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Legal Malpractice: A Survey of the Virginia Law

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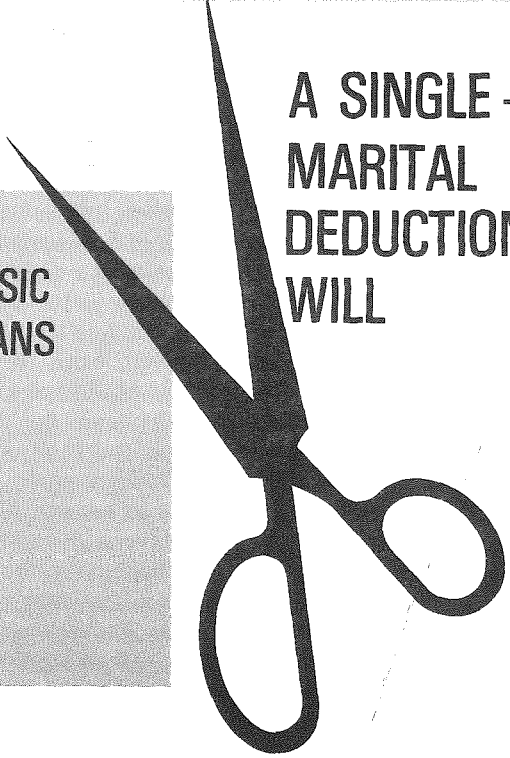
A SINGLE-TRUST MARITAL DEDUCTION WILL

BASIC PLANS



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One of the fundamental tenets of estate planning declares that there is no such thing as a typical estate and therefore there can be no such thing as a typical estate plan. Emphasis is placed on the unique character of each case and the positive need to tailor the plan to fit the client's total situation. Nonetheless, one must not start from scratch in every instance.

The attorney who is trying to pare repetitious work to a minimum can develop a series of basic estate plans or designs, and then select the pattern that most closely approximates the client's needs and alter it accordingly. By following

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EDITOR'S NOTE: This article is based on *Simplifying the Marital Deduction Will*, 1 VA. B. ASS'N J. 12 (1975).

this approach, he will not only produce a plan that fits as well as one tailor-made from scratch, but also one that was developed most efficiently due to the time saved by starting from a model.

This article will offer a basic form that can be easily altered to respond to the needs of many clients who have a moderate estate and wish to take advantage of the estate tax marital deduction. For purposes of discussion, it will be assumed that the estate is $250,000 or less and that the client has expressed the following: "I want my wife to have all of the income from my property throughout her life and then the property should pass to my children. In the event that the income from my property is insufficient to meet my wife's needs, I want some provision for the property itself to be available to her. I want to minimize transfer costs such as estate taxes and administrative expenses."

The Two-Trust Approach

Many lawyers would respond by drafting a two-trust marital-deduction will. The estate would be divided into two shares and each share would become a separate trust. One trust would qualify for the marital deduction and would be included in the wife's estate on her death. The other trust would be designed to pass to the children outside of the wife's estate at her death. The wife would have all of the income from both trusts plus a general testamentary power of appointment over the marital trust, and the trustee would have a power of invasion over both trusts for the wife's benefit and possibly a power over the non-marital trust for the family's benefit.

Indeed, prior to 1954, this approach would have been indispensable to achieving the client's goal because the Internal Revenue Act of 1948 required the surviving spouse to receive all of the income and have a general power of appointment over the entire corpus before a trust would qualify for the marital deduction. The two-trust will was thus developed, giving the surviving spouse this totality of benefit and control over the property designed to qualify for the marital deduction in one trust, while the second trust served as a conduit of the other half of the estate to the children outside of the wife's estate.

The Portion Trust

The Internal Revenue Code of 1954, however, is much more liberal, and allows a marital deduction also where the surviving spouse "is entitled for life to all the income from . . . a specific portion thereof . . . with power in the surviving spouse to appoint . . . such specific portion." Section 2056(b)(5). This "portion trust" is suggested as the basic pattern to be used for the average client with the moderate estate. Admittedly, this model is not as flexible as the two-trust approach, nor does it have the same potential for optimizing the marital deduction. However:

- It is flexible enough for many clients;
- Drafting is made appreciably easier, thus producing a desirable economy in time as well as reducing the opportunities for error;
- The single trust is significantly easier to fund and to administer, since there is only one investment portfolio and no allocation problem;
- The administrative expenses saved in lower fiduciary fees, only one annual accounting, and other ways may well more than offset the failure to optimize the marital deduction by having only one trust;
- The client is more likely to understand his will without detailed explanation; and
- The possibility that the corpus of one or both of the trusts in a two-trust will might be too small to justify a trust is eliminated.

A discussion of the advantages and disadvantages of the portion trust will be found in Lovell, *Marital Deduction Simplified,* 93 Trusts & Estates 760 (1954).

The pattern presented, then, contemplates a will creating only one trust, from which the wife will get all of the income and over one-half of which she will have the required general testamentary power of appointment. The portion over which she has the power of appointment will qualify for the marital deduction and be included in her estate at her death. The other portion, or balance, will pass to the children outside of her estate at her death. In other words, instead of using a two-trust will, the estate planner is establishing a single trust that is divided into two portions.

