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Howard D. Rosen

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# AN OVERVIEW OF MARITAL DEDUCTION FORMULA CLAUSES

HOWARD D. ROSEN\*

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## I. INTRODUCTION

This article is primarily concerned with the drafting, and, to a lesser extent, with the administration of the literary provisions which are known as marital deduction formula clauses. While such formulae appear in trust instruments as well as in wills, this article makes reference to their use in the will. However, this discussion is equally applicable to the use of these provisions in trust instruments. As a preface to any discussion of marital deduction formula clauses, a brief description of the federal estate tax marital deduction is in order.

The federal estate tax marital deduction is granted by section 2056 of the Internal Revenue Code of 1954.<sup>1</sup> That section provides for a deduction, in arriving at a decedent's taxable estate, of an amount equal to the value of qualifying property interests<sup>2</sup> which pass or have passed to the decedent's surviving spouse, to the extent that such property interest was included in the decedent's gross estate. Section 2056(c)(1) limits the allowable marital deduction to one-half of the

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1. Hereinafter referred to as the Code.

2. The Treasury Regulations use the alternative term "deductible interest." Treas. Reg. § 20.2056(a)-1 (1958). Qualifying property is property which: (1) is included in the decedent's gross estate, (2) does not result in a deduction under § 2053 by reason of its passing to the surviving spouse, (3) does not result in a loss deductible under § 2054, and (4) is not a non-deductible terminable interest. Briefly, a terminable interest is an interest in property which will terminate or fail on the lapse of time or on the occurrence or the failure to occur of some contingency. Common examples include: life estates, terms for years, annuities, patents and copyrights. A terminable interest is non-deductible when another interest in the same property—a remainder interest for example—has passed from the decedent to some other person for less than an adequate and full consideration in money or money's worth, and by reason of this passing, the other person or his heirs or assigns may possess or enjoy any part of the property after the termination or failure of the spouse's interest. Treas. Reg. § 20.2056(b)-1 (1958). An example of a non-deductible terminable interest (non-qualifying property) would be a bequest of a life estate to the spouse, with a remainder over to a third party. A discussion of the exceptions to this rule is beyond the scope of this article. See note 4 *infra*.

decendent's "adjusted gross estate." This term is used in the Code solely to measure the maximum allowable marital deduction. It is arrived at by subtracting from the gross estate the deductions allowed by sections 2053 and 2054, namely: funeral expenses, administrative expenses, claims against the estate, certain debts of the decedent, and losses incurred during the settlement of the estate which are in the nature of casualty losses.<sup>3</sup>

Once the adjusted gross estate has been determined, computing the maximum marital deduction simply involves applying a fraction of one-half to that figure. At this juncture, two points should be made clear. First, the marital deduction is *not* one-half of the adjusted gross estate *unless* qualifying property equal to or greater in value than one-half of the adjusted gross estate passes or has passed to the surviving spouse; that is, the estate will be allowed a dollar for dollar deduction for qualifying property interests which pass to the surviving spouse, up to a maximum deduction of 50 percent of the adjusted gross estate. Any qualifying interests which pass to the surviving spouse in excess of that amount will result in no further immediate tax reduction, and, in fact, as discussed below, may result in a greater overall estate tax when the surviving spouse's subsequent estate is considered.

The second point which must be clarified relates to the discussion in this article of the tax-wise desirability of whether to "leave" the surviving spouse more or less than a certain amount; this discussion relates only to how much of the property passing to the surviving spouse will *qualify* for the marital deduction, and is not intended to limit the extent to which the surviving spouse should be provided the *beneficial enjoyment* of the decedent's properties.

Thus, in certain instances, discussed below, prudent estate planning indicates a need to limit the amount of qualifying property passing to the surviving spouse to an amount equal to the maximum allowable marital deduction (i.e., 50 percent of the adjusted gross estate). Such a need, *inter alia*, makes the exclusive use of a specific pecuniary or other specific bequest somewhat impractical (as discussed below) and for this reason, and other non-tax reasons, literary "formulae" were developed to assure that no more, and no less, than the desired 50 percent of the adjusted gross estate would pass to the surviving spouse as qualifying property.<sup>4</sup>

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3. The computation of the adjusted gross estate where community property is involved requires a further deduction for: (1) the decedent's share of community property included in the gross estate, whether owned at death or transferred in contemplation of death, (2) insurance proceeds includable in the gross estate to the extent that the policies upon which such proceeds were payable were purchased with community assets, and (3) a portion of the § 2053 and § 2054 deductions. INT. REV. CODE OF 1954 § 2056(c)(2). Note that the status of property as community property is determined at its *acquisition*, not at death, so inquiry might be required as to whether the decedent and his spouse ever resided in one of the community property states.

4. A detailed discussion of the technical requirements necessary to obtain the marital deduction, other than those requirements which relate to the drafting and understanding of a formula provision, is beyond the scope of this article. For a comprehensive discussion of the

## II. WHETHER TO USE THE MARITAL DEDUCTION OR SUCCESSIVE ESTATES

The first question the estate planner must answer in regard to formula clauses is whether to take advantage of the marital deduction allowed by section 2056(a). In reaching a determination regarding this initial consideration the basic choices available to him (to express his client's wishes) are: to utilize the technique of successive estates, to utilize the marital deduction to whatever extent desirable, or to utilize a combination of the two. In the successive estate technique, the surviving spouse is bequeathed a life estate in some part or all of the decedent's property and the decedent, or the surviving spouse via a special power of appointment, designates the takers of the gift over. Since this form of bequest does not qualify for the marital deduction, the immediate effect of using this technique is to incur an estate tax at the decedent's death measured by the value of all of his assets. However, this type of life estate is not includable in the surviving spouse's gross estate at her death, so the end result of utilizing this technique is to permit the surviving spouse to use and enjoy the property for the balance of her lifetime, with the remainder interest passing to pre-designated successors at the spouse's subsequent death at no further estate tax cost. Such a technique could be useful in a situation where the respective spouse's estates are nearly equal in value and the parties are somewhat advanced in their years.

Use of the marital deduction technique is generally not indicated in this situation since it would result in a higher overall estate tax (both estates considered); even though the estate tax in the estate of the first to die is reduced if the deduction is used, upon the death of the second spouse a "piling on" effect would occur, which, in most instances, would throw the second estate into a higher estate tax bracket and would result in a greater combined estate tax.<sup>5</sup> The overall estate tax savings which can be achieved by using the successive estate technique (when indicated by estates of nearly equal value) may be greater than

substantive aspects of § 2056, *see, e.g.*, C. LOWNDES, R. KRAMER, & F. MCCORD, FEDERAL ESTATE AND GIFT TAXES chs. 41, 42 (3d ed. 1974) [hereinafter cited as LOWNDES]; R. STEPHENS, G. MAXFIELD & S. LIND, FEDERAL ESTATE AND GIFT TAXATION (3d ed. 1974).

5. *See* LOWNDES, *supra* note 4, at ch. 41. Assume that *H* and *W* are an elderly couple and that each has an adjusted gross estate of \$1,000,000. The following illustrates the estate tax savings realized by using the successive estate technique as compared to using the marital deduction technique. The successive estate technique:

	<i>H</i>	<i>W</i>
Adjusted Gross Estate	\$1,000,000	\$1,000,000
Exemption	<u>60,000</u>	<u>60,000</u>
Taxable Estate	<u>\$ 940,000</u>	<u>\$ 940,000</u>
Estate Tax	<u>\$ 303,500</u>	<u>\$ 303,500</u>
Total Estate Taxes		<u>\$ 607,000</u>

indicated by a simple calculation; by circumventing estate taxation in the second estate (with respect to property taxed in the first estate), not only is bracket equalization achieved (a theoretically ideal situation), but also any appreciation in the property which occurs between the first and second death goes *untaxed* to the designated successors.

