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Some Marital Deduction Problems for the South Carolina Lawyer

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SOME MARITAL DEDUCTION PROBLEMS FOR THE SOUTH CAROLINA LAWYER

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1. USE OF THE MARITAL DEDUCTION

As we know, the Code of Internal Revenue (§ 2056) since 1948 has allowed a special deduction in computing a taxable estate, of any amount up to 50% of the adjusted gross estate[1] which passes from a decedent to a surviving spouse.[2] Section 2056(a) which allows the deduction, reads as follows:

> Allowance of Marital Deduction. For purposes of the tax imposed by section 2001, the value of the taxable estate shall, * * * 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.

The deduction may be in the form of a specific bequest or devise to a surviving spouse or it may be a fractional interest in the entire estate or in the residuary estate, despite the fact that the assets are unidentified, but the total deduction cannot exceed 50% of the adjusted gross estate. The purpose of Congress in allowing this deduction was to place common law states upon an equal basis with community property states, thus achieving "geographical" equalization.[3] Since the theory of

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1. Which is defined, generally, as the gross estate less funeral and administrative expenses, debts, charitable bequests or devises and losses, less any community property in the estate. See § 2056 (c)(2)(A).

2. It makes no difference, in this regard, whether the property passes under a will or by intestacy. The IRS agrees that a widow's dower passes to her from the decedent but whenever dower consists of a life interest in property, as in S. C., the IRS refuses to allow it on the ground that it is a terminable interest. United States v. Crosby, 257 F.2d 515 (5th Cir. 1958). However, if the property cannot be partitioned but has to be sold by the executor so that the widow's dower may be paid in cash, the interest may be allowed. Jackson v. United States, 292 F.2d 331 (6th Cir. 1961). There is a split of authority as to whether a widow's allowance will qualify but the IRS later took the view that it is a terminal interest. P. D. Rensenhouse, 31 T.C. 818 (1959). Amounts paid to widows in settlement of will contents and the like may be allowed if they are not terminable interests. L. J. Sutcher, 34 T.C. 918 (1960); J. P. Barrett, 22 T.C. 606 (1954); T. W. Tebb, 27 T.C. 671 (1957). A cash settlement for a terminable interest will not be allowed. Chritton v. U.S., 59-2 U.S. Tax Cas. 11, 883 (N.D. Ill.).

3. See MERTEN, LAW OF GIFT AND ESTATE TAXATION, § 29.01 (1959).

community property is that all property acquired by either husband or wife during the marriage (except property acquired as the separate property of either) is the result of a kind of marital partnership, only one-half of the family owned property is considered owned by the first spouse to die. The marital deduction was designed to allow the same result in the case where the decedent lived in a non-community property state. Tax savings in the estate of the first spouse to die may be very substantial. Commerce Clearing House[4] estimates the maximum savings as shown:

Size of Estate	*Maximum Savings Possible*	*Size of Estate*	*Maximum Savings Possible*
$ 100,000	$ 4,800	$1,500,000	$ 290,800
150,000	16,850	2,000,000	422,700
200,000	27,900	2,500,000	569,000
250,000	36,800	3,000,000	728,400
300,000	44,800	4,000,000	1,076,600
400,000	61,800	5,000,000	1,461,600
500,000	78,800	6,000,000	1,866,600
600,000	97,000	7,000,000	2,286,600
700,000	116,200	8,000,000	2,721,600
800,000	135,200	9,000,000	3,167,200
900,000	156,000	10,000,000	3,612,200
1,000,000	177,000		

These estimates of maximum possible savings are seldom reached as they assume that the surviving spouse had absolutely no estate of her own and that the first spouse left her the exact amount of the marital deduction. Nevertheless, the marital deduction does result in substantial benefits, and is a most important factor in estate planning.

It must, however, be used with discretion. If it is used to reduce the estate of the first spouse although the surviving spouse has a substantial estate of her own, the overall estate taxes might be considerably greater than would otherwise be the case. Despite this increase in overall taxes, it is possible that because of a shortage of cash in the estate of the first spouse it might be desirable to use the marital deduction to the greatest extent possible so as to reduce the tax in the estate of the first spouse. Nevertheless, if there is no over-riding consideration

4. 2 CCH FED. EST. & GIFT TAX REP. § 7155 (1960).

of liquidity, unless it is expected that the second spouse will live for many years after the death of the first spouse, or will give away a substantial part of the property left to her, the problem should be one of equalizing the two estates.

