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Funding of Marital Deduction Trusts Through Equalization Clauses: Confusing Concepts of Terminable Value and Terminable Interest

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clarifying the eighty percent test Congress should consider a retreat from a purely mechanical approach so as to effectuate the policies behind the surtax exemption under section 11(d) and its disallowance to multiple corporations under section 1561, without such a preponderance of unwarranted spillover effects.

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Funding of Marital Deduction Trusts Through Equalization Clauses: Confusing Concepts of Terminable Value and Terminable Interest

In a recent decision, the Tax Court concluded that an interest passing to a surviving spouse under a trust instrument qualified for a marital deduction where the interest was vested indefeasibly on the date of death but might have no value. The author suggests that the Internal Revenue Service attack upon this estate plan was based upon mistakenly equating terminable interest with terminable value—a confusion which has existed at least since the issuance of Revenue Procedure 64-19 in 1964.

In 1967 settlor-decedent ("Settlor"), Charles W. Smith, transferred the bulk of his assets to a revocable inter vivos trust.[1] Article IV of the trust instrument directed itself to trust distributions. It provided in pertinent part that the corpus was to be divided into two separate portions if the Settlor's wife survived him. The spouse was given a general power of appointment over the first portion, which was intended to qualify for the marital deduction. The remainder passed to a residuary, non-marital trust. The funding of each was determined by an equalization clause.[2] The Trustee filed the estate

of the eighty percent (80%) test regardless of some stock ownership in each corporation, they could have added the four words added by the regulations, i.e., "singly or in combination." *See* note 42 *supra.* If Congress intended it to be necessary to own some stock in each corporation, they could have adopted the language proposed by the 1969 Treasury Proposals by adding the two words "same" and "these." *See* note 40 & accompanying text *supra.*

1. On June 7, 1920, the date of death, decedent's estate was valued at $3,492,764.32. Of this amount $3,288,519.99 was held in the trust.

2. The clause in pertinent part read as follows:

> (b) There shall then be allocated to the Marital Portion that percentage interest in the balance of the assets constituting the trust estate which shall when taken together with all other interests and property that qualify for the marital deduction and that pass or shall have passed to Settlor's said wife under other provisions of this trust or otherwise, obtain for Settlor's estate a marital deduction

tax return[3] claiming, pursuant to section 2056[4] of the Internal Revenue Code,[5] a marital deduction in the amount of $1,521,245.86.[6] The Internal Revenue Service disallowed the marital deduction for all of the amounts which passed to the surviving spouse via the terms of

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> which would result in the lowest Federal estate taxes in Settlor's estate and Settlor's wife's estate, on the assumption Settlor's wife died after him, but on the date of his death and that her estate were valued as of the date on (and in the manner in) which Settlor's estate is valued for Federal estate tax purposes; Settlor's purpose is to equalize, insofar as possible, his estate and her estate for Federal estate tax purposes, based upon said assumptions.
> (c) There shall finally be allocated to the Residual Portion the remaining percentage interest in the balance of the assets constituting Settlor's estate.
> (d) The percentage interest of the Marital and Residual Portions shall be determined and fixed by using asset values for all such purposes as finally established for Federal estate tax purposes. In selecting a valuation date for the purpose of the Federal estate tax, Settlor directs Trustee to select the date which will result in the greatest tax benefit to Settlor's wife and Settlor's estates, regardless of the effect this selection may have on the amount provided by this Article for Settlor's wife.

This clause requires the trustee to distribute to the marital portion an amount which will equalize the decedent's and his wife's estate. See note 6 *infra*, for the precise calculation. This equalizes the tax due on the widow's death.

3. There was no probate of decedent's will and no appointment of a personal representative; therefore, the Northern Trust Company, as trustee in possession of the assets, filed the estate tax return as required by applicable regulations. *See* Treas. Reg. § 20.6018-2 (1958).

4. The marital trust was designed to avoid the terminable interest rule of section 2056(b)(1) by fitting within the general power of appointment exception provided in section 2056(b)(5).

