanged their property "solely for property of a like kind" in a tax-free transaction. INT. REV. CODE OF 1954, § 1031 (a).

[40] Rev. Proc. 64-19, § 2.02, 1964-1 (pt. 1) CUM. BULL. 682, 683.

> *Marital Trust.* If my wife survives me, I give, devise, and bequeath to my Trustee, as a separate trust, an amount equal to the maximum estate tax marital deduction allowable in determining the federal estate tax payable by reason of my death, diminished by the value for federal estate tax purposes of all items in my gross estate for federal estate tax purposes which qualify for said deduction and which pass or have passed to my wife under other provisions of this will, by operation of law, pursuant to contract or otherwise than under this devise and bequest. In making the computations necessary to determine the amount of this devise and bequest, values as finally determined for federal estate tax purposes shall control. My Executor may, in setting aside this share, distribute assets, in cash or in kind or partly in cash and partly in kind; provided, however, that no asset shall be allocated to this trust unless it qualifies for the marital deduction.
>
> *My Executor, in order to satisfy this devise and bequest, shall distribute to my Trustee assets, including cash, fairly representative on the date or dates of distribution of appreciation or depreciation in the value of all property available for distribution in satisfaction of this devise and bequest.* [Italics added for emphasis.]

Advantages:

No "fractionalization" of assets. This formula gives the spouse a dollar claim against the estate and does not give her an interest in any specific asset of the estate. In satisfying the bequest, therefore, the executor is not required to make pro rata distribution of each asset unless this appears desirable.

Sharing of appreciation or depreciation. By the specific terms of this formula, the portion of the estate ultimately passing to the surviving spouse must accurately reflect the changes in value which have occurred in the estate since the date of the decedent's death.

No capital gain. While the formula initially calls for a dollar amount to pass to the surviving spouse, the requirement that the distribution in satisfaction of the bequest accurately reflect appreciation and depreciation means that the spouse is not entitled to a fixed and definite amount. Thus, distribution of assets in satisfaction of the bequest should not result in capital gain to the estate, at least under the rationale of Revenue Ruling 56-270.[41] At the same time, since the surviving spouse has no vested interest in any asset, no capital gain should be recognized on the theory of an exchange of property.

[41] See notes 20-21 *supra* and accompanying text.

Disadvantages:

Possibility of capital gain. Before declaring with finality that no capital gain results from the use of this formula, however, the estate planner should consider the implications of *Commissioner v. Brinkerhoff*.[42] In that case, although the will directed the executor to sell certain property and distribute the proceeds to named legatees, the property itself was distributed at the request of the legatees. The court held that the distribution of the propery was a taxable event, and gain was realized to the estate to the extent that fair market value at date of distribution exceeded its basis in the hands of the estate. The rationale of this holding was that each legatee had a claim for a dollar amount against the estate, the amount being measured by fair market value of the asset at date of distribution. Distribution of the property itself was in satisfaction of the claim and resulted in taxable gain to the estate.

The normal interpretation of the ratable sharing formula is that it gives a set dollar amount to the surviving spouse but requires that the assets used to fund the bequest fairly represent the appreciation or depreciation of estate assets. One author has suggested, however, that a court might construe the formula to give the spouse a dollar amount which is not determinable until date of distribution.[43] In this event, the *Brinkerhoff* rationale could apply to force recognition of capital gain when this dollar amount is satisfied with assets which have appreciated since the date of the decedent's death.[44]

Distribution of basis. This formula gives the spouse an amount equal to the marital deduction when valued at estate tax values, but directs that the bequest be satisfied with assets "fairly representative." This may be construed to require the executor to distribute assets having a date-of-death value equal to the marital deduction but at the same time fairly representative of any appreciation.[45] Such a distribution may prove an insurmountable challenge unless the fiduciary, at least to some extent, makes pro rata distributions of

[42] 168 F.2d 436 (2d Cir. 1948). See also Lindsay C. Howard, 23 T.C. 962 (1955).

[43] Polasky, *supra* note 16, at 829.

[44] "The fact that the ultimate value realized by the taxpayers in the present case depends upon the fluctuating value of the property devised to the executors does not affect our conclusion . . . ." 168 F.2d at 440. This language would strengthen any argument that the rationale of the case would apply to the ratable sharing formula.

[45] See Polasky, *supra* note 16, at 829 n.84.

each asset, bringing him back to the undesired "fractionalization" of assets.

Second valuation. To determine what amount would be "fairly representative of appreciation or depreciation" in estate assets, a second valuation of all assets in the estate is required. This valuation creates administrative problems for the fiduciary, especially where stock in a closely held corporation is a significant portion of the estate.

CONCLUSION

The choice of a marital deduction formula cannot be lightly made. It must rest primarily upon a thorough knowledge and careful analysis of the assets of the individual testator and of his desires for the disposition of his estate. To a lesser extent, it will be based upon the personal preference of the draftsman, upon his experience with the formulae, and upon the desires and experience of the proposed fiduciary with whom he is working. To the draftsman faced with these choices some general observations may be directed.

The true pecuniary clause is the easiest of the formulae to draft and to explain to the client, and it offers broad flexibility to the fiduciary in the choice of assets with which to fund the marital bequest. Its outstanding advantage, however, is its safety; all incidents of the true pecuniary formula are known and may be anticipated and provided for in the estate plan. By way of contrast, each of the other basic formulae possesses some area in which no definite prediction of its tax effects can be made. While these questions will presumably be answered by litigation or rulings in the future, it should be an aim of the estate planner to avoid subjecting the estates of *his* clients to such controversies.