2. A TERMINABLE INTEREST IN THE SURVIVING SPOUSE WILL NOT QUALIFY FOR THE MARITAL DEDUCTION

As we have seen, the original purpose of the marital deduction was to equalize the tax in non-community property states with the tax in community property states—where the spouses owned the family property equally. The property interest, therefore, of the surviving spouse had to be "ownership" of its equivalent. Thus, Congress provided that the property passing to a surviving spouse could not qualify for the marital deduction if it created a terminable or conditional interest.[5] This is known as the "terminable interest" rule.

Congress recognized, however, that it might be unwise to leave outright to a widow without investment experience a large amount of property, free from any restraint. The Code of Internal Revenue, therefore, as originally enacted in 1948, allowed as a basic exception to the terminable interest rule the creation of a trust for the surviving spouse if she received all of the income or earnings therefrom and was given a specific power of appointment over the principal exercisable in favor of herself (during life) or her estate (after death). Congress also allowed insurance payable to the surviving spouse to qualify if she received all earnings from the fund (or earnings and principal was paid to her as an annuity) and if she had the right to withdraw principal during her life or had a similar power of appointment.[6] However, after several cases[7] held that a life bequest to a surviving spouse, with requisite power of appointment, failed to qualify for the marital deduction since there was no

5. See INT. REV. CODE OF 1954, § 2056(b) setting forth this limitation on the applicability of the marital deduction.

6. An exemption was also allowed from the terminable interest rule in that the surviving spouse could be required to survive the decedent by as long as six months before she qualified for the bequest.

7. Pipe v. United States, 241 F.2d 210 (2d Cir. 1957); McGehee v. United States, 260 F.2d 818 (5th Cir. 1958); Boyd v. Gray 175 F. Supp. 57 (W. D. Ky. 1959).

trust created, the exception was broadened[8] to include a life estate, whether or not in trust, and in 1958 this was made retroactive to 1948.

The question frequently arises, in the life estate with power of appointment, as to whether the power is sufficiently broad to qualify the property passing to the surviving spouse for the marital deduction. The statute merely provides that the power must be exercisable in favor of the surviving spouse or her estate and must be exercisable alone and in all events.[9] The Regulation[10] is more detailed and states:

> Power of appointment in surviving spouse. (1) The conditions set forth in paragraph (a)(3) and (4) of this section, that is, that the surviving spouse must have a power of appointment exercisable in favor of herself or her estate and exercisable alone and in all events, are not met unless the power of the surviving spouse to appoint the entire interest or a specific portion of it falls within one of the following categories:
>
> (i) A power so to appoint fully exercisable in her own favor at any time following the decedent's death (as, for example, an unlimited power to invade); or
>
> (ii) A power so to appoint exercisable in favor of her estate. Such a power, if exercisable during life, must be fully exercisable at any time during life, or, if exercisable by will, must be fully exercisable irrespective of the time of her death (subject in either case to the provisions of § 20. 2056(b)-3, relating to interests conditioned on survival for a limited period); or
>
> (iii) A combination of the powers described under subparagraphs (i) and (ii) of this subparagraph. For example

8. The Senate Committee Report on the 1954 Code states:
Present law requires * * * that the property be placed in trust and because of doubt under the law of the various states as to what constitutes a "trust", it is not clear when a life estate will qualify as a trust. Nor is it clear where property is placed in trust and the surviving spouse has an income interest in and power of appointment over part of the property, when the interest given the surviving spouse constitutes a transfer in trust qualifying for the martial deduction.
The bill (1954 CIR) makes it clear that property in a legal life estate, as well as property in trust, qualifies for the marital deduction and that a right to income plus a general power of appointment over only an individual part of the property will qualify that part of the property for the marital deduction.

9. INT. REV. CODE OF 1954 § 2056(b)(5).

10. U. S. TREAS. REG. § 20.2056(b)(5)(g)(1954).

the surviving spouse may, until she attains the age of 50 years, have a power to appoint to herself and thereafter have a power to appoint to her estate. However, the condition that the spouse's power must be exercisable in all events is not satisfied unless irrespective of when the surviving spouse may die the entire interest or a specific portion of it will at the time of her death be subject to one power or the other (subject to the exception in § 20.2056(b)-3, relating to interests contingent on survival for a limited period).