In a real life situation, however, an elderly married couple may not be overly concerned about the lowest overall estate tax result, but may be more concerned with the estate tax which would be due at the death of the first to die, and such cash flow and psychological factors must also be considered.

Use of the marital deduction technique may be advantageous in several situations. One use of the deduction is to equalize the estates of the respective spouses.<sup>6</sup> To illustrate: if *H* is the beneficial owner of the family properties and *W* owns little or no property in her own name, *H* is permitted to pass to *W*, estate tax-free, on his death, up to one-half of his adjusted gross estate. The tax theory behind this is that *W*'s tax-free half of *H*'s estate will be taxable in her estate, and in fact, in order to qualify for the marital deduction,<sup>7</sup> the property passing tax-free to her must be of such a nature that it would be included in her gross estate when she dies (if she still owned it). Sometimes it may be desirable to avoid or reduce the estate tax at *H*'s death (notwithstanding whether the two estates are equalized) and defer it until *W*'s death in order to avoid liquidating certain assets, such as a closely-held business or investment real estate. If this is the case, it would seem appropriate to utilize the full marital deduction, even though on paper

The marital deduction technique, assuming *H* dies first (*W*'s adjusted gross estate includes the prior marital bequest from *H*):

	<i>H</i>	<i>W</i>
Adjusted Gross Estate	\$1,000,000	\$1,500,000
Marital Bequest and Deduction	500,000	—
Exemption	<u>60,000</u>	<u>60,000</u>
Taxable Estate	<u>\$ 440,000</u>	<u>\$1,440,000</u>
Estate Tax	<u>\$ 126,500</u>	<u>\$ 503,000</u>
Total Estate Taxes		<u>\$ 629,500</u>

The "piling-on" effect referred to in the text resulted in an overall increase in estate taxes in these small estates of \$22,500. If the couple were not elderly the use of the marital deduction technique would be indicated since the estimated increase in estate tax would theoretically be more than offset by the use of the initial tax savings in any reasonable investment medium.

6. Prior to 1942, residents of the community property jurisdictions could exclude the surviving spouse's share of the community property from the estate of the first spouse to die, as long as such share did not represent a "mere expectancy" prior to death. In 1942 a provision was enacted into the 1939 Code which required both shares of the community property to be included in the estate of the first spouse to die unless separate and actual contribution on the part of the survivor could be shown. In 1948, the 1939 Code was amended and community property was again accorded the pre-1942 treatment, with the residents of common law jurisdictions statutorily placed on an equal footing with the community property jurisdictions by permitting an estate tax-free equalization of the spouses' estates at the death of the first spouse to die via the marital deduction.

7. See Treas. Reg. § 20.2056(b)-1 (1958).

the calculations will show a greater overall estate tax using this technique.<sup>8</sup>

Other important factors which must be considered integrally with the above considerations are the likely disposition the surviving spouse will make of the property, her age, her health, etc. That is, if she is 25 years younger than *H* and in good health, it might be desirable to utilize the full marital deduction as there is a good chance she will consume or dispose of the property by the time she dies.

As should be quite obvious from the foregoing, this initial consideration, like most in estate planning, is highly dependent on the facts and circumstances in each case. Thus, the estate planner, in choosing whether to use the marital deduction must carefully analyze the assets, circumstances, and dispositive wishes of the testator.<sup>9</sup>

### III. WHY FORMULA PROVISIONS ARE USED

As suggested in the introduction, formula provisions are designed to *automatically* provide the surviving spouse with the maximum gift of property at the decedent's death which will qualify for the marital deduction.<sup>10</sup> The testator's purpose in utilizing a formula provision may be to assure himself that at his death his spouse will be certain to inherit a minimum part of his estate at its value at that time. For example, if *H* executed a will today and bequeathed the sum of \$200,000 to *W*, this sum would result in the maximum marital deduction for *H*'s estate only if the value of his adjusted gross estate *on that day* was from \$200,000 to \$400,000; thus, using the preceding figures, *on that day* *W* would be assured of from 50 percent to 100 percent of *H*'s estate. This form of bequest is known as the non-formula pecuniary bequest.<sup>11</sup> The problem here is, that if next year *H*'s property has appreciated to \$1,000,000, *W* will still only receive the same \$200,000 bequest, which would then only represent 20% of *H*'s estate. In addition, the benefit of the full marital deduction (assuming it was desired) is lost. *H*, of course, has the option of amending his will by codicil each time his property values change in order to preserve the maximum marital deduction for his estate, but it is obvious that this would become quite unworkable. Similar difficulties arise when a non-formula residuary bequest is used<sup>12</sup> which need not be further illustrated here; the point is clear: use of a formula provision allows the testator to place the will in a drawer and leave it there. He is assured that his spouse will receive a certain minimum share of his estate without having to amend the will each time property values change.

8. See note 5 *supra*.

9. Edwards, *Marital Deduction Formulae—A Planner's Guide*, 1967 DUKE L.J. 254 (1967).

10. *Id.*

11. J. CASNER, *ESTATE PLANNING* 792 (3d ed. 1961) [hereinafter cited as CASNER].

12. That is, a non-formula residuary bequest of one-half of the residue may or may not produce the maximum marital deductions and may require adjustment when property values change.

Use of a formula provision does not preclude the concurrent use of specific bequests to the spouse and often this should be considered for certain assets. When dealing with high bracket estates, the formula may be used (in theory) to avoid over-funding the marital deduction.<sup>13</sup> The evil implications in that technical phrase are: any property passing to the surviving spouse via the marital deduction passes to her estate tax free, to be later taxed in her estate at her death—one time. Any property passing to her in excess of the maximum allowable marital deduction (the over-funding situation) is theoretically taxed twice—first in *H*'s estate, since it did not avoid taxation via the marital deduction, and second, at *W*'s death in her estate.<sup>14</sup> Analyzing the numbers, without considering the human element involved, it is obvious that it is generally not advantageous to leave *W* more than the maximum allowable marital deduction, and the formula provisions ostensibly accomplish this.<sup>15</sup>

#### IV. TYPICAL FORMULA PROVISIONS AND THEIR APPLICABILITY

Formula bequests fall into one of two major categories: formula pecuniary bequests, and formula fractional bequests.

The pecuniary bequest is a bequest of a fixed dollar *amount* or an *amount* which may be so fixed by reference to the adjusted gross estate; the fractional share bequest is a bequest of a fractional part of a defined fund.<sup>16</sup> It is not an amount, but rather it is bequest of *things*.<sup>17</sup> With this basic distinction simplistically stated we may move on to examples of the various formulae.

For purposes of the following discussion, the formula pecuniary bequest is divided into three sub-categories: (1) the true worth pecuniary bequest, (2) the minimum worth pecuniary bequest, and (3) the "64-19" pecuniary bequest. The formula fractional bequest is referred to as the fractional residuary bequest, the estate residue, thus, being designated as the defined fund against which the fraction is to be applied. The three pecuniary formulae are primarily distinguishable in the manner in which the amount distributed to the surviving spouse or to a trust for her benefit<sup>18</sup> is valued. Thus, the following preface may be used with each of the three pecuniary formula bequests:

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13. Trapp, *Marital Deduction Formula Bequests: Selected Tax and Administrative Problems With Six Different Formulas*, 1973 U. MIAMI TAX INST. [hereinafter cited as TRAPP]. The statement in the text has reference to the "date of distribution" or "true worth" pecuniary bequest.