5. Unless otherwise indicated all section references are to the Internal Revenue Code of 1954, as amended.

6. This amount is determined by the following calculations:-

Computation of Marital Trust

Total	Gross Estate		$3,492,764.32
Plus:	Debts and Claims (directed to be paid from assets held in "residual portion")		246,252.10
			3,739,016.42
Less:	Promissory Note		220,337.48
			3,518,678.94
Less:	Joint Tenancy Property	$111,549.24	
	Taxable Gift of Real Estate	74,000.00	
	Bequest of Goods and Chattels	5,595.00	
			191,144.24
			3,327,534.70
Less:	Total Gross Estate of Alice M. Smith		667,331.47
			$2,660,203.23

$2,660,203.23 ÷ 2 = $1,330,101.62
Total marital deduction pursuant to
§ 2056 = $1,330,101.62 + $191,144.24 =
$1,521,245.86

the trust instrument. The Service based its disallowance of the deduction on the theory that the surviving spouse's interest was a terminable interest as defined in Section 2056(b)(1).[7] The Service argued that as of the date of death the surviving spouse's interest was neither indefeasibly vested nor unconditional, as is required to qualify under *Jackson v. United States,*[8] because conditions could develop such that nothing would pass to the surviving spouse. On appeal, the Court of Appeals for the Seventh Circuit *held:* The interest passing to the surviving spouse under the trust provisions qualified for the marital deduction because that interest was indefeasibly vested on the date of death; the possibility[9] that the value of the interest passing under the equalization clause may be zero is irrelevant; rather, it is in the interest (whatever its value) which must terminate in order for the terminable interest rule to apply. *Estate of Charles W. Smith,* 565 F.2d 455 (7th Cir. 1977), aff'g 66 T.C. 415 (1976).

Section 2056(a) provides that in determining the value of the taxable estate for federal estate tax purposes, a marital deduction shall be allowed from the value of the gross estate in an amount equal to the value of any interest which passes or has passed from the decedent to his surviving spouse, subject to certain conditions and limitations. Section 2056(b)(1) contains one of these limita-

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7. Section 2056 provides in pertinent part:

> (b) *Limitation in the Case of Life Estate or Other Terminable Interest—*
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> (1) *General Rule.* Where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction shall be allowed under this section with respect to such interest—
>
> (A) If an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse); and
>
> (B) If by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse;

I.R.C. § 2056(b). Related to this is the last sentence in § 2056(e):

> Except as provided in paragraph (5) or (6) of subsection (b), where at the time of the decedent's death it is not possible to ascertain the particular person or persons to whom an interest in property may pass from the decedent, such interest shall, for purposes of subparagraphs (A) and (B) of subsection (b)(1), be considered as passing from the decedent to a person other than the surviving spouse.

8. 376 U.S. 503 (1964).

9. It is the mere possibility of termination and not its actuality or likelihood which controls. Estate of Joseph Nachimson, 50 T.C. 452, 457 (1968) (citing Estate of Wallace S. Howell, 28 T.C. 1193, 1195 (1957); S. REP. No. 1013 Pt. II, 80th Cong., 2d Sess. 7-8, *reprinted in* [1948] U.S. CODE CONG. & AD. NEWS 1222, 1228). The court of appeals categorized the possibility that Mrs. Smith would receive nothing as "remote." 565 F.2d at 459.

tions. It provides that if the interest passing to the surviving spouse is a "terminable interest" no deduction shall be allowed for such interest.[11] Traditionally, the Treasury and the courts have applied these conditions strictly,[12] at times disregarding the policy behind the terminable interest rule.[13] This approach has frustrated the purpose of the marital deduction, which is to achieve uniformity of federal tax impact between community property and common law states.[14] *Jackson v. United States*[15] is a good illustration.

In *Jackson*, the Supreme Court was faced with the question whether, under California law, a widow's allowance was a deductable interest. The Probate court's award would terminate if the widow married or died. Even though neither of these events occurred,[16] the Court held the allowance to be a nondeductible terminable interest. The Court reasoned that since the proper time for determining the nature of the interest is at the moment of death,[17] it was not certain at that time whether the interest would terminate. Hence, it was not indefeasibly vested and therefore nondeductible.

