Summer 1976

An Attack on The Optimum Marital Deduction: Revenue Ruling 76-176

J. Rodney Johnson
University of Richmond, rjohnson@richmond.edu

J. RODNEY JOHNSON

An Attack on The Optimum Marital Deduction: Revenue Ruling 76-176

A RECENT development in the field of estate and gift taxation—the issuance of Revenue Ruling 76-156[1]—may be an indication of a policy decision on the part of the Internal Revenue Service to clamp down on the increasing utilization of the estate planner's most flexible tool in the area of post-mortem estate planning—the disclaimer. Due to the potential importance of this ruling, it seems desirable (1) to deal with the ruling, itself, in some detail, (2) to see how the ruling might affect an estate planning concept suggested in these pages last year, and (3) to determine what course of action the prudent estate planner might adopt now that this ruling has been issued.

The Ruling

The residuary clause of Decedent's will, admitted to domiciliary probate in State Y on February 28, 1974, provided in part as follows:

> All the residue of my estate, real and personal and wherever situate, I devise and bequeath to my issue who shall survive me, per stirpes and not per capita. In the event that any of my issue renounce his or her interest in my estate arising under this clause, such issue shall have the right to appoint all or any part of such interest, subject to any conditions, trusts and restrictions as such renouncing issue may determine, to any of my issue and the spouses of any of my issue. Such right shall be exercised in writing and delivered to my executors within one year after the qualification of my executors; . . .

On February 27, 1975, Decedent's son gave the appropriate notice to the executors and to the probate court that was required in order to renounce the residuary gift and to exercise the special power of appointment in favor of a daughter-in-law and two grandchildren. Under the law of State Y a beneficiary is authorized to renounce a testamentary gift of property and still control its disposition through the exercise of a special power of appointment. Accordingly, the probate court of State Y accepted both the renunciation and the exercise as validly made.

The gift tax regulation[2] that determines the consequences of such a disclaimer reads as follows:

> The gift tax also applies to gifts indirectly made. Thus, all transactions whereby property or property rights or interests are gratuitously passed or conferred upon another, regardless of the means or device employed, constitute gifts subject to tax. Where the law governing the administration of a decedent's estate gives a beneficiary, heir, or next-of-kin a right to completely and unqualifiedly refuse to accept ownership of property transferred from a decedent (whether the transfer is effected by the decedent's will or by the law of descent and distribution of intestate property), a refusal to accept ownership does not constitute the making of a gift if the refusal is made within a reasonable time after knowledge of the existence of the transfer. The refusal must be unequivocable and effective under local law. . . . In any case where a refusal is purported to relate to only a part of the property, the determination of whether or not there has been a complete and unqualified refusal to accept ownership will depend on all of the facts and circumstances in each particular case, taking into account the recognition and effectiveness of such a purported refusal under the local law.

It would seem from a reading of the above regulation that state law, which is referred to two separate times, is to be a dominant factor in measuring the efficacy of a disclaimer to perform its intended func-

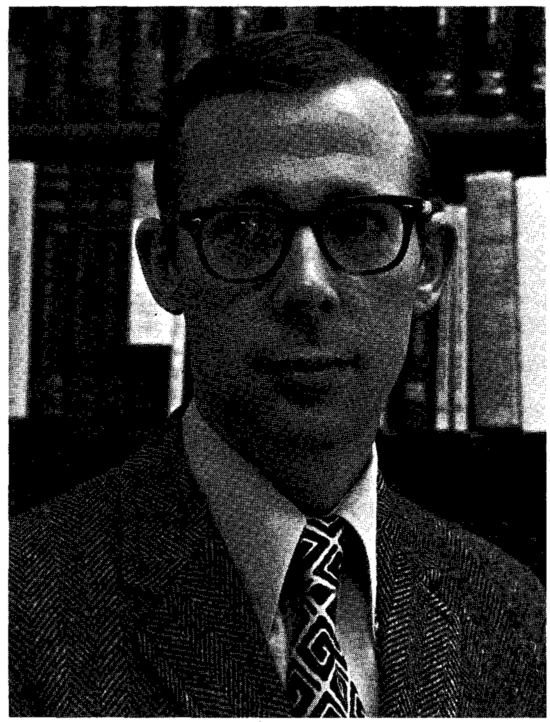
[1] I.R.B. 1976-17, 22.