14. For simplicity, the § 2052 exemption is disregarded.

15. LOWNDES, *supra* note 4, at § 42.3.

16. That fund is usually defined as the residuary estate.

17. Of course, application of such fraction to the defined fund will produce an *amount* to be claimed as a deduction on the estate tax return. Polasky, *Marital Deduction Formula Clauses in Estate Planning—Estate and Income Tax Considerations*, 63 MICH. L. REV. 809 (1965) [hereinafter cited as Polasky].

18. Such a trust must either constitute an "estate trust" or qualify under § 2056(b)(5) in order

If my spouse survives me, I give, devise and bequeath to her outright a pecuniary amount equal to fifty percent (50%) of the value of my adjusted gross estate as finally determined for federal estate tax purposes, less the federal estate tax value of all items included in my gross estate which qualify for the marital deduction and which pass or have passed (as such terms are defined in section 2056(e) of the Internal Revenue Code of 1954 and successor statutes) to my spouse under other provisions of this will, by operation of law, pursuant to contract or otherwise than under this devise and bequest. My executor is specifically empowered, in setting aside this bequest, to distribute assets in cash or in kind, or partly in cash and partly in kind; provided, however, that no asset shall be allocated to fund this bequest unless it qualifies for the federal estate tax marital deduction, it being my intention to obtain the maximum marital deduction for my estate.

#### A. The "True Worth" Provision

As stated above, the pecuniary formulae are primarily distinguishable in the manner in which the satisfaction or funding of the pecuniary obligation is measured. The following clause provides for measurement by using the values of the assets distributed as determined at the date or dates of distribution:

In setting aside this bequest, or in making any distribution in respect of this bequest, my executor shall use values to be determined at the date or dates of distribution.

The effect of the true worth provision is indicated to some extent by its name. The surviving spouse receives property which, on the date of distribution, is equal in value to the pecuniary bequest being satisfied. Use of this type of formula precludes the surviving spouse from sharing in any appreciation or depreciation in estate assets which occurs between the estate valuation date,<sup>19</sup> which is the date the pecuniary amount is fixed, and the date the marital bequest is satisfied, which date may be somewhat later. To illustrate: assume the valuation date is the date of death and that the adjusted gross estate on that date was valued at \$1,000,000. Under the foregoing pecuniary formula, the amount of the bequest to the spouse is fixed on that date at \$500,000. Assume further that at the valuation date the estate owned 1,000 shares of stock X which was valued at \$500,000, and that ten months after the date of death the same 1,000 shares of stock X had appreciated to \$1,000,000. If stock X is used to satisfy the true worth pecuniary bequest the entire 1,000 shares would have to be distributed to the surviving spouse if the bequest were satisfied at the date of death, while only 500 shares of stock X would have to be

to obtain the marital deduction. See, e.g., Schlesinger, *Comparison of Marital Deduction Arrangements*, 2 TAX ADVISOR 155 (1971).

19. The valuation date is either the date of death or a date determined pursuant to § 2032.



distributed to satisfy the bequest if the distribution to *W* occurred ten months after the date of death.

The foregoing illustrates how the true worth pecuniary bequest precludes the surviving spouse from sharing in the appreciation or depreciation of the estate assets. This is not intended to convey any negative connotations, however, unless such a formula was used in ignorance of this effect. Such effect may be desirable in larger estates where it may be important to freeze the value of the widow's share and shift estate appreciation to a generation-skipping trust. In determining whether to use this or any other type of pecuniary provision, the composition of the estate assets must be carefully scrutinized. Since the satisfaction of this type of bequest with appreciated assets results in a gain taxable to the estate,<sup>20</sup> the use of the true worth provision would seem more appropriate in estates where it is likely that adequate amounts of cash would be available to fund the bequest.<sup>21</sup> As a corollary, the true worth provision is particularly inappropriate if the estate consists largely of non-liquid assets such as closely-held stock or real estate.

The fixed amount quality of this type of bequest will avoid the overfunding problem, which may be important where the surviving spouse has substantial assets of her own. Moreover, in estates where potential animosity exists between the beneficiaries, the fixed amount quality of this formula may relieve, to some extent, beneficiary pressures on the fiduciary with regard to allocation of assets used to satisfy bequests and the like.<sup>22</sup>

#### B. *The "Minimum Worth" Provision*

In order to preclude the possibility of any gain being recognized by the estate on funding the pecuniary bequest and to provide the executor with somewhat greater flexibility to affect the amount of the distribution in kind, the following clause can be used with the above preface:

In setting aside this bequest, or in making any distribution in respect of this bequest, my executor shall value any distribution in kind at the lower of the income tax basis (as adjusted to the date or dates of distribution pursuant to section 1016 of the Internal Revenue Code of 1954 and successor statutes) or the fair market value of the asset at the date or dates of distribution. In the event that my executor shall use items of income in respect of a decedent (as defined in section 691 of the Internal Revenue Code of 1954 and successor statutes) in setting aside this bequest or in making any distribution in respect of this bequest, such items shall be valued at the lower of their federal estate tax value (as adjusted pursuant to section 1016 of the Internal Revenue

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20. See note 72 *infra*.

21. See note 13 *supra*.

22. *Id.*

Code of 1954 and successor statutes) or their fair market value at the date or dates of distribution.

I hereby waive the application to my estate of the State "64-19" Statute (cite statute) (or successor statutory provisions) and the so-called "64-19" statutes of any other jurisdiction, as such statute or statutes would apply but for this waiver.

The minimum worth provision does not operate true to its designation. The bequest to the surviving spouse will always consist of property with a fair market value (at the date or dates of distribution) *at least equal* to the pecuniary amount being satisfied. The formula directs the executor to satisfy the bequest by *valuing* any distribution at the lower of its adjusted income tax basis or fair market value at the date (or dates) of distribution. Thus, the fair market value of any distribution will *always* be at least equal to the pecuniary amount being satisfied, and in many cases, it will be greater.<sup>23</sup> In fact, when the estate consists largely of appreciated assets a situation comparable to an overfunding<sup>24</sup> may result. This occurs because the assets used to *fund* the bequest would be valued, for that purpose, at their income tax bases (since the income tax basis is always lower than fair market value when an asset has appreciated), and the surviving spouse would, thus, receive assets with a greater fair market value than the pecuniary amount to which she is entitled. This factor may or may not be critical, depending upon the relative sizes of the two estates involved. If it is important to initially freeze the value of the assets under the control of the surviving spouse, perhaps the true worth bequest would better serve the purpose. If this factor is not critical, and often it is not, the income tax consequences may have a greater bearing on the decision regarding which formula to use. As mentioned above, funding the true worth pecuniary bequest with appreciated assets will result in the recognition of a gain taxable to the estate; funding a minimum worth pecuniary bequest will never result in the recognition of gain to the estate, and in fact, may result in the recognition of losses to the estate if the executor is alert when the time comes to distribute assets in satisfaction of the marital bequest.

23. Thus, assume the pecuniary bequest to be satisfied is \$250,000 and the executor has the following assets available:

	Value	Adjusted Basis to Estate
Cash	\$250,000	\$250,000
Securities	25,000	50,000
Land	180,000	50,000
	<u>\$455,000</u>	<u>\$350,000</u>

The minimum *value* which the executor could distribute in satisfaction of the bequest is \$250,000. This could be composed of all of the cash; all of the securities and \$225,000 in cash and so on. If the executor desired to distribute greater value he could distribute all of the land (actual value of \$180,000) measured by using its \$50,000 basis, and \$200,000 cash for a total of \$250,000 in basis and \$380,000 in actual value.

