

7-1975

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Recommended Citation

J. Rodney Johnson, *Drafting for the Optimum Marital Deduction*, Va. B. Ass'n J. July 1975, at 3

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Drafting for the Optimum Marital Deduction

WHILE the marital deduction provided for by federal estate tax law may not necessarily be the controlling factor in planning the will of a married person, it is certainly one of the most important factors because of the sheer magnitude of this deduction—up to 50% of the adjusted gross estate.¹ A direct consequence of this importance is reflected in the fact that the marital deduction has become the most written-about topic in the estate planning area. Most of what has been written about this subject can be divided into the two following categories: (1) an explanation of the operation of the marital deduction or one of its facets; or (2) a discussion of how to obtain the maximum marital deduction through the use of one of several competing formula clauses.

The Maximum vs. The Optimum Deduction

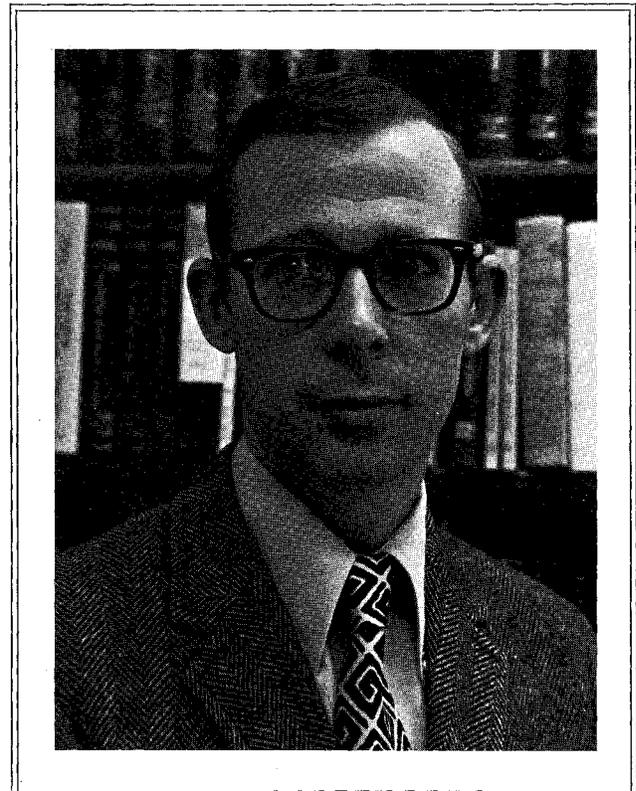
Some estate planners are beginning to suggest that those of their brethren who find themselves regularly focusing on this latter goal of maximizing the marital-

¹ IRC 2056.

EDITOR'S NOTE: This is Professor Johnson's second contribution to the Journal. It is offered as a companion piece to the article entitled "Simplifying the Marital Deduction Will" which appeared in the January, 1975 issue.

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deduction, as an end unto itself, may be suffering from a form of estate planner's myopia. They are taking the position that instead of focusing on the maximum amount that can be transferred tax-free to the wife, counsel should recognize that the proper ambit of his task in the typical case is to maximize the amount of his client's estate that will end up in the hands of the ultimate beneficiaries (usually the children), after having insured that the wife is adequately provided for during her life and has the degree of control over the ultimate disposition of the assets that is consistent with the husband's plan. What counsel should be seek-



ing then is not the smallest possible tax bill at the death of the husband. Rather, he should be seeking to minimize the total estate tax burden imposed on the husband's assets as they pass from him, through his wife, to the ultimate beneficiaries. Assuming that the desired goal is to achieve the lowest overall tax bill (the sum of the taxes at the husband's death and at the wife's death plus an interest factor if appropriate), it is quite simple to conclude that instead of striving for the maximum marital deduction, counsel should be searching for the optimal transfer from husband to wife—the amount that will “set the stage,” so to speak, for the lowest overall tax bill even though it may not take full advantage of the marital deduction.