(2) The power of the surviving spouse must be a power to appoint the entire interest or a specific portion of it as unqualified owner (and free of the trust if a trust is involved, or free of the joint tenancy if a joint tenancy is involved) or to appoint the entire interest or a specific portion of it as a part of her estate (and free of the trust if a trust is involved), that is, in effect, part of her estate (and free of the trust if a trust is involved), that is, in effect, to dispose of it to whomsoever she pleases. Thus, if the decedent devised property to a son and the surviving spouse as joint tenants with right of survivorship and under local law the surviving spouse has a power of severance exercisable without consent of the other joint tenant, and by exercising this power could acquire a one-half interest in the property as a tenant in common, her power of severance will satisfy the condition set forth in paragraph (a)(3) of this section that she have a power of appointment in favor of herself or her estate. However, if the surviving spouse entered into a binding agreement with the decedent to exercise the power only in favor of their issue, that condition is not met. An interest passing in trust will not be regarded as failing to satisfy the condition merely because takers in default of the surviving spouse's exercise of the power are designated by the decedent. The decedent may provide that, in default of exercise of the power, the trust shall continue for an additional period.

(3) A power is not considered to be a power exercisable by a surviving spouse alone and in all events as required by paragraph (a)(4) of this section if the exercise of the power in the surviving spouse to appoint the entire interest or a specific portion of it to herself or to her estate requires the joinder or consent of any other person. The power is

not "exercisable in all events", if it can be terminated during the life of the surviving spouse by any event other than her complete exercise or release of it. Further, a power is not "exercisable in all events" if it may be exercised for a limited purpose only. For example, a power which is not exercisable in the event of the spouse's remarriage is not exercisable in all events. Likewise, if there are any restrictions, either by the terms of the instrument or under applicable local law, on the exercise of a power to consume property (whether or not held in trust) for the benefit of the spouse, the power is not exercisable in all events. Thus, if a power of invasion is exercisable only for the spouse's support, or only for her limited use, the power is not exercisable in all events. In order for a power of invasion to be exercisable in all events, the surviving spouse must have the unrestricted power exercisable at any time during her life to use all or any part of the property subject to the power, and to dispose of it in any manner, including the power to dispose of it by gift (whether or not she has power to dispose of it by will).

(4) The power in the surviving spouse is exercisable in all events only if it exists immediately following the decedent's death. For example, if the power given to the surviving spouse is exercisable during life, but cannot be effectively exercised before distribution of the assets by the executor, the power is not exercisable in all events. Similarly, if the power is exercisable by will, but cannot be effectively exercised in the event the surviving spouse dies before distribution of the assets by the executor, the power is not exercisable in all events. However, an interest will not be disqualified by the mere fact that, in the event the power is exercised during administration of the estate, distribution of the property to the appointee will be delayed for the period of administration. If the power is in existence at all times following the decedent's death, limitations of a formal nature will not disqualify an interest. Examples of formal limitations on a power exercisable during life are requirements that an exercise must be in a particular form, that it must be filed with a trust during the spouse's life, that reasonable notice must be given, or that reasonable intervals must elapse between successive partial exercises. Examples of formal limitations on a power exercisable by

will are that it must be exercised by a will executed by the surviving spouse after the decedent's death or that exercise must be by specific reference to the power.

(5) If the surviving spouse has the requisite power to appoint to herself or her estate, it is immaterial that she also has one or more lesser powers. Thus, if she has a testamentary power to appoint to her estate, she may also have a limited power of withdrawal or of appointment during her life. Similarly, if she has an unlimited power of withdrawal, she may have a limited testamentary power.

Whether or not the language of the will does in fact give the surviving spouse as broad a power as is required by the foregoing regulation is a matter of state law. As the Tax Court pointed out in *Allen v. Commissioner*,[11] to say otherwise "would predispose the existence of a body of federal property law of general application which does not in fact exist. On the contrary, legal rights and interests are created by state law". In *Tarver v. Commissioner*,[12] the Tax Court construed the will "in the light of rules of construction prevailing in South Carolina." In the *McGehee* case[13] the 5th Circuit Court of Appeals said:

> The character and extent of the property rights which passed to the decedent's husband by her will are to be determined under law of Florida. *Helvering v. Stuart*, 317 U.S. 154. The Supreme Court of Florida has established precedents which point for us the way to decision.