24. See discussion of the overfunding concept at note 13 *supra* and accompanying text.

Beyond the immediate tax saving consequences of using the minimum worth bequest, greater flexibility is provided the executor to vary the size (value) of the surviving spouse's bequest. Thus, a shifting of value between the marital and non-marital shares of the estate becomes possible, since in satisfying the marital bequest the executor may use depreciated assets, or cash, thus limiting the value of the assets distributed to the spouse to the pecuniary amount being satisfied, and shifting asset values to the non-marital share. Alternatively, the executor may shift asset values to the marital share by funding the bequest with appreciated assets. The point is that the executor has the choice and post-mortem estate planning is, thus, available to a considerable extent.

Because of the greater flexibility vested in the executor, the minimum worth pecuniary bequest should be used advisedly in estates where beneficiary relationships are less than harmonious, unless the surviving spouse has maximum control over the non-marital share of the estate.<sup>25</sup>

Furthermore, because the executor does have the ability to shift asset values between the marital and non-marital shares, this form of pecuniary bequest should generally not be used in conjunction with a residuary charitable bequest, since this power in the executor may render the amount of the charitable residuary uncertain and possibly non-deductible.<sup>26</sup>

One practical advantage of the minimum worth bequest which is noteworthy is the potential savings in appraisal fees which may be realized through the use of this form as compared with the other two pecuniary formulae and the fractional formula. If the "64-19" formula<sup>27</sup> is used, an appraisal of all estate assets available for distribution is required (at each distribution, as is the case with a properly administered fractional formula); if the true worth formula is used, an appraisal of the assets used to fund the bequest is required; on the other hand, if the minimum worth formula is used, an appraisal is only required of those assets with fair market values less than basis, since it is only in that situation where fair market value becomes administratively relevant. Thus, funding the minimum worth bequest with appreciated assets may entirely avoid a revaluation of estate assets, and result in a substantial reduction of estate appraisal fees.

### C. "Fairly Representative" or "64-19" Provision

Since 1964, marital deduction formula clauses have undergone certain changes, primarily to reflect the requirements of Revenue Procedure 64-19.<sup>28</sup> A pecuniary formula provision which requires dis-

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25. See note 13 *supra*.

26. See, e.g., *First Nat'l Bank v. United States*, 443 F.2d 480 (5th Cir.), *cert. denied*, 404 U.S. 983 (1971); *Stewart v. Commissioner*, 436 F.2d 1281 (3d Cir.), *cert. denied*, 404 U.S. 828 (1971); *Treas. Reg. § 20.2055-2(b)* (1958).

27. See section IV, C *infra*.

28. *Rev. Proc. 64-19, 1964-1 CUM. BULL. 682.*

tributions to be valued at federal estate tax values, and which authorizes the executor to select the assets with which he will satisfy the bequest, is subject to the requirements of this revenue procedure. The requirements of this procedure may be satisfied by using either the minimum worth bequest since the aggregate fair market value of the assets distributed will not be less than the amount of the bequest (the true worth provision is not subject to the revenue procedure), or by a so-called "fairly representative" pecuniary provision which requires that the aggregate fair market value of property distributed in satisfaction of the marital bequest be fairly representative of the appreciation and depreciation in the estate assets occurring between the valuation date and the date or dates of distribution. Remedial statutes incorporating these requirements have been adopted by the legislatures of several states<sup>29</sup> and when this is the case the provision needn't be included in the formula clause.<sup>30</sup> A typical "64-19" provision follows:

In setting aside this bequest, or in making any distribution in respect of this bequest in satisfaction of the above described pecuniary amount, my executor shall value any distribution in kind at the value of such item as finally determined for federal estate tax purposes.

Unless the legislature of the state wherein the decedent was domiciled has enacted a "64-19" statute, the following additional clause will be necessary to comply with the requirements of Revenue Procedure 64-19 and avoid disallowance of the marital deduction:

provided that the property so allocated to this bequest shall be selected in such a manner that such property shall have an aggregate fair market value fairly representative of the appreciation and depreciation in value to the date or dates of such allocation of all property then available for allocation to the above described bequest.

The "64-19" formula substantially removes flexibility to vary the *amount* of the surviving spouse's share since the distribution must take into account appreciation and depreciation occurring in all estate assets available for distribution. For this reason such a provision may be useful in estates with contentious beneficiaries since the size or amount of the marital portion in relation to the non-marital portion of the estate is not subject to the discretion it would be subject to if the above minimum worth provision were used;<sup>31</sup> this aspect of the formula tends to reduce pressures on the fiduciary with regard to allocation of assets to satisfy bequests.

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29. *E.g.*, New York's ESTATES, POWERS AND TRUST LAW § 2-1.9(b)(2) (1967) (aggregate value distributed may not be less than the amount of the bequest); FLA. STAT. § 734.031 (1973) (a fairly representative remedial type statute).

30. Rev. Proc. 64-19, § 2.02, 1964-1 CUM. BULL. 682, at 683. For purposes of this article these "fairly representative" provisions and statutes are referred to as "64-19" provisions or statutes.

31. *See* note 23 *supra*.

As stated above, the use of a "64-19" provision may result in substantial appraisal fees since proper administration of the formula requires a revaluation of *all* estate assets available for distribution in order to assure that the value of the distribution is "fairly representative" of the appreciation and depreciation in estate assets.

Unlike the minimum worth provision, funding a "64-19" bequest with depreciated assets will not result in the recognition of a loss to the estate because the sole value measuring criterion is the federal estate tax value of the asset. That is, the basis of the asset distributed will always be the value of such asset for purposes of determining the satisfaction of the pecuniary obligation. By the same token, no gain is recognized upon funding this bequest with appreciated assets which were included in the gross estate.

In none of the three foregoing pecuniary formulae is the marital share considered to be a "beneficiary succeeding to the property of the estate" for purposes of sharing in excess deductions and losses on termination of the estate.<sup>32</sup> This factor may not carry great weight in choosing between a pecuniary formula and a fractional formula, but it is worth noting.

#### D. *The "Fractional Residuary" Provision*

The second type of formula bequest is the fractional formula bequest. The fraction may be stated in general terms<sup>33</sup> or it may be stated in detail, such as the following provision:

All the rest, residue and remainder of my estate, real or personal, of whatever nature and wherever located, (with the exception of property over which I have a power of appointment created on or before October 21, 1942, which power, if any, I hereby expressly decline to exercise) remaining after the payment of all death taxes as directed by Article X of this will, legally enforceable debts, expenses of administration and any other legally enforceable charges against my estate I give as follows:

If my wife survives me, I give to her the following described fractional share of my residuary estate:

The numerator of the fraction shall be the maximum estate tax marital deduction (allowable in determining the federal estate tax payable by reason of my death) minus the federal estate tax value of all items included in my gross estate which qualify for said deduction and which pass or have passed (as such terms are defined in section 2056(e) of the Internal Revenue Code of 1954 and successor statutes) in a form which qualifies for the federal estate tax marital deduction from me to my said wife under other provisions of

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32. Treas. Reg. § 1.642(h)-3 (1956).

33. Such terms include a bequest of "that fractional part of the residuary estate equal to the maximum marital deduction."

this will, by operation of law, pursuant to contract and otherwise than under this fractional share gift of my residuary estate. The denominator of the fraction shall be the value of my residuary estate (in computing both the numerator and the denominator the values as finally determined for federal estate tax purposes shall control).

The general rule, simply stated, is that the fractional share formula bequest entitles the widow to a fraction of *each item* in the residue.<sup>34</sup> As with most rules which are easy to state, it is easier said than done.