The One-Trust Will

An estate planner might construct a one-trust will along the following lines:

Last Will and Testament
of
John Deaux

Exordium.

Article 1

Disposition of tangible personal property.

Article 2

If my wife, Mary Deaux, survives me, or if we die under such circumstances that the order of our deaths cannot be established

by proof, in which case my said wife shall for purposes of this Article be deemed to have survived me, I bequeath and devise all of the residue of my estate and appoint any property over which I have a power of appointment to my Trustee, in trust, to invest and reinvest the same and to pay the net income to my said wife at least quarter-annually, and at any time or from time to time to pay her so much of the principal, whether the whole or a lesser amount, as my Trustee may in its sole discretion determine. In exercising this discretionary power, my Trustee may, but need not, consider any other resources of my said wife, and I desire, but do not direct, that my Trustee consider the wishes and needs of my said wife not only for herself, but also for the support, maintenance, and education of my children, and that my Trustee make such payments of principal for these purposes as my said wife may request. All such payments shall be made directly to my said wife and, upon receipt by her, may be used or applied by her in whatever manner she may wish, regardless of the purpose for which the payment was made. Upon the death of my said wife, my Trustee shall distribute all property then belonging to the principal of the trust to my issue surviving my said wife, per stirpes, subject, however, to the right of my said wife, by a will specifically referring to this Article of this will, to appoint one-half of said property to such person or persons, including her estate, and in such estates, interests, and proportions as she shall direct.

If my said wife does not survive me, all rights and interests under this Article that depend upon a person surviving her shall take effect as if she had survived me and had died immediately after my death without possessing or exercising her said testamentary power of appointment.

Article 3

Appointment of all fiduciaries and their compensation.

Article 4

Standard "boiler-plate" used to confer powers on fiduciaries in two-trust marital deduction wills, mutatis mutandis.

Testimonium.

/s/ John Deaux

Attestation.

Observations On the Will

Source

Article 2 is based on Forms X-2b and X-2c in the will manual published by United States Trust Company, New York City.

Minors

Since some of the issue who are

to take may be minors when the trust will terminate at the wife's death, in some states, the trustee may be given the power to distribute the minors' shares pursuant to the Uniform Gifts to Minors Act. This will incorporates the normal discretionary invasion powers for maintenance, education, and benefit found in the traditional minor's trust and should be sufficient for the average case, unless the client wants the trust to continue beyond the beneficiary's minority. In the latter situation, and in those states where the trustee cannot employ the Uniform Gift to Minors Act, suitable trust provisions can be plugged into the pattern after or as a part of Article 2.

Determining the Portion

This plan fails to optimize tax savings for a number of reasons. For instance, no account is taken of property that qualifies for the marital deduction which might have passed or be passing to the surviving spouse other than under the will—such as survivorship property and life insurance. Quite often, survivorship property is nominal, and the insurance can be factored into the estate plan by changing the insurance beneficiary designation to "The Trustee to be named in my Last Will and Testament."

If there is substantial other property, and counsel desires to reduce the marital portion accordingly, then a formula must be developed to define the precise portion that will exactly equal the maximum marital deduction allowable in the estate. Such a formula has been evolved by Mr. Robert M. Lovell, of the Hanover Bank, New York City, and reproduced in J. CASNER, ESTATE PLANNING 863 n. 156 (Little, Brown, Boston, 3d ed. 1961). When using such a formula to define the marital portion, one can also include a number of other provisions commonly associated with the two-trust will —e.g., a "5 and 5" power in the balance, payment of estate taxes from the balance, inter vivos power in the surviving spouse in the marital portion, restriction of the trustee's invasion rights on behalf of the surviving spouse to the marital portion until it has been exhausted, and permission to the trustee to invade the balance for the benefit of third parties.

While a specific portion formula clause will generally accomplish most of the ends normally obtained in the two-trust will—and with a resultant reduction in administrative expenses—this approach cannot completely replace the two-trust will. For instance, the Internal Revenue Service may require that estates using the portion approach regard the portion as consisting of an interest in all of the assets in the estate, thereby pre-

venting disqualified terminable interests from being allocated away from the marital share as can currently be done in a two-trust will. This difficulty should pose no problem in the average case, however, since the incidence of these interests in estates is quite rare.

Possibility for Tax Avoidance

The Treasury Regulations take the position that in order for a portion of a trust to qualify for the marital deduction, the portion must be expressed as a fractional or percentile share of a property interest, and they expressly provide that if the annual income of the surviving spouse is limited to a specific sum or if she has the power to appoint only a specific sum out of a larger fund, the interest passing to her does not qualify for the marital deduction. Treas. Reg. §20.2056(b)-5(c). In other words, a specific sum is not equal to a specific portion.

In *Northeastern Pennsylvania National Bank & Trust Co. v. U.S.*, 387 U.S. 213 (1967), the Supreme Court held this regulation to be invalid insofar as it required the income right to be a fractional or percentile share of the entire interest and, according to the dissent, the majority necessarily eliminated the requirement that the power of appointment be keyed to a fractional or percentile share.