The Present Practice

Before looking at a possible method of optimizing the marital deduction it may be helpful to review the present practice attributed to most estate planners. It appears that the standard approach of virtually every draftsman today is to more or less automatically take the maximum marital deduction except in those cases where the wife has an estate of her own. In these latter cases, the conventional wisdom suggests that she should be given enough of her husband's estate so that their separate estates will be approximately equal. How well does this approach work? A recently published study, presenting the results of a computer simulation of thousands of cases, concludes that this “. . . indiscriminate use of the marital deduction can nullify all the other estate planning that the taxpayer has done.”² The variables used in this study were as follows:

(a) The size of the decedent's estate was varied (by increments of \$200,000) from \$200,000 to \$2,000,000.

(b) The size of the survivor's estate was also varied (by increments of \$200,000) from \$200,000 to \$2,000,000.

(c) The after-tax rate of return of the survivor was varied (by increments of 6%) from 0% to 30%.

(d) The after-tax rate of return of the other beneficiaries was also varied (by increments of 6%) from 0% to 30%.

(e) The remaining life of the survivor after the decedent's death was varied (by increments of three years) from one to twenty-two years.

² Schne, *An Analysis of the Optimum Marital Deduction*, *The Tax Adviser*, pp. 222, 230 (April 1974).

(f) The percentages of the decedent's estate transferred to the survivor were 0%, 20%, 40%, 50%, 60%, 80% and 100%.

Varying each of the above factors independently of the others, the author generated a total of 28,000 cases and the following results:

(1) The present practice of taking the maximum marital deduction would have resulted in obtaining the optimal transfer in only 10% of the cases;

(2) In 55% of the cases the optimal amount to have transferred would have been zero; and

(3) In 21% of the cases the optimal amount to have transferred would have been 100%.

A Proposed Solution

Although the author of the above study suggests some general rules to guide the estate planner in his search for the optimal transfer in any given case, it is believed that there may be a simpler and more accurate way to accomplish this goal. Two of America's greatest estate planning authorities, W. Barton Leach and James K. Logan, speaking generally about the tendency of some testators to make too rigid dispositions and the need for flexibility in an estate plan, had the following observation to make.

To regulate events in 1980, the judgment of a mediocre mind on the spot is incomparably preferable to the guess in 1960 of the greatest man who ever lived.³

Capitalizing on this observation, it would seem that the ideal solution for the present problem is simply to postpone determining the amount of the transfer until most of the variables have either become known or at least become estimable with a greater degree of accuracy. Specifically, counsel would wait until approximately seven or eight months⁴ after the decedent's death to determine how much he will in fact transfer to his surviving spouse. This post-mortem determination is accomplished by leaving the entire estate to the wife and then allowing her (with advice of counsel) to determine the optimal transfer and then disclaim ownership or refuse to accept the remaining portion of her husband's estate.

³ Leach & Logan *Future Interests and Estate Planning*, p. 241 (Foundation Press 1961).

⁴ This time period is chosen in order to allow sufficient time after the alternate valuation date has passed within which to make the decision.

Counsel wishing to structure a will to take advantage of this option will find that it requires very few changes to his basic marital-deduction will form. He would begin just as usual, to-wit:

(a) Divide the estate into two shares with whatever formula clause is regularly used, the appropriate share going into the "Marital" trust and the other share going into the "Family" trust.

(b) The "Marital" trust will provide that

- (1) Wife gets all income for life,
- (2) Trustee has power to invade corpus for wife's benefit, and
- (3) Wife has an inter vivos and testamentary general power of appointment over the corpus with a remainder to the "Family" trust to the extent that wife fails to exercise her power.

