1980

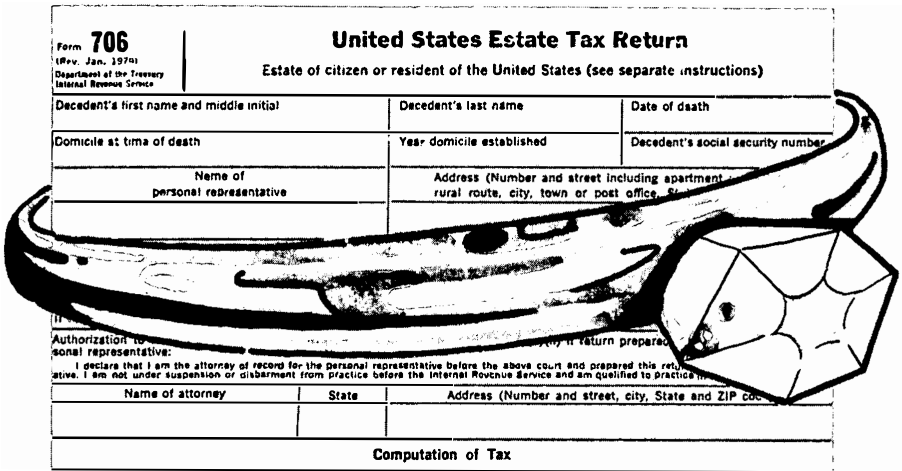
The Estate Tax Marital Deduction

Harold Dubroff
Douglas A. Kahn
University of Michigan Law School, dougkahn@umich.edu

Recommended Citation
Kahn, Douglas A. "The Estate Tax Marital Deduction." H. Dubroff, co-author. *Prac. Law.* 26, no. 7 (1980): 23-42.

The Estate Tax Marital Deduction

Harold Dubroff and Douglas A. Kahn



covers and illustrates
the technical requirements for a qualified
marital deduction, the limitations on the amount
of the deduction, and the terminable interest rule.
This article is based on a chapter in an ALI-ABA book,
FEDERAL TAXATION OF ESTATES, GIFTS, AND TRUSTS
(3d ed. 1980).

The cstate tax marital deduction, section 2056 of the Internal Revenue Code ("Code"), was enacted in 1948, along with the split-income provisions of the income tax law and the

Harold Dubroff is Professor of Law at the Albany Law School of Union University and author of THE UNITED STATES TAX COURT: AN HISTORICAL ANALYSIS (1979).
Douglas A. Kahn is Professor of Law at the University of Michigan Law School and author of FEDERAL INCOME TAX (1979) and coauthor of CORPORATE TAXATION AND TAXATION OF PARTNERSHIPS AND PARTNERS (1979) and FEDERAL TAXATION OF GIFTS, TRUSTS, AND ESTATES (1977).

marital deduction and split-gift provisions of the gift tax law. The purpose was to give married residents of common law states approximately the same federal tax advantages that were available to married residents of community property states.

Ordinarily, upon the death of a married resident of a community property state, only one-half of the community property is taxed in the decedent's estate. Section 2056 achieves approximately the same result for married residents of common law states by providing a deduction—limited, in general, to the greater of $250,000 or one-half of the estate—for the value of property interests included in the decedent's gross estate that pass from the decedent to the surviving spouse.

The surviving spouse's interest in community property is a fee interest that, if retained until death, will be subject to estate tax. In order to mirror this aspect of community property, section 2056 does not permit a marital deduction for life estates or certain other so-called terminable interests that would not be taxable in the surviving spouse's gross estate.

If an interest qualifying for the marital deduction has passed from the decedent to the surviving spouse, the deduction may not be waived in order to reduce the estate of the surviving spouse or to obtain other tax advantages in the estate of the decedent or the surviving spouse. Rev. Rul. 59-123, 1959-1 C.B. 248. However, if the surviving spouse makes a qualified disclaimer of a property interest that otherwise would pass from the deceased spouse, the disclaimed interest is not deemed to pass to the surviving spouse. §§2045 and 2518 of the Code, to which all future section references will be made, unless indicated otherwise.

The marital deduction is computed on Schedule M.

RESIDENCE AND MARITAL STATUS • Except as otherwise provided by treaty, the marital deduction is available only in the estate of a decedent who was either a citizen or a resident of the United States at the time of death. §2106; Treas. Reg. §20.2056(a)-1(a). The surviving spouse, however, need not be a citizen or a resident of the United States. Treas. Reg. §20.-2056(a)-1(a).

The decedent must have been married at the time of death and survived by the spouse. §2056(a). For purposes of section 2056, a legal separation does not terminate the marital status. S.Rep.No. 1013, 80th Cong., 2d Sess. 6 (1948).