Apparently in some states a gift of a life estate, together with an unlimited right to consume creates a fee simple.[14] This, however, is not the law in South Carolina where an estate for life does not ripen into a fee simple even though the donee has the power to invade or consume corpus or even appoint the remainder.[15] Since under South Carolina law the question of what

11. 29 T.C. 465 (1957).
12. 26 T.C. 490 (1956), aff'd 255 F.2d 913 (4th Cir. 1958).
13. McGehee v. United States, *supra* Note 7 at 821.
14. Horsley v. United States, 160 F.2d 43 (5th Cir. 1947).
15. Rogers v. Rogers, 221 S.C. 360, 370, 70 S.E.2d 637, 642 (1952) where the Court said:

> It is within the power of a testator to give property to another for life with full power of disposing of the principal during his life and by will at his death, and yet what is given is a life estate coupled with a power and not an absolute gift of personal property or a devise in fee of real estate. Dallinger v. Merrill, 224 Mass. 534, 113 N.E. 279, 282.
>
> It is well established in this state that the fact that a life estate is given to one coupled with the power to consume the corpus does not enlarge the estate into a fee or an absolute estate.

See also Shevlin v. Colony Lutheran Church, 227 S.C. 598, 88 S.E.2d 674 (1955); Lynch v. Lynch, 161 S.C. 170, 159 S.E. 26 (1931); Forest v. Jennings, 107 S.C. 117, 92 S.E. 189 (1917).

estate or power was given by a decedent's will is essentially one of the *intent* of the decedent, the relevant facts will differ materially according to whether the power is over the remainder or whether the power is to invade or consume principal, and the cases will be discussed with this distinction in mind.

In the *Tarver* case,[16] the will provided that the surviving spouse should have the right to withdraw the corpus from the trust "for her use and/or the use or benefit of our children as she deems advisable." The court held that since the will as a whole showed great solicitude for the testator's children and since the remainder over was to them, the power given the surviving wife to withdraw corpus was meant to be limited to that amount necessary for her own or the children's welfare. The court said:

> It seems clear to us, when the will is read as a whole, that the decedent intended that the surviving spouse should have the right to draw out only so much of the corpus as might be necessary for her personal use or the use or benefit of the children, and that he contemplated that there would be an unused part of the corpus which should be retained for the benefit of his children . . . .[17]

In *Landers v. Commissioner*,[18] it was similarly held that in Georgia a remainder over showed that the testator intended that the power given the surviving spouse to invade should be held limited by her *need.* Where any qualifying words are used in connection with the power to invade, even though such words are so broad that they will preclude any charitable deduction for a remainder over, such as amounts necessary for the "comfort", "welfare" or "well-being", the surviving spouse's power to invade will be deemed a limited one and the marital deduction not allowed.[19]

Even where there are no restrictions whatever placed in the will it has been held that where state law prohibits the surviving spouse from *wasting* corpus, the interest will not qualify for the marital deduction. In *Commissioner v. Lincoln-Rochester Trust Co.*,[20] the court said:

16. Estate of Tarvek v. Commissioner, *Supra,* Note 12 at 496.
17. *Id.,* at 504.
18. 38 T.C. 828 (1962).
19. See J. J. Semms, 32 T.C. 1218 (1959); E. W. Noble, 31 T.C. 888 (1958). A recent decision on this point is Piatt v. United States, 321 F.2d 79 (6th Cir. 1963).
20. 297 F.2d 891 at 893, (2d Cir. 1962).

> While the widow might consume the principal she might (under New York law) only do so in good faith, and had no power to dispose of any portion not consumed, by gift or appointment to herself or others by instrument, corpus not so consumed being governed by testator's will.

Many courts have said that a life estate in the surviving spouse coupled with a power "to use" the property with remainders over is not sufficient to comply with the regulation as to the marital deduction because a right "to use" or "consume" does not imply a right to give away the property.[21] Thus, there is a failure to comply with the language of the regulation, though not of the statute.

The words "use" or "consume" unless coupled with a power to dispose may not indicate an unlimited right. There are apparently no South Carolina cases on this point, but the Supreme Court of Georgia has discussed the question in its opinion in *Comer v. Citizens & Southern National Bank*,[22] where the Court said:

> We may here consider further the true scope of the words, "to be used and disposed of by him during his life as he may see proper." The verb "use", standing alone, does not imply a particularly broad power of disposition. See In re Dorgan's Estate (D.C.) 237 Fed. 507, 508, where there was a definite life estate, a definite remainder, and a power in the life tenant "to use" without let or hindrance. It was held that the language did not embrace a broad power of disposal for purposes other than the beneficiary's own use, although there was a further provision that she might "sell and convey any real estate left by me". Clearly the right to give the property away was not covered. But the word "use" must always be regarded in the particular connection in which it appears, 66 C.J. 66; and, when coupled with the words "and dispose of", the scope is greatly broadened. The expression "dispose of" usually includes a power of gift. 18 C.J. 1280, and citations. When we add the words "as he may see proper", additional breadth is given. The entire statement, "to be used as he may see proper", is, to our minds, almost as broad as testator could make it. We construe the phrase, "to be used and disposed of by him

21. *E.g.*, Estate of Landers v. Commissioner, *Supra* Note 18.
22. 182 Ga. 1 at 3, 185 S.E. 72 at 82 (1936).