[2] Reg. 25.2511-1(c).

tion. Nevertheless, although the ruling concedes that the law of State Y permits the type of disclaimer option presented in the instant case and also concedes that the formal actions of the disclaimant complied with the requirements of local law, it holds that ". . . the substance of the transaction should be governed by Federal law." Then, after a brief discussion of the principles contained in the first two sentences of the above quoted regulation, the ruling focuses specifically on the word "unequivocal" (sic) in the fourth sentence of the regulation which it interprets to mean "unambiguous in its consequences." The ruling then goes on to hold that the disclaimant made a taxable gift when he exercised the special power of appointment on the following basis:

> If a beneficiary renounces a testamentary bequest in the beneficiary's favor, yet directs the renounced bequest to certain of the natural objects of the beneficiary's bounty by exercising a special power of appointment which causes the property to be disposed of in a manner which is not specifically ascertainable from the terms of the decedent's will, then the beneficiary has availed himself (or herself) of a positive opportunity to personally effect the ultimate disposition of the property in which the beneficiary supposedly has renounced the ownership interest. In these circumstances, the act of renunciation, rather than being an act of singular and unambiguous import, becomes uncertain as an indication or sign that the beneficiary has completed (sic) and unqualifiedly refused ownership of the property given under the will. In effect, the beneficiary is making a transfer of the beneficiary's own property interest. The disclaimer in this case serves only to disguise the essence of the entire transaction. To ascribe independent significance to these mutual rights and activities (i.e., renunciation of the absolute gift coupled with the grant of and the selective exercise of the special power of appointment) would exalt form over substance, and thereby defeat the uniform application of the revenue act by not taxing what is in actuality a transfer by the beneficiary.

The Ruling seems to reflect a real sense of frustration on the part of the Commissioner at the "loophole" made available through the selective use of disclaimer options and to manifest an intent on his part to plug that hole to the extent possible—even at the cost of weakening the Service's credibility by the present overly broad and poorly reasoned ruling. In order to



J. Rodney Johnson taught at the William and Mary Law School before joining the faculty of the University of Richmond Law School. He received a J.D. from William and Mary School of Law and an LL.M. from New York University School of Law. He is the author of a number of articles in the fields of estate planning and fiduciary administration.

facilitate analysis of the ruling, we might look at the following simple illustration of a pure disclaimer:

> A dies testate survived only a son, B, to whom he leaves his entire estate, and B's son C. Under local law, if B disclaims the testamentary gift from A he will be treated as having predeceased A with the end result that C will take the entirety of A's estate under the local "anti-lapse" statutes.

What happens, then, when B disclaims for the sole purpose of causing C to take the property directly from A and thus avoid the gift tax that would be imposed if B accepted the testamentary gift and then made an inter-vivos transfer of the same to C? (1) Has B not "caused the property to be disposed of in a manner which is not specifically ascertainable from the terms of the decedent's will"? (2) Has not B "availed himself of a positive opportunity to personally effect the ultimate disposition of the property in which (he) supposedly has renounced the ownership interest"? (3) Has not B "in effect" made a transfer of his property to C? (4) Does not the disclaimer in this case serve "only to disguise the essence of the entire transaction"? (5) Does not ascribing independent significance to these mutual rights and activities "exalt form over substance"? (6) Does not this disclaimer, if allowed, "defeat the uniform application of the revenue act by not taxing what is in actuality a transfer by the beneficiary"? Of course all of these questions are answered "yes" in this case, just as they were in the ruling. But it is clear that B would not incur a gift tax liability in the hypothetical case as a result of his disclaimer while the disclaimant in the ruling did incur a gift tax liability. And these were the only reasons offered—except for the fact that the disclaimant in the ruling accepted and exercised a special power of appointment which, standing alone, is never the occasion for the imposition of a gift tax.

It is submitted that the better view of the present fact situation is that the son was given two distinct gifts under the will—(1) a power to draw the property to himself by accepting an outright gift and (2) a power to distribute the property among a specific class of beneficiaries established by the decedent—and that he completely and unqualifiedly disclaimed the former and accepted and exercised the latter, as was expressly permitted under the law of State Y, which is made a primary consideration by the controlling regulation. Accordingly, no gift was made as a consequence of the facts recited in the ruling. While it is true that giving tax avoidance effect to such a transaction does place a premium on form, it must be remembered that the essence of a disclaimer is the exaltation of form over substance in the fullest sense of that phrase as is demonstrated by the simple hypothetical posed above.

