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The Optimum Marital Deduction Survives the Tax Reform Act

SEVERAL years ago an article appeared in the pages of this journal which suggested that those attorneys who regularly focused on obtaining the maximum marital deduction in the wills they were drafting for their clients might be suffering from a form of estate planner's myopia.¹ That is, they were losing sight of their ultimate goal of minimizing the total estate tax burden imposed on the husband's assets as they pass from him, through the wife, on to the ultimate beneficiaries. The danger foreseen was that, as an attorney employed one of the various formula clauses designed to obtain every possible dollar of marital deduction at the husband's death, the attorney might also unwittingly and unnecessarily increase the estate tax burden at the wife's later death. A study based on a computer simulation of 28,000 cases was referred to which indicated that (1) drafting for the maximum marital deduction would have been appropriate in only 10% of the cases whereas (2) the marital deduction should not have been used at all in 55% of the cases and (3) the entire estate should have been transferred to the wife in 21% of the cases. Accordingly, it was concluded that instead of striving for the maximum marital deduction, the attorney 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 estate tax bill for husband and wife together, even though this amount may not take full advantage of the marital deduction.

Sometimes it is much easier to devise a theory which will solve a problem than it is to implement that particular theory from a practical standpoint.

¹ Johnson, *Drafting for the Optimum Marital Deduction*, 1 Va. Bar Assn. J. 3 (July 1975).

And the practical problem in drafting for the optimum marital deduction is that all of the variables which it is necessary to resolve in order to determine the amount of the optimum transfer from the husband to the wife are all unknown at the time the husband's will is drawn. These variables include, among others: (1) the size of the husband's estate at the time of his death, (2) the size of the wife's estate at the time of the husband's death, (3) the after tax rate of return of the wife and the children at the time of the husband's death, and (4) the life expectancy of the wife at the husband's death. The solution offered to this problem of the unknown variables was simply to postpone the ultimate decision about the size of the transfer from the husband to the wife until after the date of the husband's death, at which time most of the above variables would either have become known or at least estimable with a greater degree of accuracy. The procedure suggested to effect this postponed decision was to leave the entire estate to the wife and then allow her, with advice of counsel, to determine the optimum transfer and then to disclaim the ownership of (but not the benefit from) the remaining portion of the husband's estate. This action would result in the property so disclaimed being excluded from the wife's gross estate at her later death, even though she retained the benefit therefrom for the rest of her life. The only property that would be included in her gross estate would be the optimum portion of her husband's estate of which she had accepted ownership. The article concluded by presenting “form” language that might be used by an attorney desiring to employ the optimum marital deduction concept, a general discussion of the problems and opportunities therein, and its integration with existing Virginia law.

In the spring of 1976 the federal government issued Rev. Rul. 76-156² which, though not aimed at the above plan, nevertheless came down hard on the use of disclaimers and placed the above procedure for obtaining the optimum marital deduction clearly in jeopardy. Accordingly, an update to the original article was published in these pages in which the ruling in question was discussed and a minor modification to the original procedure was outlined which would preserve the essence of the above plan and render it invulnerable to successful attack under the revenue ruling in question.³

Now, in the wake of the Tax Reform Act of 1976, it becomes necessary to write what it is hoped will be the final portion of this unintended trilogy. First of all the good news—the essence of the original plan still survives. Moreover, the concept of drafting for the optimum marital deduction has even greater validity after TRA '76 than it did under prior law. This greater validity is due to three primary factors: (1) the introduction of several new variables in the amount of the marital deduction and in the amount of the unified credit which now make it even more difficult to determine the optimum marital transfer at the time of drafting the will, (2) the minimum effective estate tax rate of 32% (after the unified credit is fully phased in) which requires the estate planner to pay increasing attention to the amount of assets exposed to estate taxes, whether this exposure be at the husband's death or the wife's death, and to eliminate as far as possible all double exposure, and (3) the new statutory recognition of disclaimers in federal law.⁴

Moreover, it is no more difficult to employ the optimum marital deduction disclaimer concept after TRA '76 than it was under prior law. An attorney 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:

1. 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.

² I.R.C. 1976-17, 22.

³ Johnson, *An Attack on the Optimum Marital Deduction: Revenue Ruling 76-176*, 2 Va. Bar Assn. J. 10 (Summer 1976).