> during his life as he may see proper," as applied to Hugh M., Jr., to mean that during his life Hugh M., Jr. had the power to consume, sell, mortgage, or give away, the fee in this property as he might desire.

On the other hand, where the intent of the testator to give his surviving spouse the right to consume or use the property is very clear and there are no restraints by reason of state law, it will be held that the power qualifies for the marital deduction. Thus, in *Estate of Bourke*,[23] it was held that where the surviving spouse was given the right to request any amount of trust principal, even the whole thereof, it qualified for the marital deduction, and that it was immaterial under California law that there were remainders over. In *Hoffman v. McGinnes*,[24] it was held that in Pennsylvania that where a surviving spouse was given the right "to use and spend any or all of the principal of my estate, if she so desires," the spouse had an unlimited power "exercisable alone in all events" and qualified for the marital deduction.

Both of the above cases involved trusts. Regulations section 20.2056(b)(5)(g)(2) specifically provides that:

> An interest passing in trust will not be regarded as failing to satisfy the condition merely because takers in default of surviving spouse's exercise of power are designated.

However, regardless of a trust, and where the surviving spouse's interest is a life estate, some cases hold that unless there is a specific restriction the interest qualifies.

In *McGehee v. United States*[25] the court said that a life estate with power of use and disposition in the surviving spouse would qualify for the marital deduction. In *Boyd v. Gray*[26] it was held[27] that property given to the surviving spouse for life with power to use and disposition was sufficient under Kentucky law for qualification under the marital deduction.

Although several of the above cases hold that a power to consume or invade will be considered unlimited unless some words of limitation are implied or the state law will prohibit the spouse from "wasting" the property (which is not the case in South

23. 19 CCH Tax. Ct. Mem. 496 (1960).
24. 277 F.2d 598 (3rd Cir. 1960).
25. McGehee v. United States, *supra*, note 7.
26. Boyd v. Gray, *supra*, note 7.
27. This was after the 1954 amendment and the 1958 Act making it retroactive.

Carolina), the Commissioner has not agreed with any of these cases. To avoid litigation in this field, it is suggested that in creating a power to invade, which will qualify for the marital deduction, that the power be coupled with a power of disposition sufficiently broad to cover the giving of the property away. This would seem to be particularly advisable where there are remainders over to children or other natural objects of a testator's bounty. It has been suggested by the 2nd Circuit Court of Appeals[28] that any problems in this connection may be avoided by using the statutory language. The statute, however, merely says what shall be done, not how it shall be done. That is left up to the draftsman of the will.

There are no particular problems in connection with the power to dispose of the remainder of the property. The draftsman, however, must be careful to be sure that there are no hidden traps. For example, in *In re Mervin G. Pierpont*,[29] the testator established a trust for his widow which in every respect complied, as to payment of income, with the marital deduction rules. The will also provided that the corpus of the trust "shall be paid over free of this trust in such a manner and proportions as my said wife shall designate under her last will and testament".[30] Under Maryland law the language of this power did not include the widow's estate. For this reason the power was held to be insufficient to qualify the widow's share for the marital deduction.

> Ordinarily, Lallah's power of appointment would be deemed general; that is, there would be no limitations on her choice of appointees, including her estate or her creditors. See Morgan v. Commissioner (40-1 USTC § 9210), 309 U.S. 78 (1940). But the scope of Lallah's power of appointment is to be determined under the law of Maryland, and, as this Court has recognized in Estate of William C. Allen (Dec. 22, 702), 29 T.C. 465 (1957), the donee of an otherwise general power of appointment does not, under Maryland law, have the right to appoint property subject to the power to his estate or for payment of his debts, absent language expressly conferring such right in the instrument by which the power of appointment is granted.