Assuming a "true residuary" bequest,<sup>35</sup> the phrase "each item in the residue" means the items in the residue at the time of distribution.<sup>36</sup> The ease or difficulty encountered in applying the fraction to each of these items is a function of the type of assets involved. Obviously, no problem is encountered in applying a fraction of 766/1000 to a residue consisting entirely of cash. But the residue of an estate rarely consists entirely of cash, so problems are to be expected. For example, if the residue consists of shares of stock the fraction will be applied to the number of shares, any odd shares will be sold and the proceeds allocated pro rata to the marital and non-marital bequests.<sup>37</sup> Of course, this procedure may also have the undesirable result of creating odd-lots of shares.<sup>38</sup> A better alternative may be to reach some kind of agreement between the respective beneficiaries—a give and take arrangement, which, even though it may result in taxation to the beneficiaries, may prove to be a more workable approach.

Similar, and perhaps more complicated problems present themselves via this fractionalization issue when closely-held stock or investment realty are involved since fractionalization may result in an impairment of value and marketability.<sup>39</sup> From the foregoing discussion, it is evident that the use of the formula fractional bequest is appropriate in an estate consisting mostly of cash, insurance, and other highly liquid assets, thus avoiding the fractionalization problem. This formula may be used where other types of assets are involved, but perhaps assets such as closely-held stock or investment realty should be the subjects of specific bequests.

Use of the fractional formula bequest may be appropriate in the estate of an author, an insurance salesman, or other estates where it is expected that a substantial part of the asset value will consist of items of income in respect of a decedent. Funding the fractional formula

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34. R. COVEY, *THE MARITAL DEDUCTION AND THE USE OF FORMULA PROVISIONS* (1966) [hereinafter cited as COVEY].

35. *Id.*

36. CASNER, *supra* note 11, at 799.

37. See, e.g., Tarbox, *The Pregnant Marital Deduction*, 112 *TRUSTS & ESTATES* 414, 416 (1973) [hereinafter cited as Tarbox].

38. COVEY, *supra* note 34.

39. Trapp, *supra* note 13.

bequest with section 691 items will not accelerate income recognition as might be the case if a pecuniary formula bequest is so funded.<sup>40</sup>

The value relationship between the marital and non-marital shares is fixed, since each share receives a uniform proportion of the appreciation and depreciation of the residuary assets. This factor removes the discretion the fiduciary would have (regarding the size and composition of the marital share) if a pecuniary formula were used, and thus eliminates or reduces to a considerable extent beneficiary pressures on the fiduciary to allocate value and/or specific assets to or away from the marital share.<sup>41</sup> The sharing of appreciation factor may be troublesome if it is important to avoid overfunding of the marital deduction and consequent enlargement of the surviving spouse's estate.

Since manipulation of the size of the marital bequest is virtually eliminated when the fractional formula is used, this form is entirely compatible with a residuary charitable bequest.

The fraction itself is easily arrived at—initially. The problem is, that each time a non-pro rata distribution is made the fraction must be recalculated.<sup>42</sup> The numerator and denominator are originally computed using federal estate tax values. The estate is then revalued at each partial distribution, reduced by all unpaid principal charges, and the fraction then recast in terms of current market values. The numerator is reduced by distributions to the spouse and the denominator is reduced by distributions to the spouse and other beneficiaries, payment of expenses (whether or not deductible), and the like.<sup>43</sup> A new fraction is then arrived at which is to be used for the period until the next partial distribution.<sup>44</sup>

As this fraction is to be applied to distributions of property to the widow in satisfaction of her bequest, some questions arise as to its applicability in allocation of the residuary income of the estate, *i.e.*, what is the effect of a payment of administrative expenses from the non-marital share, etc.<sup>45</sup> There appear to be two principal methods of solving this allocation problem (the problem concerns allocation of the income earned on assets which are used to pay expenses, taxes, etc.)<sup>46</sup>

Under the gross share method the income is distributed among the residuary beneficiaries in the original shares fixed by the will; this results in a disproportionately greater distribution to the non-marital share, since it has typically been reduced by payment of administrative expenses and taxes.

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40. Treas. Reg. § 1.691(a)-4 (1957). See also Trapp, *supra* note 13.

41. Trapp, *supra* note 13.

42. Polasky, *supra* note 17, at 841-42.

43. COVEY, *supra* note 34; Tarbox, *supra* note 37, at 459, quoting Covey, *Recent Developments Concerning Estate, Gift and Income Taxation—1972*, 7 U. MIAMI INST. ON ESTATE PLAN. § 73.124, at 111 (1973).

44. See authorities cited in note 43 *supra*.

45. Cf. Polasky, *supra* note 17, at 848.

46. COVEY, *supra* note 34.

Under the net share method the income is allocated among the residuary beneficiaries based on the net distributable shares of the beneficiaries. This method benefits the marital share since its relative proportion of the residue increases as administrative expenses and taxes are paid out of the non-marital share.

Intelligent estate planning dictates that the method by which estate income is to be allocated should not be left to guesswork or to the courts, but rather should be specified in the instrument.

#### V. CONSTRUCTION PROBLEMS: STATE LAW

State law construction problems have primarily involved a determination of whether a pecuniary or fractional formula bequest was intended by the testator. State courts, being generally unskilled in federal tax matters, have tended to construe the various formulae every which way—except in the manner the testator may actually have intended.

New York, of course, has produced a plethora of litigation on whether a particular provision was intended to be a formula pecuniary or a formula fractional bequest.<sup>47</sup>

The primary administrative effect of a provision being construed as a formula fractional bequest is to permit the surviving spouse to share in the appreciation (and depreciation) of the residuary assets.<sup>48</sup> The courts have felt that this is just what the testator would have wanted (it somehow seemed better than just giving *W* a fixed amount, regardless of appreciation) and consequently have tended to construe questionable provisions as residuary bequests.<sup>49</sup> In fact, some courts have bent over backwards to so construe certain bequests.<sup>50</sup> The courts have generally based their decisions construing fractional bequests on the use of such language as: "a *portion* of my estate . . .",<sup>51</sup> "that *part* of my . . . estate. . .",<sup>52</sup> "the value of *one half* of my

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47. See, e.g., *In re Penny's Will*, 43 Misc. 2d 517, 251 N.Y.S.2d 490 (Sur. Ct. 1964); *In re Ossman's Will*, 27 Misc. 2d 632, 209 N.Y.S.2d 251 (Sur. Ct. 1960); *In re Estate of Florence F. Bing*, 23 Misc. 2d 326, 200 N.Y.S.2d 913 (Sur. Ct. 1960); *In re Estate of Theodore F. Mueller*, 34 Misc. 2d 584, 228 N.Y.S.2d 399 (Sur. Ct. 1962).

48. This is necessarily the effect of a fractional share bequest; the beneficiary receives a fractional part of each asset in the residue, and, if such asset has appreciated, the beneficiary likewise receives the same fractional share of the appreciation which goes along with the asset.

49. At least two reported cases have noted a constructional preference for the fractional share bequest because of the appreciation sharing factor. *In re Penny's Will*, 43 Misc. 2d 517, 251 N.Y.S.2d 490 (Sur. Ct. 1964); *In re Schimenti's Will*, 42 Misc. 2d 983, 249 N.Y.S.2d 641 (Sur. Ct. 1964).

50. *In re Palitz*, 27 N.Y.2d 540, 261 N.E.2d 261, 313 N.Y.S.2d 118 (1970). In this case the bequest was of such part of the estate as equals the *amount* by which one-half of the adjusted gross estate exceeded the other qualifying gifts to the wife. The court held it was a fractional bequest.