In *Smith*, the Service argued that the interest was conditional at decedent's death, the moment which *Jackson* mandated the nature of the interest was to be determined. This contention was based upon the terms of the funding provision, under which it was possible that the spouse's interest could have been worthless. Therefore, the Service characterized the interest as a nondeductible terminable interest under section 2056(b)(1).[18]

The Tax Court rejected this argument, stating that the Service was "confusing the terminable interest rule and the determination

11. *See* note 7 *supra.*

12. At least one author has assailed the strict approach as "highly technical and strained," Lauritzen, *Safeguarding the Marital Deduction,* 1 REAL PROP., PROB. & TR. J. 162 (1966); Lauritzen, *The Marital Deduction and Revenue Procedure 64-19,* U. MIAMI INST. EST. PLAN. ¶ 67,916 (1967).

13. *See, e.g.,* Jackson v. United States, 376 U.S. 503, 509 (1964). The purpose of the terminable interest rule is to assure that interests deducted from the estate of the deceased spouse are included in the estate of the survivor. An equalization clause could be used to circumvent this policy; but to do so would necessarily involve fraud on the part of the spouse. *See* text accompanying notes 27-31 *infra.* The court of appeals discussed the policy at length and seemed to be influenced by the fact that when Mrs. Smith died in 1971 the entire amount which had passed to her pursuant to the equalization clause was taxed to her estate. 565 F.2d at 459. Perhaps this marks the beginning of a more realistic approach to the marital deduction—a much needed trend.

14. *Id.* at 510. *See generally* United States v. Stapf, 375 U.S. 118, 128 (1963).

15. 376 U.S. 503 (1964).

16. *See* note 9 *supra.*

17. Jackson v. United States, 376 U.S. 503, 508 (1964) (citing S. REP. No. 1013 Pt. II, 80th Cong., 2d Sess. 10, *reprinted in* [1948] U.S. CODE CONG. & AD. NEWS 1222, 1228).

18. *See* note 7 *supra.*

of the value of the property interest passing to the surviving spouse."[19] In other words, it is the "interest" which must vest and not a precise amount. The court of appeals affirmed the result and rationale stating, "the criterion is not the possible termination of value, . . . but the possible termination of interest.' "[19.1]

This distinction has been established in numerous situations.[20] Nevertheless, the Service's position, that an interest of no monetary value necessarily terminates, comports with lay definitions of the terms and thus appears logical. This argument did appeal to at least one member of the Tax Court.[21] As stated in the dissenting opinion, by the trust's terms nothing was to be allocated to the marital portion if the value of the surviving spouse's assets equaled or exceeded the value of the assets in the decedent's estate.[22] The dissent went on to say that to characterize this non-funding as a valuation problem, and then to state that the interest did not terminate but rather became worthless, was incorrect.[23] The dissent concluded that irrespective of whether the interest was a "vested right," the potential non-funding was an event upon which the surviving spouse's interest would have failed.[24]

A literal application of this argument could result in the disallowance of virtually all formula bequests. This proposition follows from the possibility that the net assets of the decedent's estate may be insufficient to meet debts and expenses, thereby subjecting any bequest to termination. The Service has never argued this position; rather, it has been content to characterize the problem as one of valuation. The fact that the value actually received under the terms of the trust is to be determined by two variables (the size of both the husband's estate and the wife's estate), rather than just one (the size of the husband's estate), should not alter the result[25] where the

19. 66 T.C. at 428.

19.1. 565 F.2d at 459.

20. *See, e.g.*, First Nat'l Bank v. United States, 335 F.2d 91 (4th Cir. 1964); Bradham' v. United States, 287 F. Supp. 10 (W.D. Ark. 1968). In *Bradham* the court held that the commuted value of the widow's right to dower is an interest which vests at the time of the husband's death, even though the amount which would fulfill the interest could not be determined at that time. The amount which eventually passed was allowed as a marital deduction. *See also* Ritter v. United States, 297 F. Supp. 1259 (S.D.W. Va. 1968). In *Ritter* the court allowed a marital deduction for an amount which would fulfill the following vested interest: "a sum which will be adequate . . . to purchase a residence for my wife." 297 F. Supp. at 1261.