28. May v. United States, 283 F.2d 853 (2d Cir. 1960).
29. 21 CCH Tax Ct. Mem. 1515 (1962).
30. *Id.* at 1516.

> Because decedent in his will did not expressly grant to Lallah the right in question, it would appear that respondent's determination must be sustained . . . .[31]

The draftsman does not have to worry about this particular problem in South Carolina. Here, a general power includes the right to appoint property to an estate. In *Price v. Ouija Realty Co.*,[32] it was held that where the appointee left all of the appointee's estate (which would include the appointed property) to her executor, to build a wing to a hospital, the power was properly executed. Some years before her death the decedent's uncle had left certain property to her for life with the remainder (if she had no children) "to such person or persons" as she "in her last will and testament shall appoint". The decedent's will provided that the residue of her estate was given to her executor to build a wing to the hospital. The suit was brought by the decedent's executor to confirm his right of sale. It was contended that the power of appointment given the decedent by her uncle ran only to a "person or persons" and not to the decedent's executor. The court rejected this contention, saying:

> Defendant's construction is too literal and technical. It fails to give effect to the necessary implication arising from the language quoted (the residuary clause of decedent's will) from which the intention to appoint her executor to succeed to the estate appears with sufficient clearness.[33]

Of course, the validity of the bequest under the marital deduction section of the IRC depends upon the power, not upon whether or not it is exercised. However, statutory limitations upon the right of exercise may be a limitation upon the power itself. In South Carolina, the statute[34] providing for the exercise of a power contains no limitations whatever. It reads:

> A general devise of the real estate of a testator or of the real estate of such testator in any place or in the occupation of any person mentioned in the will or otherwise described in a general manner, shall be construed to include any real estate or any real estate to which such description shall extend, as the case may be, which the testator may have power to appoint in any manner he may think proper and shall op-

31. *Id.* at 1519.
32. 113 S.C. 556, 101 S.E. 819 (1919).
33. *Id.* at 559, 101 S.E. at 820.
34. S.C. CODE § 19-233 (1962).

erate as an execution of such power unless a contrary intention shall appear upon the face of the will. In like manner a bequest of the personal estate of the testator or any bequest of personal property described in a general manner shall be construed to include any personal estate or any personal estate to which such description shall extend, as the case may be, which the testator may have power to appoint in any manner he may think proper and shall operate as an execution of such power unless a contrary intention shall appear upon the face of the will.

3. THE NEW REQUIREMENT OF THE IRS WHERE THE MARITAL DEDUCTION IS TAKEN BY MEANS OF A PECUNIARY FORMULA.

Where a surviving spouse is left specific property, either outright or in trust with a qualifying power of appointment, or is left a fractional interest in specific property or the residuary estate, this discussion in inapplicable. However, it is common practice in South Carolina for a surviving spouse to be left a marital share exactly equal to 50% of the adjusted gross estate less other property in such estate passing to her by reason of the death of the decedent.

The writer has customarily favored this formula clause. Through its use, an attorney reduces the risk resulting from a client's failure to review periodically his estate plan. However, the IRS holds that the satisfaction of a pecuniary bequest in assets *at distribution values* will result in a recognized gain or loss as a consequence of the distribution.[35] Thus a formula clause may be coupled with a direction to the executor to distribute assets in satisfaction of bequests *at estate tax values*, rather than at distribution values. This permits a non-taxable and flexible allocation of assets between marital shares.

For many years it has been ruled that if the executor is authorized to satisfy the amount of this bequest with property of the estate at its distribution value there will be a gain or loss to the estate of any appreciation or depreciation in the estate assets used to satisfy the bequest. To avoid this possible tax

35. Rev. Rul. 56-270, 1956-1 Cum. Bull. 325 as clarified by Rev. Rul. 60-87, 1960-1 Cum. Bull. 286. The rationale of the ruling is that the formula results in a dollar amount bequest to the surviving spouse which is satisfied by the assets distributed to her. Thus the transaction in substance amounts to a sale of the assets.

upon the estate most wills provide that the executor shall satisfy the bequest at estate tax values.

The IRS now takes the view that this gives the executor discretionary power to satisfy the marital deduction with assets worth less than the amount of deduction allowed and that unless this possibility is eliminated the marital deduction, in such case, will not be allowed.

In a preliminary announcement[36] the following example was given:

> EXAMPLE. At the time of his death, a decedent's estate consists of two blocks of stock, each worth $100,000. His will leaves his widow half of his estate or $100,000; but the executor is empowered to satisfy this bequest with assets valued at $100,000 for estate tax purposes. When the executor is ready to distribute the estate, one block of stock is worth only $75,000 and the other is worth $125,000 under decedent's will, the executor could give the widow either block of the stock, or $100,000 in cash.

The announcement continued:

> The executor's power, in the above example, to shift the interest of the widow in the estate in relation to the other beneficial interests would not meet the Code's requirements for a marital deduction. It has been argued that the executor would be required by local law to make an equitable distribution to all parties, but this point has not been clearly established by statute or court decision. However, under Rec. Proc. 64-19, the IRS will allow the marital deduction if the executor agrees that he will distribute to the widow an amount equal to a fair share of the value of all the assets on the date of distribution; and if the widow agrees that if she accepts any lesser amount, she will treat the difference as a gift to the other beneficiaries.