(c) The "Family" trust will provide that

- (1) Wife gets all of the income for life,
- (2) Trustee has power to invade corpus for wife's benefit, but
- (3) *Instead of giving wife a special testamentary power of appointment exercisable among the children, she is given an inter vivos and testamentary general power of appointment.*

Will the consequence of giving wife a general, instead of a special, power of appointment over the family trust be to cause all of husband's estate to be included in her estate at her death? The answer of course is yes—if she accepts the power. However, the plan is that she will not accept the power unless she determines that 100% of her husband's estate would be the optimal transfer to her under the circumstances then existing. If the final computations lead counsel to conclude that the optimal transfer would have been 50% of the adjusted gross estate, she would simply release her general power of appointment insofar as it allows her to appoint to herself, her estate, her creditors, or the creditors of her estate. Such a release (i.e. releasing her general power of appointment into a special power of appointment) has been recognized in Virginia for over thirty years.⁵ Will this release result in any gift tax liability on the part of the wife? No. Generally speaking, the release of a

general power of appointment is treated as an exercise and therefore deemed a transfer of property. Thus a releasor of a general power of appointment is ordinarily exposed to a gift tax liability. However, for almost twenty-five years Virginia law has provided that the release above suggested would operate as a disclaimer⁶ and federal law specifically provides that "(a) disclaimer or renunciation of such a (i.e. a general) power of appointment shall not be deemed a release of such power."⁷ Must wife give up her income interest in order to disclaim her general power of appointment? Again the answer is no. The regulations state that one may disclaim a general power of appointment without disclaiming "other interests"⁸ and it is clear from a reading of these regulations that a life right to income would be encompassed in the phrase "other interests." These same regulations also recognize the possibility of making partial disclaimers in those jurisdictions where they are effective under local law. Virginia law does permit partial releases and provides that they shall operate as disclaimers if made before acceptance and within the appropriate time.⁹ Thus if it is determined that the optimal transfer to wife is 75% of husband's estate, wife would simply accept the marital trust, her income right under the family trust, her general power of appointment over one-half of the family trust, but release (disclaim) her general power into a special power over the other half of the family trust. Or, if the optimal transfer is determined to be only 20% of husband's estate, wife would release (disclaim) her general power into a special power insofar as the entire family trust is concerned and also over 60% of the marital trust, while retaining her income rights in both trusts.

Timing Is Critical

Whenever one wishes to make a disclaimer in order to obtain a federal tax advantage it is necessary to recognize that, while there may be several limitation periods involved, one of them—the federal one—is always going to control the tax consequences of the disclaimer. Here we have a good example of differing state and federal rules. Virginia law recognizes an outer limit of two years in which to disclaim a power of appointment¹⁰ whereas the federal regulations pro-

⁵ Section 55-279(2)(b) *Va. Code Ann.* (1950).

⁶ Section 55-286.1 *Va. Code Ann.* (1950).

⁷ IRC 2514(b).

⁸ IRC Regulation 25.2514-3(c)(5).

⁹ Sections 55-279(2) and 55-286.1 *Va. Code Ann.* (1950).

¹⁰ Section 55-286.1 *Va. Code Ann.* (1950).

vide that "(i)n the absence of facts to the contrary, the failure to renounce or disclaim within a reasonable time after learning of its existence will be presumed to constitute an acceptance of the power."¹¹ It is believed that the seven to eight month time period suggested above will be acceptable as a reasonable time and thus keep the presumption of acceptance from arising. It should be noted that all of the information (e.g. alternate values) will not be available to the survivor until at least six months after the decedent's death. Therefore, from a practical standpoint, all that is being envisioned is a one or two month period within which to make the decision after all of the relevant facts have been ascertained.

Other Opportunities

So far this discussion has been restricted to a consideration of disclaiming powers of appointment as a means of transferring the optimal amount to the surviving spouse. It should be reasonably clear, however, that the well-settled Virginia law¹² relating to disclaimers of property interests will also allow wife to disclaim all or any portion of her income interest in either of the trusts involved. Similarly, in the event that the estate plan does not call for the use of the management potential offered by a professional trustee, husband can simply leave his entire estate to wife outright, with a proviso that any property interest she might disclaim will pass instead to the children, etc., with a contingent trust to serve as a receptacle if any of the potential beneficiaries are under age.

Several Problems

While the present practice of giving the surviving spouse only a special power of appointment over the family trust may often fail to achieve the optimal transfer, it does at least guarantee that a portion of husband's estate will be preserved for the children except to the extent that the trustee has invaded the corpus to respond to actual needs of the wife.