51. *In re Penny's Will*, 43 Misc. 2d 517, 518, 251 N.Y.S.2d 490, 491 (Sur. Ct. 1964); *In re Estate of Theodore F. Mueller*, 34 Misc. 2d 584, 585, 228 N.Y.S.2d 399, 409 (Sur. Ct. 1962) (emphasis added).

52. *In re Estate of Florence E. Bing*, 23 Misc. 2d 326, 327, 200 N.Y.S.2d 913, 914 (Sur. Ct. 1960) (emphasis added).



adjusted gross estate . . .",<sup>53</sup> "such *percentage* . . .";<sup>54</sup> the decisions construing formula pecuniary bequests have hinged on the use of such language as: "*amount*" or "*sum*".<sup>55</sup> In Florida, the courts have exhibited somewhat greater insight and common sense than the New York courts. In the two reported Florida appellate decisions, the following bequests have been properly construed as pecuniary formula bequests: "50% of my adjusted gross estate. . .",<sup>56</sup> and "one-half of my adjusted gross estate."<sup>57</sup> To avoid these problems, in any jurisdiction, it is best to spell out what type of bequest is intended rather than leave that determination to the state courts.

Additional construction problems arising at the state level include: the refusal of state courts to reduce the amount of the formula gift by other qualifying property passing to the surviving spouse (when such reduction was not clearly stated), thus rejecting the contention that a primary purpose of using the formula provision is to preclude overfunding of the marital deduction;<sup>58</sup> confusion regarding computation of the fraction and its administration;<sup>59</sup> problems concerning which items are to be deducted before the adjusted gross estate is determined;<sup>60</sup> and problems with whether the marital share is to be charged with any taxes or expenses of administration.<sup>61</sup> The foregoing should serve to illustrate the care and specificity required in the drafting of these provisions. It is generally advisable to include specific statements of intent throughout the will to further insure against litigation.

## VI. THE EXECUTOR'S POWER TO AFFECT THE AMOUNT OF THE FORMULA BEQUEST

The ability of the executor to affect the amount of the formula bequest may be classified into those powers created by the Internal Revenue Code and those powers created by the dispositive provisions of the instrument itself.<sup>62</sup>

The powers of the executor created by the Internal Revenue Code

53. *In re Ossman's Will*, 27 Misc. 2d 632, 633, 209 N.Y.S.2d 251, 252 (Sur. Ct. 1960) (emphasis added).

54. *Estate of Victor Mauck*, 20 Fiduc. Rep. 113 (Orphan's Ct., Montgomery County, Pa. 1970) (emphasis added).

55. *Gilmour's Estate*, 18 App. Div. 2d 154, 156, 238 N.Y.S.2d 624, 625 (Sup. Ct. 1963); *Gauff's Estate*, 27 Misc. 2d 407, 408, 211 N.Y.S.2d 583, 585 (Sur. Ct. 1960) (emphasis added).

56. *King v. Citizens & S. Nat'l Bank*, 103 So. 2d 689, 690 (Fla. 3d Dist. 1958).

57. *Rose v. First Nat'l Bank*, 165 So. 2d 226, 227 (Fla. 3d Dist. 1964).

58. *Reben's Will*, 115 N.Y.S.2d 228 (Sur. Ct. 1952); *Ganong v. Hauger*, 239 Ore. 483, 398 P.2d 187 (1965).

59. See Covey's comment on Surrogate Di Falco's opinion in one of the *Palitz* cases, Covey, *Recent Developments Concerning Estate, Gift and Income Taxation*—1972, 7 U. MIAMI INST. ON ESTATE PLAN. § 73.124, at 111 (1973).

60. *Estate of Modisette*, 53 Misc. 2d 1050, 280 N.Y.S.2d 611 (Sur. Ct. 1967).

61. *Ballantine v. Tomlinson*, 293 F.2d 311 (5th Cir. 1961), *applying* FLA. STAT. § 734.05 (1959).

62. CASNER, *supra* note 11, at 788.

generally operate in such a manner as to directly affect the size of the adjusted gross estate for federal estate tax purposes, thereby affecting any formula gift geared to the adjusted gross estate. Such Code granted powers include:

- (1) the election under section 642(g) which permits the executor to choose whether to deduct section 2053 and section 2054 items on the estate tax return or on the fiduciary income tax return;
- (2) the section 2032 alternate valuation date election, whereby the executor may directly affect the amount of a formula bequest;
- (3) the election under section 213(d) which authorizes the executor to deduct the decedent's last medical expenses either on the estate tax return as a section 2053 item or on the decedent's last income tax return.

Faced with these possibilities, it is prudent for the draftsman to include provisions expressly authorizing the executor to exercise his discretion in the interest of an overall tax reduction in making any such election, and as an essential part of such authorization, the draftsman should include a provision directing that no compensating adjustments between income and principal or between the marital and other bequests shall be made as a result of such elections by the executor.<sup>63</sup>

With regard to the powers created by the instrument itself, the executor may be authorized to satisfy pecuniary marital bequests by distributing cash or assets in kind or a combination of both. Such authority usually includes a provision (or implies it) empowering the executor to choose those assets with which he will satisfy the pecuniary bequest. With the added direction in the instrument that the funding of the bequest be measured by the federal estate tax values of the assets distributed in kind it was possible for the executor to fund the bequest with depreciated or low value assets, thereby creating the very real possibility that the surviving spouse would receive assets with date of distribution values far below the marital gift to her. The Internal Revenue Service blocked this manipulative path with the issuance of Revenue Procedure 64-19.<sup>64</sup> This pronouncement deals specifically with the situation where the executor is authorized to choose, in his discretion, assets to distribute in kind to satisfy a pecuniary marital bequest at federal estate tax values. The service now requires that either the instrument or local law provide that the assets distributed in kind to satisfy such bequest be either: (1) fairly representative of the appreciation and depreciation in the estate assets avail-

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63. Fleming, *From Peter to Paul*, 96 TRUSTS & ESTATES 1089 (1957); cf. *Warms' Estate*, 140 N.Y.S.2d 169 (Sur. Ct. 1955).

64. Rev. Proc. 64-19, 1964-1 CUM. BULL. 682.

able for distribution, or (2) have an aggregate fair market value at the date or dates of distribution no less than the amount of the pecuniary bequest being satisfied.<sup>65</sup> Notwithstanding the requirements of Revenue Procedure 64-19 and the various state "64-19" statutes, the executor still retains substantial power to vary the actual amount (in funding) of the marital bequest, especially where the "minimum worth" formula pecuniary bequest is utilized with a provision waiving the applicability of the state "64-19" statute (if it is of the "fairly representative" variety).

The executor's ability to affect the composition of a fractional formula bequest varies proportionately with the testator's definition of the residue.<sup>66</sup> The larger the residue, the less the executor may affect its composition.<sup>67</sup> The maximum possible residue would consist of all property disposed of by the will, that is, where the will contained no specific bequests or the like.<sup>68</sup> When legacies, administrative expenses, estate taxes, etc., are to be paid before the residue is constituted, the residue is, of course, reduced. Each time the defined residue is so reduced the executor's power to determine those items which will initially constitute the residue is increased since he has the discretion to first select the assets which are to be used in satisfaction of these prior amounts.<sup>69</sup> Covey<sup>70</sup> has indicated a preference for what he terms the "true residuary" fractional share provision, that is, defining the residue as that which is left after payment of debts, administration expenses and all estate and death taxes, thus indicating a preference for maximizing the executor's power to determine the composition of the residue. This "true residuary" provision is to be preferred, if for no other reason, than for its ease of administration. That is, it is somewhat easier to administer than its counterpart, the "pre-tax" residuary provision, which defines the residue as being that which remains after payment of all legacies, debts, and administrative expenses, but *before* payment of taxes. The "pre-tax" provision merely complicates matters as it may require a tracing of the assets which initially constituted the residue (and parts of which were liquidated to pay taxes) in order that the spouse receive the proper proportion of each item distributable to the marital share.<sup>71</sup>

## VII. INCOME TAX CONSEQUENCES

A pecuniary formula bequest is considered a bequest of a specific sum, an amount, so that the satisfaction (funding) of such bequest with

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65. Rev. Proc. 64-19, § 2.02, 1964-1 CUM. BULL. 682, 683.