The true pecuniary formula is not without its disadvantages. There is a definite possibility of capital gain, although this can be minimized by funding the marital share as soon after the death of the decedent as practicable and by judicious selection of assets. Under this formula, it is possible that the residuary may not participate in the estate if there is substantial depreciation in the value of the estate. It is also possible that use of this formula may create problems in some estates where there are insufficient liquid assets.

The no-less-than formula is a relatively minor departure from the true pecuniary but possesses an additional advantage in the possi-

bility that no capital gain would be recognized upon distribution of appreciated assets. However, the uncertainty as to the effect of this clause in the event of over-all appreciation of the estate makes it preferable only when rapid funding of the marital share is not practicable, and substantial appreciation of estate assets is anticipated. The uncertain maximum under this clause also dictates that it should not be used in any estate plan containing a charitable remainder.

The fractional share formula gives the marital share the right to its proportionate part of each estate asset, assuring that the surviving spouse and the residuary legatees maintain their relative positions in spite of appreciation or depreciation. Where this result is deemed necesssary, this formula should be used. Many corporate fiduciaries also prefer this formula[46] because there is no question of what assets pass to and make up the marital share and thus less chance of criticism by any beneficiary. The fractional share, however, should be used with caution when closely held corporate stock or real property is a significant asset of the estate, unless these assets are excluded from operation of the formula. The draftsman should also recognize that this formula imposes greater administrative burdens on the fiduciary than do other formulae.

The ratable sharing formula has no significant advantage over the fractional share formula. On the contrary, it appears to involve a greater possibility of capital gain and requires a second valuation of each asset in the estate. The ratable sharing formula exists almost exclusively as the product of a statute designed to protect existing instruments from disallowance of the marital deduction under Revenue Procedure 64-19. To date, eleven states have adopted such statutes, and all but two convert an offending formula into a ratable sharing one.[47]

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[46] Bronston, *State and Federal Taxation: Tax Problems of Formula Type of Marital Deduction Bequest,* 96 TRUSTS & ESTATES 887 (1957); Durand, *Draftsmanship: Wills and Trusts,* 96 TRUSTS & ESTATES 871 (1957); Golden, *A Decade with the Marital Deduction,* 98 TRUSTS & ESTATES 304 (1958).

[47] See Cantwell, *Revenue Procedure 64-19, Statutory Relief,* 104 TRUSTS & ESTATES 953 (1965); Covey, *Statutory Panacea for 64-19?,* 104 TRUSTS & ESTATES 69 (1965).

California and New York have adopted the no-less-than approach. CAL. PROB. CODE § 1029; N.Y. PERS. PROP. LAW § 17-f(2)(b). Alabama, Colorado, Florida, Maryland, Minnesota, North Carolina, Ohio, South Carolina, Tennessee, Virginia, and Wisconsin have adopted the ratable sharing criteria. ALA. CODE tit. 58, § 7(3) (Supp. 1965); COLO. REV. STAT. § 153-10-49 (enacted by Colo. Laws 1965, ch. 327); FLA. STAT. ANN. § 734.031 (Supp. 1966); MD. ANN. CODE art. 93, § 392 (Supp. 1966); MINN. STAT. ANN. § 525.528 (Supp. 1966); N.C. GEN. STAT. § 28-158.1 (Supp. 1965); OHIO REV. CODE ANN. 1339.41 (Page

The marital deduction is quite often the key to an effective estate plan, and in many instances, maximum benefit requires the use of a self-adjusting formula clause. No clause is without disadvantages, but through thorough analysis of the facts and careful draftsmanship, they can be avoided or at least mitigated. To those dealing with this problem in the future, however, a word of caution. The past several years have seen more revision of ideas concerning the marital deduction than any period since its introduction in 1948, and there is every reason to believe this state of flux will continue.[48] Today's certainties may be tomorrow's problems; today's advantages, tomorrow's disadvantages. Every estate planner must keep abreast of these developments in order to properly assess the relative value of the available marital deduction formulae in a given situation and must always be alert for events requiring the change of existing instruments.

Supp. 1966); S.C CODE ANN. § 19-567 (Supp. 1966); TENN. CODE ANN. § 30-1317 (Supp. 1966); VA. CODE § 64-71.2 (b) (Supp. 1966); WIS. STAT. ANN. § 231.55 (Supp. 1967). Mississippi, in a statute since repealed, adopted both approaches in that it allowed the fiduciary to select the standard by which he would distribute assets. Miss. Laws 1964, ch. 294, effective June 5, 1964, repealed effective March 2, 1966, by Miss. Laws 1966, S.B. 1633. The Mississippi statute did not satisfy the requirements of the proccdure. See Cohen, *Treasury Views on Current Questions,* 104 TRUSTS & ESTATES 9-10 (1965). A new statute adopting the ratable sharing approach has been adopted. Miss. Laws 1966, H.B. 436.

[48] At present, a controversy concerning the effect of the rules of vesting on the marital deduction appears to be brewing. See Lauritzen, *Safeguarding the Marital Deduction,* 1 REAL PROP., PROB. & TRUST L.J. 162 (1966); *Report, Vesting of Testator's Property as It Relates to the Marital Deduction, id.* at 164.