The Present Problem

While the ruling may be quite wrong, one must recognize that it is the law of the land until such time as it is withdrawn by the Commissioner or overturned by the courts. Accordingly, it is necessary for this writer to refer to a plan discussed in these pages last year[3] which is clearly in jeopardy under the present ruling. In discussing ways to optimize the marital deduction, it was suggested that one might create the traditional two-trust marital deduction will but, instead of giving the surviving spouse a general power of appointment over the "marital" trust and only a special power of appointment over the "family" trust, the estate planner seeking the optimum as opposed to the maximum marital deduction could give the surviving spouse a general power of appointment over both trusts. Then, after the husband's death (when the optimum transfer could be more accurately computed), the surviving spouse could reduce the amount of the property passing to her for tax purposes by the simple means of releasing her general powers into special powers to the extent necessary. This would be accomplished by her giving up the right to appoint to herself, her estate, her creditors, or the creditors of her estate, while retaining the power to appoint to anyone else in the world. This partial release of a general power into a special power has been recognized by statute[4] in Virginia for over thirty years and it has been provided by statute[5] for almost twenty-five years that if such a release is timely made it will operate as a disclaimer. This certainty of result under established state law is of small comfort, however, in the face of the Commissioner's present posture of ignoring state law under analogous circumstances in order to focus on the substance of the transaction which in turn will be "governed by Federal law." Accordingly, it would be clearly imprudent, at this time, to use the plan as originally described.

A Solution to the Problem

The present inability to follow the "optimum" plan as originally described, however, does not mean that the "optimum" plan must be abandoned. One very minor modification will preserve the essence of the plan and render it invulnerable to the Commissioner's attack under Rev. Rul. 76-156. One should begin by drafting the will exactly as described in the previous article, and then add the following language:

> In the event that my wife, (X), should disclaim the general powers of appointment granted her in Article ...., above, either as to all of my estate or to any portion thereof, then, as to such property over which the general power has been so disclaimed, I give the XYZ

(Continued on page 22)

[3] Johnson, *Drafting for the Optimum Marital Deduction,* 1 Va. Bar Ass'n. J. 3 (July 1975).

[4] *Va. Code Ann.* Section 55-279(2)(b) (Repl. vol. 1974).

[5] *Va. Code Ann.* Section 55-286.1 (Repl. vol. 1974).

Revenue Ruling 76-156

(Continued from page 12)

> Bank[6] a special power of appointment exercisable among such of my kindred and spouses of my kindred as the XYZ Bank in the sole exercise of its absolute discretion shall determine to be best in the light of circumstances existing at the time of such exercise. The special power of appointment herein given to the XYZ Bank may be exercised at any time or times during my said wife's lifetime and must be exercised no later than ....[7] following the death of my said wife. To the extent that the power is not validly exercised within .... following the death of my said wife, the corpus then remaining shall be distributed, per stirpes, among my then surviving issue.[8]

It is anticipated that the XYZ Bank, though having absolute power over the appointments to be made, will not be unmindful of such advice as the surviving spouse may choose to offer concerning to whom appointments should be made and how much should be set off to the various appointees.[9] Accordingly, the shift of the actual decision making power to the corporate fiduciary, in the legal sense, will not operate to weaken the surviving spouse's potential to affect the ultimate disposition of the property in the ordinary case. But, since the surviving spouse will be merely offering advice to the bank, as opposed to exercising the power herself, it is clear that no adverse gift tax consequences will arise under Rev. Rul. 76-156.

In the event that it is not practicable to redraft an existing document that has been drawn along the lines of the original plan, the indicated course of action at the husband's death (assuming the ruling is still in effect) would be to determine the optimum transfer as per the original plan and then to disclaim the general power of appointment over the surplus absolutely (as opposed to releasing it into a special power). This will result in the remainder interest in the disclaimed portion passing to the takers in default (typically the children) in equal shares after the death of the surviving spouse, and leave the surviving spouse in a position to make any desirable adjustments through the exercise of her general power of appointment.

The ease with which the ruling can be out-flanked is believed to be further evidence of its unsoundness and it is hoped that the Commissioner will withdraw the ruling in the near future. In such event, a notice to that effect will appear in these pages.

[6] This would normally be the corporate fiduciary, but it would not have to be so.

[7] One must pick a time not exceeding twenty-one years in order to not violate the Rule against Perpetuities. If a long period is used, some attention must be given to the disposition of the income from the appointive property in the interim.

[8] Any time a power of appointment is used, the governing instrument should provide what limitations will or will not apply to the donee's power, e.g., to appoint in trust, to create life estates and remainders, to impose spendthrift restrictions, etc.

[9] One could also add precatory language such as "I request but do not require that the XYZ Bank, in the exercise of its power, be guided by the wishes of my wife, (X)." This would seem to be not only unnecessary but also to border on waving a red flag, and thus undesirable.