The IRS has refused to say why it will refuse to allow the marital deduction under such circumstances, but it has cited the recent case of *L. R. Jackson et al. v. United States*[37] holding that a California's widow's allowance does not qualify for the marital deduction since at the time of testator's death it is not a "vested right" (although it became vested later after a pro-

36. Rev. Rul. 64-19, 1964 Int. Rev. Bull. No. 2, at 18.
37. 376 U.S. 503 (1963).

bate court order was entered making the allowance). The IRS has evidently interpreted this decision as requiring a definite amount for a "vesting". We suggest that there are situations where the precise amount of a marital deduction can be determined only after administration has been completed—such as where a residuary estate, or a portion thereof, goes to a surviving spouse but only after taxes and administration expenses have been deducted. It is possible that the IRS is somewhat confused here between a bequest which is terminable and a bequest which is vested but subject, under circumstances, to a partial divestment. Revenue Procedure 64-19 says that wills or trusts making use of a pecuniary formula which may be satisfied with assets at estate tax values and dated prior to October 1, 1964, will nevertheless qualify for the marital deduction if both the surviving spouse *and* the executor or trustee execute and file agreements regarding the distribution of estate assets to or for the surviving spouse. However, if the instrument is dated after October 1, 1964, the agreements will not be sufficient, the will or trust itself must prohibit the satisfaction of the marital deduction bequest with depreciated assets.

In the Revenue Procedure, the form of such agreements is set forth as follows:[38]

> Section 5. Form of Agreements.
>
> .01. By Surviving Spouse.
>
> In the event of the allowance by or on behalf of the Commissioner or Internal Revenue of a marital deduction for a pecuniary bequest or transfer in trust to me or on my behalf of $_____, claimed in connection with the settlement of the Federal estate tax liability of the estate of _____, and as part of the consideration for this settlement, I hereby agree that in the event cash and other property accepted in full satisfaction of this bequest or transfer in trust is not fairly representative of my proportionate share of any net appreciation in the value, to the date or dates of distribution, of all property then available for distribution in satisfaction of such pecuniary bequest or transfer, the difference in value will be treated as a transfer or transfers by gift as of the date, or dates, of distribution, and a Federal gift tax return or returns with respect to such transfer or transfers by gift

38. Rev. Rul. 64-19, 1964 Int. Rev. Bull. No. 15, at 30-33.

will be filed if required under the gift tax provisions of the Internal Revenue Code.

_____

_____, Surviving

Spouse of _____

.02 By Executor or Trustee.

In the event of the allowance by or on behalf of the Commissioner of Internal Revenue of a marital deduction for a pecuniary bequest or transfer in trust of $_____ claimed in connection with the settlement of the Federal estate tax liability of the estate of _____, and as part of the consideration for this settlement, I hereby agree that the assets to be distributed in satisfaction of this bequest or transfer in trust will be selected in such manner that the cash and other property distributed will have an aggregate fair market value fairly representative of the pecuniary legatee's (or transferee's) proportionate share of the appreciation or depreciation in the value to the date, or dates, of distribution of all property then available for distribution in satisfaction of such pecuniary bequest or transfer. I further agree that, within six months after the final distribution of cash and other property in satisfaction of the marital deduction pecuniary bequest or transfer in trust subsequent to the date of this agreement, the cash and other property available for distribution in satisfaction of the marital deduction pecuniary bequest or transfer at each date of distribution, and fair market value of each such asset at each date of distribution.

_____

_____ Trustee, or

Executor of the Will of _____

_____

It is almost certain that the right of the IRS to issue such a ruling under section 2056 of the code will be contested. A corporate executor or trustee may be unwilling to execute the agreement on the ground that it would be improper for a fiduciary to agree in advance as to how it will exercise discretionary powers of distribution. However, it is difficult to say that an executor would not have such authority when the execution and filing of the agreement may result in the saving of a substantial tax. A more bothersome question arises as to whether a sur-

viving spouse, without children, would be properly advised to sign the agreement. If she has no pecuniary interest in the balance of the estate (that is, the non-marital deduction share) it would be immaterial to her how much tax has to be paid on the estate. By signing and filing the agreement the spouse may be agreeing to the reduction of a tax which does not affect her interest but at the same time at the cost of a possible imposition of a larger tax upon her own estate.