⁴ I.R.C. § 2518, which is also incorporated by reference into I.R.C. § 2045.



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- a. 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 power of appointment over the corpus, exercisable in favor of herself, H's kindred and the spouses of H's kindred, with a remainder to the "family" trust to the extent that wife fails to exercise her power.
- b. 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 power of appointment, exercisable in favor of herself, H's kindred and the spouses of H's kindred, with an appropriate remainder in default of exercise.

2. The "Disclaimer Clause" will provide that :
In the event that my wife (X) should disclaim the power(s) of appointment granted her in Article, above, either as to all of my estate or to any undivided portion thereof, then, as to such property over which the power has been so disclaimed, I give XYZ Bank these power(s) of appointment, to be exercisable in favor of my wife, my kindred, and spouses of my kindred; to be exercised 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 power(s) of appointment herein given to the XYZ Bank may be exercised at any time or times during my said wife's lifetime,
 - a. By deed presently operative which is delivered during the lifetime of my said wife, or
 - b. By a testamentary writing in the nature of a will which is (1) designed to become operative simultaneously with the death of my said wife and (2) shall be revocable during her lifetime.

To the extent that the power(s) are not validly exercised, the property subject to the powers shall be paid over to and become a part of the "Family" trust as it is constituted immediately after the death of my said wife.

While the overall operation of the optimum marital deduction disclaimer plan remains in general as described in the earlier articles, to which the reader is hereby referred, it is necessary to make a few comments concerning the present modifications. First of all, the rather cumbersome description of the objects of the powers in the marital and family trusts ("herself, H's kindred and the spouses of H's kindred") is mandated by a literal reading of IRC § 2518(b)(4) which requires that a disclaimed power must pass to another in order to be recognized as a "qualified disclaimer." The cumbersome language referred to above is drafted with a view in mind of (1) giving the wife her general power of appointment to use as necessary and (2) giving the fiduciary bank the power to appoint among the natural objects

of the husband's bounty if the power passes to the bank by way of disclaimer. Secondly, paralleling the position taken above of giving the successor donee the power to appoint to precisely the same objects as the original donee, it is provided that the successor donee must operate in precisely the same time frame and manner of appointment as the original donee (by deed delivered or instrument in the nature of a will executed in the lifetime of the wife). While it seems that IRC § 2518(b)(4) was inadvertently made applicable to powers and that future regulations will clarify the matter, prudence demands that the above conservative approach be taken until that time. Finally, on the matter of partial disclaimers, IRC § 2518(c)(1) speaks in terms of disclaiming an "undivided portion" of an interest. Again, conservative drafting dictates expressing the quantum of the disclaimer in terms of an undivided portion, rather than a specific amount, in order to insure that the donee is making a "qualified disclaimer" as that term is defined in IRC § 2518(b).

In conclusion, it is believed that the need for optimizing the marital-deduction is even greater after the passage of TRA '76 than it was before, and that the procedure presented in these articles is even sounder now that the subject of disclaiming powers of appointment is expressly treated in IRC § 2518.⁵

⁵ It is believed that any question concerning the soundness of this concept was laid to rest on April 28, 1977, when House Ways and Means Chairman Al Ullman introduced H.R. 6715, "The Technical Corrections Act of 1977," which is designed to make "technical, clerical and conforming" amendments to the Tax Reform Act of 1976.

Section 3(m) of the Bill "clarifies" the original intent of Congress in the enactment of the new disclaimer section, I.R.C. § 2518. The official summary of the Bill, prepared by the Staff of the Joint Committee on Taxation, explains this "clarifying" change as follows:

It is presently unclear as to whether a disclaimer is valid for tax purposes where a surviving spouse refuses to accept all or a portion of an interest in property passing from the decedent and, as a result of that refusal, the property passes to a trust in which the spouse has an income interest. The bill provides that, where a surviving spouse refuses to accept an interest in property, the disclaimer will be valid although the surviving spouse receives an income interest with respect to the property if the income interest does not result from any direction by the surviving spouse and the disclaimer is otherwise qualified. Summary, pages 29-30.

This "clarification" goes far beyond the relatively conservative procedure of disclaiming a power of appointment which passes completely to another and, assuming that this "clarification" remains in the Technical Corrections Act when it is passed this fall, any doubt concerning the concept described in this series of articles should cease.