66. CASNER, *supra* note 11, at 799; Casner, *How to Use Fractional Share Marital Deduction Gifts*, 99 TRUSTS & ESTATES 190 (1960).

67. See authorities cited in note 66 *supra*.

68. See authorities cited in note 66 *supra*.

69. See authorities cited in note 66 *supra*.

70. COVEY, *supra* note 34.

71. CASNER, *supra* note 11.

appreciated assets will generally result in a taxable gain being recognized to the estate, the amount of the gain being the difference between the adjusted basis of the asset and its fair market value at the date of distribution.<sup>72</sup> This is only true with respect to the true worth pecuniary provision, since its funding is measured by the fair market value of the assets distributed at the date or dates of distribution.<sup>73</sup> The estate is deemed to have exchanged the distributed assets in satisfaction of the pecuniary obligation and the rules of sections 1001 and 1002 then apply.<sup>74</sup> In the absence of contrary language in the instrument, the date of distribution values will be used and recognition of gain is possible.<sup>75</sup> By using the minimum worth or "64-19" pecuniary formulae, gain on distribution of appreciated assets goes unrecognized. The funding of the "64-19" bequest is measured by federal estate tax values, thus the pecuniary sum is satisfied with assets whose bases equal the obligation being satisfied and no gain or loss is realized or recognized. The minimum worth provision directs funding of the bequest (generally) at the lower of the date of distribution values or the federal estate tax values of the assets distributed,<sup>76</sup> thus any time the date of distribution values are considered in measuring the funding of the bequest they will *always* be *lower* than the adjusted basis of the asset, resulting in *recognized loss* to the estate only, and no gain.<sup>77</sup>

Fractional share formula provisions generally produce no recognized gain on funding,<sup>78</sup> with the exception of the situation where the will provides that the executor need not apply the fraction to certain assets and may substitute others to assure ease of administration. This

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72. *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940); *Suisman v. Eaton*, 15 F. Supp. 113 (D. Conn.), *aff'd per curiam*, 83 F.2d 1019 (2d Cir. 1935), *cert. denied*, 299 U.S. 573 (1936). Both of these cases involved non-formula pecuniary bequests, but the principle is equally applicable to formula pecuniary bequests. Rev. Rul. 60-87, 1960-1 CUM. BULL. 286; Rev. Rul. 56-270, 1956-1 CUM. BULL. 325. See also Durbin, *Marital Deduction Formula Revisited*, 102 TRUSTS & ESTATES 545 (1963).

73. M. FERGUSON, J. FREELAND & R. STEPHENS, *FEDERAL INCOME TAXATION OF ESTATES AND BENEFICIARIES* 548-55 (1970) [hereinafter cited as FERGUSON].

74. E.g., *International Freighting Corp. v. Commissioner*, 135 F.2d 310 (2d Cir. 1943); *Commissioner v. Mesta*, 123 F.2d 986 (3d Cir. 1941); E.F. Simms, 28 B.T.A. 988 (1933); *Estate of Stauffer*, 30 T.C. 1244 (1958). *But cf.* Rev. Rul. 55-410, 1955-1 CUM. BULL. 297, where the Internal Revenue Service refused to apply this principle to a transfer of appreciated securities to a charity in discharge of a charitable pledge.

75. Durbin, *Marital Deduction Formula Revisited*, 102 TRUSTS & ESTATES 545 (1963).

76. It is best to include in the formula an alternative funding method utilizing the lower of the adjusted income tax bases or fair market values at the date or dates of distribution. This avoids any problem concerning the distribution of after-acquired assets (subsequent to the date of death) in satisfaction of the bequest.

77. § 267(a)(1) will not cause disallowance of the loss unless the distribution is between a fiduciary of one trust and a fiduciary of another trust where the same person is a grantor of both trusts, or if the distribution is between a fiduciary of a trust and a beneficiary of such trust. The section has no application to distributions between an estate and the beneficiaries thereof. At least one authority feels that no loss would be recognized because satisfaction of a minimum worth bequest does not constitute a sale, exchange or relinquishment of a fixed obligation. See Polasky, *supra* note 17, at 867.

78. Rev. Rul. 60-87, 1960-1 CUM. BULL. 286.

may create a dollar claim in favor of the marital share which, when satisfied, will have the consequences discussed above—that is, gain may be recognized to the estate.<sup>79</sup> As a corollary, when a substitution provision is not included in the will, but rather the widow and the executor agree to a substitution of assets to avoid splitting certain properties, the widow may have to recognize a gain, as she will be deemed to have received the fractional share of the asset she was supposed to have received and then exchanged such fractional share for the asset she actually did receive.<sup>80</sup>

As a general rule, distributions of property in satisfaction of both fractional and pecuniary formula provisions carry out estate distributable net income (DNI) and are includable in the gross income of each beneficiary according to his ratable share of such DNI.<sup>81</sup> Excepted from this general rule are bequests of a specific sum of money or of specific property.<sup>82</sup> Strangely enough, pecuniary formula bequests, while considered to be bequests of a specific sum of money for purposes of gain recognition on funding with appreciated assets, are not considered specific bequests for purposes of the above exception and, thus, follow the general rule stated above, *i.e.*, they carry out estate DNI as a distribution and are includable in the beneficiary's gross income.<sup>83</sup>

Generally, assets distributed in kind in satisfaction of a formula bequest will have a basis in the hands of a beneficiary equal to their fair market value at the date or dates of distribution (regardless of which type of formula is used) to the extent that such fair market value carries out estate DNI and is included in the beneficiary's gross income.<sup>84</sup> To the extent that the value of the property is not included in the gross income of the beneficiary (as for example, when the fair market value of the in kind distribution exceeds the DNI of the estate), its basis is determined under section 1014 or section 1012.<sup>85</sup> As pointed out above, distributions in kind in satisfaction of true worth pecuniary provisions are not only included in the beneficiary's income as a distribution of DNI, but also may produce a gain to the estate as well.<sup>86</sup>

As a final point in the consideration of the income tax consequences of the various formulae, we must consider the troublesome items of income in respect of a decedent. Generally, the executor may

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79. Casner, *How to Use Fractional Share Marital Deduction Gifts*, 99 TRUSTS & ESTATES 190 (1960).

80. Polasky, *supra* note 17, at 863; Casner, *How to Use Fractional Share Marital Deduction Gifts*, 99 TRUSTS & ESTATES 190 (1960).

81. Treas. Reg. § 1.661(a)-2(f) (1956); FERGUSON, *supra* note 73, at 383; ASOFSKY, POST-MORTEM ESTATE PLANNING 178-88 (1974).

82. INT. REV. CODE OF 1954 § 663(a)(1).

83. Treas. Reg. § 1.663(a)-1(b)(1) (1956); Rev. Rul. 60-87, 1960-1 CUM. BULL. 286.

84. Treas. Reg. § 1.661(a)-2(f)(3) (1956).

85. *Id.*; Rev. Rul. 64-314, 1964-2 CUM. BULL. 167.

