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Simplifying the Marital Deduction Will

ONE of the basic 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. Accepting the validity of the foregoing, however, does not mean that one must start from scratch in each case. Instead, the attorney who is trying to pare repetitious work to a safe minimum might develop a solution to the problem by having a series of basic estate plans or patterns and then, rather than regarding these plans as Procrustean beds, he can take the pattern that most closely approximates the client's needs and alter it accordingly. The attorney following this approach can not only produce a plan that fits as well as one tailor-made from scratch but also one which, due to the time

saved by starting from a basic pattern, has been developed most efficiently.

It is this type of basic pattern that will be developed in this article—one which may rarely fit without alteration, but one which may 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 further discussion, it will be assumed that a moderate estate is \$250,000 or less and that the client has expressed his desires as follows: "I want my wife to have all of the income from my property for her life and then I want the property to pass on to my children. In the event that the income from my property is insufficient to respond to my wife's needs, I want some provision for the property itself to be available to her. I want to minimize transfer costs (estate taxes and administrative expenses)."

Many lawyers would respond to this client's request by drafting a "two-trust marital-deduction will." This plan contemplates a division of the estate into two shares and then placing each share into separate trusts. One of these trusts 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



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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 obtaining the client's goal because the 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. Thus developed the pattern for the "two-trust" will, giving the surviving spouse this totality of benefit and control over the property designed to qualify for the marital deduction in one trust and then creating a second trust to serve as a conduit of the other half of the estate to the children outside of the wife's estate.

The 1954 Code, however, is much more liberal and allows a marital deduction not only as above but 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."¹ It is this "portion trust" which is suggested as the basic pattern to be used for the average client with the moderate estate described above. Admittedly, this pattern is not as flexible as the "two-trust" approach nor does it have the same potential for optimizing the marital deduction. However, it is submitted that (1) it is flexible enough for many clients, (2) drafting is appreciably easier, thus producing a desirable economy in time as well as reducing the opportunities for error, (3) the single trust will be significantly easier to fund and to administer (no allocation problems, only one investment portfolio, etc.), (4) the administrative expenses saved by having only one trust (lower fiduciary fees in most cases, only one annual accounting, etc.) may well more than offset the failure to optimize the marital deduction, and (5) the client is more likely to understand his will without detailed explanation.²

The pattern presented, then, contemplates the 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

¹ IRC 2056(b)(5). The regulations under this section provide that if there is a difference between the two portions, the smaller controls the amount of the marital deduction (e.g. income from one-third of the corpus and a power over one-half thereof would restrict the maximum marital deduction to one-third). Regs. 20.2056(b)-5(b).

² A discussion of the advantages and disadvantages of the portion trust will be found in Lovell, Marital Deduction Simplified, 93 Trusts & Estates 760 (1954).

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 using a simple one-trust will that is divided into "two portions."

Example Of A 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

In addition to the powers now or hereafter conferred by law, my Executor and my Trustee shall have all of the powers enumerated in Section 64.1-57 of the Code of Virginia (1950); provided, however, that neither of these fiduciaries shall exercise any of the authority and discretion conferred upon them in such manner as to disqualify my estate for the marital deduction allowed under the Federal estate tax law.

Testimonium.

/s/ JOHN DEAUX

Attestation.

Observations On The Will— Determining The Portion

The above form³ fails to optimize tax savings for a number of reasons. For instance, no account is taken of property that might have passed or be passing to the surviving spouse other than under a will which qualifies for the marital deduction—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 beneficiary designation to “The Trustee to be named in my Last Will and Testament.”⁴ 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.⁵ If one uses such a formula to define the marital portion, then 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,

³ Article 2 is based on Forms X-2b and X-2c in the will manual published by United States Trust Company, New York City.

⁴ See sections 38.1-409.1 and 38.1-442.1 of the Code of Virginia (1950) which provide for such beneficiary designation.

⁵ Such a formula has been developed by Mr. Robert M. Lovell of the Hanover Bank, New York City, and reproduced in Casner, Estate Planning, page 863 at fn. 156.

inter-vivos power in the surviving spouse in the marital portion, restriction of the Trustee’s invasion rights for the surviving spouse to the marital portion until it has been exhausted, allow the Trustee to invade the balance for the benefit of third parties, etc.).

While one may use a specific portion formula clause to generally accomplish most of the ends normally obtained in the “two-trust” will, with a resultant reduction in administrative expenses, this approach cannot completely replace the “two-trust” will. For instance, IRS may require that those estates using the portion approach regard the portion as consisting of an interest in all of the assets in the estate. This would mean that disqualified terminable interests could not be allocated away from the marital share as can currently be done in a “two-trust” will. This should pose no problem in the average case, however, since the incidence of these interests in estates is quite rare.

Administrative Powers

It has been suggested by some estate planners in Virginia that the incorporation of the statutory powers might result in a denial of the marital deduction because of the broad powers granted therein to fiduciaries. This is not believed to present a problem because the regulations provide that “(p)rovisions granting administrative powers to the trustee will not have the effect of disqualifying an interest passing in trust unless the grant of powers evidences the intention to deprive the surviving spouse of the beneficial enjoyment required by the statute.”⁶ Assuming, arguendo, that the bare incorporation of the statutory powers might cause a problem, it is submitted that the proviso following the incorporation eliminates this issue.

Minors

It is recognized that when the trust terminates at the wife’s death some of the issue who are to take may be minors. One of the incorporated powers would allow the trustee to distribute such beneficiary’s share pursuant to Virginia’s Uniform Gifts to Minors Act.⁷ This “canned-trust” 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 bene-

⁶ Regs. 20.2056(b)-5(f)(4). See also Rev. Rul. 66-39, 1966-1 C.B. 223.

⁷ Section 64.1-57(p) of the Code of Virginia (1950).

ficiary's minority. In such latter case, suitable trust provisions can be plugged into the pattern after or as a part of Article 2.

Closing Caveat—Re The Portion In The Portion Trust

The 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 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.⁸ In other words, a "specific sum" is not equal to a "specific portion."

In *Northeastern Pennsylvania National Bank & Trust Co. v. U.S.*,⁹ the Supreme Court held this regulation to be invalid insofar as it required the income right to be in 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 made possible for those who use the single trust with two portions as opposed to the traditional "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 tax-

able in her estate. The remaining \$300,000 passes tax-free to the children.¹⁰

If a standard "two-trust" will had been used in the above case, 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 in 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 which 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. Several tax authorities agree with the position that the dissent states to be the law,¹¹ one district court has so held,¹² and the government has conceded the point in another district court case,¹³ viz., a power of appointment is not disqualified because it exists over a specific sum in a larger fund rather than in a fractional or percentile portion of the larger fund. Nevertheless, since in its only reference to the power of appointment/specific portion matter, the majority in *Northeastern* said "...nothing we hold in this opinion has reference to that quite different problem, which is not before us,"¹⁴ 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.

¹⁰ Id. at 227. Note that the same result would also 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. See note 1, *supra*.

¹¹ Mertens, *Law of Federal Gift and Estate Taxation*, 1972 Cum. Sup. Para. 29.45 I-D Ex. 1., and *Tax Management Portfolio* 239, page A-37.

¹² *Allen v. U.S.*, 250 F.Supp. 155 (E.D. Mo. 1965).

¹³ *Guiney v. U.S.*, 295 F.Supp. 789 (Md. 1969), reversed on other grounds in 425 F.2d 145 (4th Cir. 1970).

¹⁴ *Supra*, note 9 at 225.

⁸ Regs. 20.2056(b)-5(c).

⁹ 387 U.S. 213 (1967).