The most obvious problem with the plan suggested herein is its reliance upon action to be taken by the surviving spouse at a time when her husband's influence is no longer a factor. Counsel might well advise her that the optimal transfer is 25% and therefore recommend that she disclaim her power over 75% of her husband's estate. However, there is

no way to insure that she will follow his recommendation. She may elect to retain the entire estate with the ultimate result that nothing may pass to the children. Whether taking this risk is justified in a given case will of course be a decision for the client to make after thorough discussion with counsel.

A second potential problem arises in those cases where wife may become incompetent concurrent with or shortly after husband's death and thus be unable to execute a disclaimer of her power. While this set of facts is not expected to occur frequently, the careful estate planner wishing to avoid the possibility of becoming "locked in" in such a case might provide that the general power of appointment over the family trust is conditional upon wife being able to exercise it. Language along the following lines should suffice:

In the event that my wife, Jane Deaux, should be declared incompetent within eight months after my death without having made a positive acceptance of the general power of appointment given her over this Family Trust, then such power shall terminate and she shall instead have only a power to appoint the Corpus of this Family Trust among such of my children, in such portions, outright or in further trust, as she in her last will and testament expressly referring to this power shall deem appropriate; and in default of exercise of this power, the Corpus of the Family Trust shall be distributed as follows:

It is believed that the above clause will result in a restoration of the status quo, that is, no problem will have been caused by the giving to her of the complete power where she is unable to exercise it because it is taken away from her under these circumstances.¹³

Is it necessary to take such a conservative approach in the disability cases? The possibility has been raised of giving wife's power to disclaim to her guardian, to be exercised for her if determined in the best interest of the plan, in these cases. In theory this is quite sound. All that is being done is simply making a conditional gift of a collateral power of appointment to her guardian. Generally a guardian would be quite hesitant to participate in the giving away of his ward's powers or property. However, where, as here, (1)

¹³ In order to completely restore the status quo, counsel would also want to make provision for the trustee to be able to invade the corpus for the benefit of the children in such a case. Counsel would not want to make either of these amendments to the marital trust. They would cause the disallowance of the marital deduction because they would transform Wife's interest into a "terminable interest" under IRC 2056(b).

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¹¹ IRC Regulation 25.2514-3(c)(5).

¹² Sections 64.1-188 through 64.1-196 *Va. Code Ann.* (1950).

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the ward has no foreseeable personal need for the property subject to the power, (2) the disclaimer is pursuant to a plan agreed upon by the ward when she was competent, and (3) the disclaimer is clearly in the best interests of the ward's family unit from a tax standpoint, there should not be such hesitancy.

Application To Smaller Estates

One should not infer from the foregoing discussion that the plan herein suggested is confined to the larger estates. This concept has potential benefit for any estate where the marital-deduction will be a factor and it lends itself to incorporation into the smaller estate plans just as easily as it does the larger ones. For instance, in an earlier issue of the *Journal*,¹⁴ a "simple" marital deduction will form was suggested for moderate estates which involved dividing an estate into two portions of one trust rather than

¹⁴ Johnson, *Simplifying the Marital Deduction*, 1 Va. Bar Ass'n. J. 12 (January 1975).

into two separate trusts. The essence of the present plan can be incorporated into that form by simply changing one word. This change will result in leaving the portion "open-ended." Instead of giving the surviving spouse a general power over "one-half" of the trust, she is given a general power over "all" of the trust. She can then proceed on to determine the optimal transfer during the post-mortem period as suggested above and release (disclaim) accordingly.

Conclusion

It is quite possible that the present practice in drafting for the marital deduction may not be as dramatically erroneous as the computer study referred to earlier has concluded. Nevertheless it is submitted that all those whose practice includes administration of estates regularly come across estates where far too much or far too little has been transferred through the use of standard clauses. It would seem then that, all other things being equal, it would be incomparably preferable to leave the determination of the optimal transfer to those who will be on the spot at the time for the transfer to occur.