86. FERGUSON, *supra* note 73.

distribute section 691 items to specific or residuary legatees without acceleration of taxation.<sup>87</sup> Specific legatees, as used here, are those persons entitled to receive the specific section 691 item from the estate in a transfer which qualifies under section 663(a)(1).<sup>88</sup> The term has no reference to the pecuniary formula clauses; and in fact, when a section 691 item is transferred to a beneficiary in satisfaction of a pecuniary amount, it may be deemed to be a sale, exchange, or other disposition such as would accelerate taxation of the income to the estate (transferor).<sup>89</sup> In an estate planning sense, whenever the minimum worth or true worth pecuniary provisions are used, it is advisable to also include a direction to the executor that no section 691 items shall be used to fund the bequest. If this direction is omitted, counsel for the estate should promptly advise the executor of the tax consequences of satisfying pecuniary bequests with such items. As mentioned above, there is no acceleration when such items fall into the residue and become fractionalized to satisfy a fractional share formula bequest.<sup>90</sup>

### VIII. OPTIONAL CLAUSES

State law usually provides for the order of abatement of legacies should the estate be insufficient to cover all debts, expenses, and legacies. According to a typical statute,<sup>91</sup> the first to abate are the residuary bequests (the fractional share formula bequests) and next in line are the general legacies (the pecuniary formula bequests). From this it should be clear that in the event of an insufficiency in estate assets the marital deduction is jeopardized. A cure is available; the typical abatement statute is inapplicable if the will discloses an intent that an alternative order of abatement is to apply.<sup>92</sup> The instrument should specify that the predominant intent is to obtain the maximum marital deduction for the estate, and a specific order of abatement should be included.

The will should contain specific provisions directing payment of *all* death taxes from the non-marital assets in order that the full amount of the marital deduction may be preserved.<sup>93</sup> This is especially important if a residuary fractional bequest is used since state statutes generally provide that in the absence of contrary directions in the will, the entire residuary estate is to bear the tax burden.<sup>94</sup> As a corollary, in light of *Ballentine v. Tomlinson*,<sup>95</sup> it is important when utilizing the

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87. Treas. Reg. § 1.691(a)-4(b)(2) (1957).

88. Cf. Treas. Reg. § 1.691(a)-2 (1957).

89. FERGUSON, *supra* note 73, at 298-99.

90. Treas. Reg. § 1.691(a)-4(b)(2) (1957).

91. E.g., FLA. STAT. § 734.06 (1973).

92. *Id.*

93. INT. REV. CODE OF 1954 § 2056(b)(4)(A). The instrument should specify that the non-marital share shall bear the burden of all death taxes imposed by virtue of inclusion of assets in the gross estate pursuant to INT. REV. CODE OF 1954 §§ 2033-44.

94. See, e.g., FLA. STAT. § 734.041(1)(a) (1973).

95. 293 F.2d 311 (5th Cir. 1961), *applying* FLA. STAT. § 734.05 (1959), which requires, in

fractional residuary formula to include a clause exempting the marital share from any charge for administrative expenses or other such expenses.

Other clauses which should be considered both for federal tax purposes and administrative purposes are:

(1) the "tainted asset" clause—this clause is designed to avoid the problems which arise under section 2056(b)(2), that is, the possibility of funding the marital share with assets or with the proceeds from the sale of assets considered non-deductible under section 2056(b)(1), such as certain terminable interests.<sup>96</sup> This clause directs that the marital bequest may only be satisfied with assets which will qualify for the marital deduction.

(2) a clause, in conjunction with the true worth or minimum worth pecuniary formulae, which directs that the marital bequest not be funded with section 691 items. This will avoid acceleration of such items.<sup>97</sup>

(3) a clause excluding from the pool of assets available to satisfy the marital share assets which qualify for the foreign tax credit, because, to the extent that such assets are used to fund the marital share, the foreign tax credit will be lost.<sup>98</sup>

(4) a clause establishing a standard to guide the executor in deciding where to claim administrative expenses and losses, such as "to effect . . . an overall reduction in the income and death taxes for the benefit of my estate and of the income beneficiary or beneficiaries thereof."<sup>99</sup> In conjunction with this clause a provision should be included directing that no compensating adjustments (Warms adjustments) between income and principal or in the amount of the marital bequest be made as a result of the executor's elections.<sup>100</sup>

(5) a simultaneous death clause<sup>101</sup> specifying the order of

the absence of contrary language in the instrument, that expenses of administration, etc., be charged against the residue. Thus, a fractional marital bequest will be charged with its proportionate share of such expenses, and the marital deduction will be consequently reduced unless a contrary provision is included in the will.

96. Regarding this Code section, it is immaterial that such tainted assets are not in fact used to fund the marital; the issue is whether such assets (or their proceeds) *may* be so used. See note 2 *supra*.

97. Such a clause, unlike the "tainted asset" clause, needn't be mandatorily included in the instrument to prevent acceleration, for in this regard the issue is not "what *may* the executor do," but rather "what *did* the executor do." Thus, if such clause is omitted, post-mortem planning can pick up where the inter vivos planning left off. Income tax acceleration is discussed in Section VII *supra*.

98. Treas. Reg. § 20.2014-3(b) (1958).

99. Fleming, *From Peter to Paul*, 96 TRUSTS & ESTATES 1089, 1092 (1957).

100. *Id.*

101. Common disaster language is frequently used in an attempt to draft a simultaneous death provision. A typical common disaster provision may read: "If my wife and I die as a result of a common disaster, then this bequest shall pass to my son." A bequest in this form would

death when *H* and *W* are both killed in a situation where it is impossible to determine which died first. This type of clause is useful if *H* owns the bulk of the couple's assets. The clause would generally specify that *W* survived him, thereby breaking up *H*'s large estate into two smaller ones with a consequent reduction in the marginal estate tax brackets and the utilization of two section 2052 exemptions.

(6) a "survivorship clause"—this specifies that the surviving spouse shall receive the marital bequest if she survives the decedent by a certain period of time. The specified period of time may not exceed six months, and if the survival provision is stated as a condition, the condition must be one which must occur within the six month period, or the marital deduction is lost.<sup>102</sup>

The survivorship clause is useful when the two estates are nearly equal in value and for one reason or another it has been decided that the marital deduction will be utilized. If the surviving spouse does not survive for at least six months, the reasons for choosing to utilize the marital deduction usually no longer exist, and this type of clause takes this into account and extinguishes the marital bequest.

## IX. CONCLUSION

The marital deduction can be the most important tax planning technique available in most estates. Loss of this benefit through improper drafting of the bequest is at best inexcusable. Proper utilization of a formula clause requires a knowledge of the administrative aspects as well as the potential tax benefits available. This article has attempted an overview of a complicated tax planning area and was not intended to be exhaustive in its coverage.

In planning the client's estate the attorney must weigh many factors in addition to the pros and cons discussed in this article. He should not force his "pet" clauses down the client's throat. His primary duty is to ascertain what the client wants and, to the best of his ability, preserve and carry out those wishes, which will be evidenced by a will or trust after the client has been made fully aware of the tax and administrative consequences of the available alternatives.

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ordinarily constitute a non-deductible terminable interest but for the possible application of the statutory exception found in § 2056(b)(3). If a property interest passed from the decedent to his surviving spouse subject to the condition that she does not die as a result of a common disaster which also resulted in the decedent's death, the above mentioned exception will not apply; and the marital deduction will be lost, if, at the time of the final audit of the estate tax return, there is still a *possibility* that the surviving spouse may die as a result of the common disaster which resulted in the decedent's death and thus be deprived of the marital bequest. Treas. Reg. § 20.2056(b)-3(c) (1954).

102. INT. REV. CODE OF 1954 § 2056(b)(3); Treas. Reg. § 20.2056(b)-3 (1954).