The need for Revenue Procedure 64-19 can seriously be questioned. While values of estate assets must be based on tax values for *determining* the amount of the marital deduction, very few wills provide specifically that the executor is authorized or empowered to use estate tax values when *distributing* assets to the spouse in satisfaction of the marital share. Moreover, even where the executor is given discretion in this regard it would seem that he must make the distribution impartially and in good faith.[39] Revenue Procedure 64-19 does not recognize this duty of impartiality.

The ruling poses a problem for attorneys who have drawn wills falling within its ambit. Should attorneys who have drawn wills using the pecuniary formula and authorizing an executor to satisfy the bequest by a distribution of assets at estate tax values, inform the client of the change in IRS position? It can hardly be assumed that the clients will be advised of the present IRS view by anyone else, and there is no assurance that the executor or attorney for the client's estate will know of the IRS requirement when the estate is being administered. An attorney must prepare wills in accordance with law then existing, but can hardly be charged with the obligation of advising the client of changes occuring during future years. Moreover, would it not be improper as possibly a solicitation of legal business for a lawyer to suggest that he might re-draw the will or prepare a codicil? These questions are difficult ones but the writer personally leans to the view that the attorney should advise the client of the change—in an objective way which does not suggest that he re-draw the will or prepare a codicil.

In his treatise on "Legal Ethics",[40] Mr. Henry S. Drinker says:

39. SCOTT, TRUSTS §§ 183-187 (2d ed. 1956). See Carrier v. Carrier, 226 N.Y. 114, 123 N.E. 135 (App. Div. 1919). See Lauritzen, *Marital Deduction Bequest—Current Problems and Drafting Suggestions,* 8 Tax Counselor's Quarterly 125 (1964).

40. DRINKER, LEGAL ETHICS, 254 (1953).

> Information to Clients as to Changes in the Law
>
> While a lawyer may send to his clients a summary of recent legislation, or a suggestion based on recent decisions or legislation clearly in the interest of the particular client, he may not properly send to clients generally a notice of an estate planning service which is capable of interpretation as a bid for employment.
>
> He may advise one whose will he has drawn to review it, by reason of changes in the law or of his personal affairs and beneficiaries.
>
> A lawyer may properly advise clients of new statutes and send them pertinent memoranda in reference to changes in the law, in a way that does not smack of advertising, but a personal letter to the client is in better taste than a circular, it being improper to do this by a folder or confidential report analyzing Government regulations.

Note that Mr. Drinker suggests that a personal letter would be better than a circularized notice.

How should the matter be handled in a codicil or a new will?

If the transfer of assets is at distribution—rather than estate tax-values, there could be no objection to the formula clause, but in such case there would be a taxable gain or loss to the estate of any appreciation or depreciation in values during this period. Despite the possibility of a taxable gain in this situation, it might be better to use a pecuniary formula to obtain the advantages of the built-in adjuster mentioned before. It has been suggested that the transfer of assets to or for the surviving spouse pursuant to the ruling might give rise to a taxable gain or loss. However, the writer is satisfied that this is not the case. There is no *realization* and consequently there can be constitutionally no gain or loss.[41]

If the will contains a clause somewhat as follows:

> Assets distributed to my said wife (or to the Trustees) in satisfaction of this bequest shall be of an aggregate value fairly representative of the appreciation or depreciation in value of all property in my estate available for distribution in satisfaction of such bequest,

it is believed that the ruling would be complied with, and the marital deduction allowed, but it raises the problem of valuation

41. Lucas v. North Texas Lumber Co., 281 U.S. 11 (1929).

of assets. It would seem that a valuation must be made as of the distribution date as well as at the estate tax date. Of course, the problem may be avoided in some cases by leaving specific items of property or a fraction of the residue of the estate to the surviving spouse. However, it must be borne in mind that the fraction of residue may give rise to a very difficult problem of computing the estate tax.[42]

It is not the use of the pecuniary formula which the IRS objects to, it is the specific authorization given the executor to satisfy the marital bequest with estate assets at estate tax values. The fact that the will uses the estate tax values in computing the *amount* of the marital bequest does not mean that such values may be used in determining the value of assets which are transferred in satisfaction of the bequest. This distinction is of the utmost importance and probably if the distinction is kept in mind Revenue Procedure 64-19 will have little application.

42. If the estate tax can only be computed after the marital deduction, and the marital deduction depends upon the amount of estate tax, a complicated geometric formula must be adopted. See Treas. Reg. § 20.2056 (6)-4 (c) (4).