21. Judge Irwin dissented.

22. The likelihood of this happening is irrelevant. *See* note 9 *supra*.

23. 66 T.C. at 433-34.

24. *Id.* at 434.

25. 565 F.2d at 459; 66 T.C. at 431.

additional factor (the size of the wife's estate) relates only to the value of the interest and not to its character.

The regulations[26] and the legislative history[27] of the marital deduction emphasize the importance of not confusing the concept of "interest" with that of the "property" which will eventually satisfy the interest. In the instant case, the interest to which Mrs. Smith was entitled was that percentage interest in the balance of the trust assets which would obtain for the Settlor's estate a marital deduction resulting in the lowest federal estate taxes in Settlor's estate and Settlor's wife's estate. This allocation to the marital portion was to be computed based upon the following two assumptions: (1) that Settlor's wife died after him but on the same date of his death, and (2) that her estate was valued as of the date on (and in the manner in) which Settlor's estate was valued for federal estate tax purposes.[28] Therefore, the vested interest is this fixed percentage interest. It is extremely important to note that the percentage interest, which is vested, is not a percentage of the decedent's estate which, as of the date of death, can be measured in actual amounts. Rather, the vested percentage interest is an interest the exact amount of which remains unvalued on the date of death. This percentage interest, though vested as of the decedent's death, cannot be valued until the alternate valuation date, which sets the outer limit for the time of valuing the vested percentage interest granted in the trust instrument. At that time, the executor must determine whether the date of death or alternate valuation date will be used for valuing the entire estate. The amount of the vested percentage interest will then be determined according to the assumptions in the trust instrument and the interaction of those assumptions upon the value of the estate.

In *Jackson*, the widow's allowance was conditioned upon retaining the status upon which her right depended; thus, the interest itself (analogous to the "percentage interest" here) could have terminated. In contrast, Mrs. Smith's percentage interest was not dependent upon any conditions, the surviving spouse always being entitled to this percentage. Rather it was the *value* of this percentage interest which was to be determined at a later time. Taken together, *Jackson* and *Smith* clearly illustrate that the nature of the interest is to be determined as of the date of death, but the value

26. Treas. Reg. § 20.2056(b)-1(e)(2)(1958).

27. S. REP. No. 1013 Pt. II, 80th Cong., 2d Sess. 4, 8, *reprinted in* [1948] U.S. CODE CONG. & AD. NEWS 1222, 1225, 1229.

28. For the precise language of the equalization clause, see note 2 *supra*.

of the interest need not always be determined at such time.[29]

Both the Tax Court and the court of appeals emphasized that the result was within the "letter and spirit" of the marital deduction.[30] The spirit alluded to is to capture the value of the interest in either the husband's or the wife's estate, but not both. Even the Service conceded that the purposes of the marital deduction and the terminable interest rule would not be frustrated by allowing petitioners their deduction, because the value of the marital portion of the trust was taxable to the surviving spouse's estate at her death.[31] In other words, there was no abuse in *Smith* which the terminable interest rule was designed to foreclose. Whatever amount passed from the decedent to his surviving spouse was integrated adequately in the latter's estate.[32]

While this policy is not determinative of the issue,[33] it certainly militates in favor of handling the problem in terms of valuation and not as a terminable interest. This is not to say that the equalization clause cannot lead to abuses. For example, if the wife were also executrix, she would obtain a larger marital deduction than she was entitled to by understating her assets. Her children could then sue their mother for this increased amount, and thereby remove the same from her estate.[34]

Revenue Procedure 64-19[35] was prompted by a similar potential for abuse and, ironically, was based upon the same contentions as those advanced by the Service in *Smith*. The primary assumption of the revenue procedure was that the surviving spouse must receive a nonterminable interest in value in order to have a nonterminable interest for purposes of the marital deduction. It appears that the Service mistakenly had been equating a terminable value with a terminable interest since 1964. It was not until twelve years later in *Smith* that the Court of Appeals for the Seventh Circuit and the Tax Court unequivocally stated that to do so is clearly contrary to the statute.