In order to compensate for the unavailability of the marital deduction to nonresident aliens, for the estates of nonresident aliens dying after November 13, 1966, the Foreign Investors Tax Act reduced the maximum rate of the estate tax from 77 per cent to 25 per cent and increased the exemption from $2,000 to $30,000.

Pub. L. No. 89-809, 26 Stat. 861. The Tax Reform Act of 1976 increased the maximum tax rate to 30 per cent and replaced the $30,000 exemption with a unified credit of $3,600. §§2101(d), 2102(c).

If the order of death of the decedent and the spouse cannot be established by proof, a presumption that the spouse survived, created either by the decedent's will or by local law, will be given effect if it causes the marital deduction bequest to be included in the spouse's gross estate. Treas. Reg. §20.2056(e)-2(e); *Estate of Gordon v. Commissioner,* 70 T.C. 404 (1978), *acq.* 1979-1 C.B. 1. As to the effect of the Uniform Simultaneous Death Act on property held in tenancy by the entirety, see Rev. Rul. 76-303, 1976-2 C.B. 266.

If a state court with jurisdiction over the parties or the subject matter declares a divorce invalid, the Internal Revenue Service ("Service") will follow the decision for federal tax purposes. Rev. Rul. 67-442, 1967-2 C.B. 65. A second marriage by either spouse will also be deemed invalid, and any bequests to the putative second spouse will not qualify for the marital deduction.

Not all courts have agreed with the Service that the second decree renders the divorce invalid for tax purposes. *Compare Borax' Estate v. Commissioner,* 349 F.2d 666 (2d Cir. 1965), *cert. denied,* 383 U.S. 935 (1966), *Wondsel v. Commissioner,* 350 F.2d 339 (2d Cir. 1965), and *Feinberg v. Commissioner,* 198 F.2d 260 (3d Cir. 1952), *with Gersten v. Commissioner,* 267 F.2d 195 (9th Cir. 1959). However, the Service generally will not contest the validity of a divorce until a court of competent jurisdiction declares the prior divorce to be invalid. Rev. Rul. 67-442, 1967-2 C.B. 65.

INCLUSION IN GROSS ESTATE • A property interest cannot qualify for the marital deduction unless it is included in the decedent's gross estate. §2056(a).

Examples:

A death benefit payable to the surviving spouse under the decedent's noncontributory qualified pension or profit-sharing plan would not be included in the decedent's gross estate because of section 2039(c). Thus, the benefit could not qualify for the marital deduction.

When the surviving spouse owned a policy on the life of the decedent that was not transferred to him by the decedent within three years of death, the proceeds would not be included in the decedent's gross estate, and they could not, therefore, qualify for the marital deduction.

A property interest passing to the surviving spouse as a surviving joint owner will qualify for the marital deduction only to the extent that the interest is includable in the decedent's gross estate.

If a loss deductible under section 2054 occurs with respect to a property interest, the interest cannot qualify for the marital deduction to the extent of the loss. Treas. Reg. §20.2056(a)-2(b)(3).

PASSAGE TO SURVIVOR • To be deductible, the property interest must "pass" or have "passed" from the decedent to the surviving spouse. §2056(a). An interest includable in the decedent's gross estate may pass to the surviving spouse:

• By bequest, devise, intestacy, dower or curtesy, or election against the will;

• As an appointee or taker in default under the decedent's exercise or nonexercise of a power of appointment;

• By a lifetime transfer;

• As the proceeds of life insurance on the life of the decedent; or

• As a joint tenant with right of survivorship. §2056(e).

Example
H, D's surviving spouse and sole executor of D's estate, received from D's estate $10,000 in repayment of a loan made by H to D during D's lifetime, and $5,000 as an executor's commission. Neither amount is considered as passing from D to H, and thus neither amount can qualify for the marital deduction in D's estate. However, both amounts may be deductible under section 2053.

An interest with respect to which a qualified disclaimer is made by the surviving spouse in favor of another does not pass to the surviving spouse. §§2045, 2518. A disclaimer must be distinguished from acceptance of the interest by the surviving spouse, followed by a transfer. In the latter case, the interest does pass to the surviving spouse and may qualify for the marital deduction. The subsequent transfer may be a taxable gift.

Example
H, D's surviving spouse, was entitled to a $10,000 bequest under D's will and to $50,000 as the sole beneficiary of a life insurance policy on the life of D owned by D. H disclaimed the bequest, which was added to the residue, passing to D's son, S. H directed the life insurance company to hold the $50,000 of insurance proceeds, pay the interest on this amount to him for life, and on his death, to pay the principal to S. The $10,000 bequest is considered as having passed from D to S and thus cannot qualify for the marital deduction. The $50,000 of insurance proceeds are considered as having passed from D to H, thus qualifying for the marital deduction. For gift tax purposes, H has made a gift to S of the remainder interest in the insurance proceeds. Upon H's death, the pro-

ceeds of the insurance policy will be included in his gross estate, since the settlement option he elected constituted a transfer of the proceeds, with a retention of the right to the income for life. *See* §2036.