Assuming the correctness of the dissent's interpretation of the majority's opinion, a new tax avoidance plan is now possible for those who use the single trust with two portions, as opposed to the two-trust approach. The new option is illustrated by the dissent as follows:

"Assume a trust estate of $200,000, with the widow receiving the right to the income from $100,000 of its corpus and a power of appointment over that $100,000, and the children of the testator receiving income from the balance of the corpus during the widow's life, their remainders to vest when she dies. Now suppose that when the widow dies the trust corpus has doubled in value to $400,000. The wife's power of appointment over $100,000 applies only to make $100,000 taxable in her estate. The remaining $300,000 passes tax-free to the children." Id. at 227.

Note that the same result would follow if the widow had been given the right to the income from all of the corpus and a power of appointment over only $100,000 thereof.

Had a standard two-trust will been used, with $100,000 allocated to each of the trusts in the beginning, then, assuming a similarity of investments in each trust, one-half of the $200,000 appreciation would have occurred in the marital trust and would have been taxable in the wife's estate. This option to cause all of the capital appreciation that occurs during the surviving spouse's lifetime to accrue to the balance and thus escape taxation when the surviving spouse dies is particularly appealing in today's inflationary times and would clearly be elected by many clients if the result can be guaranteed.

State of the Law

The position of the dissent that a power of appointment is not disqualified because it exists over a specific sum, rather than a fractional or percentile portion, of a larger fund has been followed in *Allen v. U. S.*, 250 F. Supp. 155 (E.D.Mo. 1965), conceded by the Government in *Guiney v. U. S.*, 295 F. Supp. 789 (D.Md. 1969), *rev'd on other grounds*, 425 F. 2d 145 (4th Cir. 1970), and accepted by several tax authorities, *e.g.*, J. MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION ¶29.45 I-D Ex. 1 (Lofit Publications, Saugerties, N. Y. 1959, 1972 Cum. Supp). Nevertheless, since in its only reference to the power of appointment over a specific sum the majority in *Northeastern* said ". . . nothing we hold in this opinion has reference to that quite different problem, which is not before us," the prudent estate planner drafting a will that embodies a single trust with two portions will continue to express the power of appointment in terms of a fractional or percentile portion and not a specific sum.

Leaving the Portion Open-Ended

The earlier statement that a one trust will does not have the same potential for optimizing the marital deduction as does a two-trust will is based on the conventional wisdom that the maximum marital deduction is also the optimum marital deduction. However, according to Schnee, *An Analysis of the Optimum Marital Deduction*, THE TAX ADVISOR, April 1974, p. 222, a computer simulation of 28,000 hypothetical cases disclosed that the maximum marital deduction was the optimal transfer in only 10 per cent of the cases. The optimal transfer was zero in 55 per cent of the cases and 100 per cent in 21 per cent of the cases.

To respond to this problem, the draftsman should change the word "one-half" in the last sentence of the first paragraph of Article 2 of the will to "all." By giving the surviving spouse a general testamentary power of appointment over the entire corpus of the trust, she will be in a position to determine, with the assistance of counsel, the optimal amount of the transfer at the time of her husband's death, when many of the existing variables will have been removed. She can then disclaim

her power of appointment over a portion of the trust in order to limit the property qualifying for the marital deduction to the optimal amount.

The disclaimer of the power of appointment over a portion of the trust will not cause her to lose the life income from that portion. It will, however, result in removing that portion of the trust out of her gross estate, since she now has only a life estate in this portion and no part of it passes from her at her death. Treas. Reg. §20.2041-3(d)(6) recognizes the possibility of a partial disclaimer of a power of appointment if it is effective under local law.

The rather obvious problem with this plan for optimizing the marital deduction is its dependence upon the surviving spouse's willingness to disclaim. There is no way to insure her readiness to do so when the time arrives. Whether the potential gain justifies taking this risk is a question that will have to be determined in light of the circumstances of each case.

The testamentary plan of a client will presumably be incorporated in a will. It is the responsibility of the lawyer to see that the provisions of the will adequately and thoroughly take care of what the testator "wants to do." By "wants to do" should be understood not the original plan or any subsequent bright ideas of the client conceived without full information of the possibilities, but rather a well-considered scheme for the best disposition of the property owned by the testator in the interests of the objects of his bounty. In this connection it should be pointed out that tax saving is not the only or even the most important consideration. Frequently, taxes may be saved only at the sacrifice of factors which otherwise are desirable or even important, and it may be preferable to pay the necessary taxes in order to accomplish a worthwhile result.

One cardinal rule in the preparation of a will is that its provisions proceed upon the assumption that the testator is going to die immediately or at least very soon. That is the only basis upon which a testamentary plan can be made. Frequently testators want to have the provisions in their wills adapted to their hopes that at some future time they will have more money or more children or that a rich uncle will have died and left them a fortune. Such contingencies should be planned for but not counted on. The only intelligent planning must be on the basis of things as they are.

H. TWEED and W. PARSONS, LIFETIME AND TESTAMENTARY ESTATE PLANNING 46 (American Law Institute, Philadelphia, 7th ed. 1966).