At this point, a brief discussion of the background and function

29. *See* Treas. Reg. § 20.2056(b)-4 (1958)(recognizes that the use of the alternate valuation date may affect the value).

30. 565 F.2d at 459; 66 T.C. at 429.

31. 66 T.C. at 429; *see* 565 F.2d at 459.

32. 565 F.2d at 459; 66 T.C. at 429 n.21.

33. *See*, Jackson v. United States, 376 U.S. 503, 509-10 (1964).

34. The Service expressed this fear in a National Office Technical Memorandum, *reprinted in part in* Kanter & Pennell, *Shop Talk: IRS Explains Why Equalization Clause Bars Marital Deduction*, 42 J. TAX. 254, 255 (1975) (citing 2 J. CASNER, ESTATE PLANNING 2136-37 (3d ed. Supp. 1973)).

35. 1964-1 C.B. 682.

of Revenue Procedure 64-19 will be helpful. A pecuniary bequest[36] funded with cash may require recognition of gain or loss by the estate for income tax purposes. For this reason it is desirable to have the widow receive some or all of the distributable assets in kind. Furthermore, to aid in administration and to avoid any suggestion that distributions must include a fractional share of each asset, the executor should be given discretion to select the assets to be distributed in satisfaction of the marital bequest. Absent further provisions, however, distribution in kind also could result in recognition of gain or loss by the estate, where the value of the distributed assets at distribution differ from their value for federal estate tax purposes.[37] To avoid incurring this tax, attorneys began to include a clause specifying that assets distributed in satisfaction of the marital bequest were to be valued at the values determined for federal estate tax purposes. It is this clause coupled with the discretion granted to the fiduciary that offered delightful opportunities for post-mortem planning. In an amicable family situation, the executor, through the use of these powers, could allocate depreciated assets to the marital share. Obviously this device would provide for excellent tax planning because it would pass less value through the surviving spouse's taxable estate.[38] This potential abuse led to the issuance of Revenue Procedure 64-19, in which the Service established a procedure which attempts to solve these problems by setting forth certain rules under which the marital deduction will be allowed in the full amount of a pecuniary bequest. If the procedure is not followed the result is the disallowance of the entire deduction. In short, the deduction will be allowed only if it is "clear" under applicable local law or by the expressed or implied provisions of the governing instruments that: (1) the fiduciary must distribute in satisfaction thereof assets having a market value on the date or dates of distribution at least equal to the amount of the bequest; and (2) the fiduciary must distribute assets, including cash, fairly representative of appreciation or depreciation in the value of all property available for distribution.

The only legal basis given in the revenue procedure for disallowing the marital deduction in the above-described situation was that "the interest in property passing from the decedent to his surviving

36. A pecuniary bequest is one phrased in terms of "an amount equal to one-half of the testator's adjusted gross estate." Revenue Procedure 64-19 does not apply to fractional bequests in which the spouse automatically shares in all appreciation and depreciation.

37. Rev. Rul. 60-87, 1960-1 C.B. 286.

38. Lloyd, *Background of Drafting Problems*, 103 TRUST & ESTATES 898-99 (1964). *See* Cohen, *Treasury Views on Current Questions*, 104 TRUST & ESTATES 9 (1965).

spouse would not be ascertainable as of the date of death, if the property available for distribution included assets which might fluctuate in value."[39] The "interest in property" is vested absolutely. Only the value of this interest may vary as the value of the property, out of which the interest will be satisfied, fluctuates. As the holding in *Smith* illustrates, this fluctuation in value does not make the interest received a terminable one. Apparently, the same incorrect analysis underlying the Service's position in *Smith* forms the underpinnings of the "safe-harbor" laid down in Revenue Procedure 64-19.

The rationale behind the Service's position in both *Smith* and the revenue procedure is that no marital deduction should be allowed for an amount which may go untaxed in the surviving spouse's estate.[40] However, should this policy-based justification be sufficient? The taxpayer in *Jackson* argued that the widow's allowance was in fact included in her estate; and, therefore, the policy of the terminable interest rule was not violated. The Court rejected this argument, stating that "there is no provision in the Code for deducting all terminable interests which become nonterminable at a later date and therefore taxable in the estate of the surviving spouse."[41] It is anomalous to allow the Service to base its procedures upon what it believes to be a contravention of the policy behind the statute when the taxpayer is strictly limited to statutory arguments. But Revenue Procedure 64-19 lacks even a clear policy basis; rather, it rests entirely upon administrative convenience. The mere potential for abuse being present, the revenue procedure denies a marital deduction irrespective of any actual abuse. Obviously such an approach is administratively convenient. This may be the reason for its publication as a revenue procedure and not as a revenue ruling. The former announces "practices and procedures for guidance to the public,"[42] whereas the latter is an "official interpretation"[43] of the law. Whether this means that a revenue procedure need not have a firm legal basis is unclear; but to allow the Service to offer to the public administratively convenient guidelines devoid of any legal basis is to condone "scare tactics." The effect of such practices is to pressure practitioners into complying with revenue procedures which are not mandated by statute. Viewed in this perspective, the Service was almost forced to appeal the Tax Court decision.

39. Rev. Proc. 64-19, 1964-1 C.B. at 682, 683.
40. *See* note 13 *supra*.
41. 376 U.S. at 509.
42. Rev. Proc. 72-1, 1972-1 C.B. 693, 695.
43. *Id.* at 693.

Perhaps even more disturbing is that Revenue Procedure 64-19 is only one application of the Service's position which, if applied to other situations, could present insurmountable problems to estate planning in general. Thus, despite this apparent taxpayer's victory, the war is far from over. The Service will persist in its position until the issue is resolved in the Supreme Court or at least in most of the circuits. Until then, any estate planning must proceed on uncertain grounds at a time when the Tax Reform Act of 1976 presents enough uncertainty.

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Scope of Tax Benefit Rule Limited

In Putoma Corp. *the Tax Court decided that foregiveness of interest indebtedness owed by a corporation (which had deducted for the accrued but unpaid interest) to a shareholder did not result in taxable income to the corporation because the interest foregiveness was a contribution to capital. The authors dispute the court's analysis and suggest a framework for future decisions concerning this problem.*

As a general proposition, when a deduction is followed in a subsequent year by a recovery in money or property of the previously deducted liability, the taxpayer must treat the recovery as gross income.[1] The item is deemed to be recovered when liability for the item terminates.[2] This judicial doctrine is known as the "tax benefit rule" and is composed of three distinct requirements: (1) an amount previously deducted, (2) which resulted in a tax benefit, and (3) which was recovered during the taxable year at issue.[3]

The Treasury Regulations provide that the tax benefit rule is applicable to recoveries of previously deducted bad debts, taxes, delinquency amounts, other expenditures or accruals, and all other

1. I.R.C. § 111; 1 MERTENS, LAW OF FEDERAL INCOME TAXATION § 7.4 (1974). I.R.C. § 111(a) provides: "Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the *recovery exclusion* with respect to such debt, tax, or amount." (emphasis added).

Recovery exclusion is defined in I.R.C. § 111(b)(4) to be that amount that did not result in a reduction of the taxpayer's tax. Treas. Reg. § 1.111-1(a) (1956) expands on the statutory language by providing that the rule of exclusion (and thus inclusion) applies equally with respect to all other losses, expenditures, and *accruals made the basis of deductions from gross income for prior taxable years.*

2. *See* Bear Mfg. Co. v. United States, 430 F.2d 152 (7th Cir. 1970), *cert. denied,* 400 U.S. 1021 (1971).

3. Estate of David B. Munter, 63 T.C. 663, 679 (1975) (Tannenwald, J., concurring).