At one time, an interest disclaimed by another in favor of the surviving spouse was not deemed to have passed from the decedent to the surviving spouse. However, in 1966, section 2056 was amended to provide that in the case of a decedent dying on or after October 4, 1966, property passing to the surviving spouse as a result of a disclaimer by a third party may qualify for the marital deduction to the same extent as though the property had passed to the spouse directly from the decedent. Although the Tax Reform Act of 1976 eliminated the special disclaimer rule in section 2056, it substituted a general disclaimer rule that has the same effect, assuming the statutory requirements of a qualified disclaimer are met. §§2045, 2518.

An interest acquired by the surviving spouse in settlement of a contest of the decedent's will is considered to have passed from the decedent to the surviving spouse if the acquisition constituted a bona fide recognition of his rights in the decedent's estate, as distinguished from a disguised gift to him from other beneficiaries of the estate. Treas. Reg. §20.2056(e)-2(d)(2). *See Farley v. United States,* 581 F.2d 821 (Ct. Cl. 1978); *Bel v. United States,* 452 F.2d 683 (5th Cir. 1971), *cert. denied,* 406 U.S. 919 (1972). A probate decree awarding the interest to the surviving spouse is evidence that the interest passed because of rights in the estate. However, a decree is neither essential nor conclusive. Treas. Reg. §20.2056(e)-2(d)(2); *Estate of Dutcher v. Commissioner,* 34 T.C. 918 (1960); *Estate of Barrett v. Commissioner,* 22 T.C. 606 (1954).

The interest must pass to the surviving spouse as beneficial owner, whether outright or in trust for his benefit. An interest transferred to the surviving spouse as trustee for another or subject to a binding agreement to transfer the interest to another does not pass to the surviving spouse. Treas. Reg. §20.2056-(e)-2(a). *Cf. McLean v. United States,* 65-2 U.S. Tax Cas. ¶12,326 (6th Cir. 1965), *aff'g per curiam* 224 F. Supp. 726 (E.D. Mich. 1963); *First Nat'l Bank v. Nelson,* 355 F.2d 546 (7th Cir. 1966).

AMOUNT OF DEDUCTION • Three limitations provide a ceiling on the maximum allowable marital deduction:

• The marital deduction may not exceed the net value of the property passing to the surviving spouse.

• The marital deduction may not exceed the greater of $250,000 or one half of the decedent's adjusted gross estate ("the Basic Limitation").

• The Basic Limitation is subject to

partial reduction if the decedent made after 1976 lifetime gifts to a spouse that did not exceed $200,000 ("the Gift Tax Limitation").

The net value limitation and the Basic Limitation are applied separately, and the more restrictive of the two controls. The Gift Tax Limitation is effective only in connection with the Basic Limitation. Stated differently, the marital deduction is limited to the lesser of the net value of the property passing to the surviving spouse or the Basic Limitation less the Gift Tax Limitation.

NET VALUE

The net value of an interest passing to the surviving spouse is the gross estate tax value—the date-of-death value, alternate valuation date value, section 2032A value, or section 2040(c) value—of the interest less any charges against the interest. Thus, for example, the gross value of the interest must be reduced by:

- Any federal or local estate or inheritance tax payable, either under the will or applicable local law, out of the interest. §2056(b)(4)(A). If the executor is authorized to pay death taxes out of the marital share of the estate, the value of the interest passing to the surviving spouse must be reduced by the amount of those taxes, even if the executor actually pays the death taxes out of the nonmarital share and thus leaves the marital interest intact. *Estate of Wycoff v. Commissioner,* 59 T.C. 617 (1973), *aff'd,* 506 F.2d 1144 (10th Cir. 1974); Rev. Rul. 79-14, 1979-1 C.B. 309. Therefore, in order to maximize the marital deduction, usually the will should direct that federal and local death taxes be paid from the portion of the estate not qualifying for the marital deduction. *See Dodd v. United States,* 345 F.2d 714 (3d Cir. 1965). In some cases, however, it may be preferable to forego the maximum marital deduction in order to take full advantage of the unified credit.

- Any mortgage or other lien to which the interest is subject. §2056(b)(4)(B). However, if under the will or applicable local law, the estate is obligated to discharge the lien, then the amount of the lien is not deducted in valuing the interest. Treas. Reg. §20.2056(b)-4(b).

- The value of any portion of the interest or of any property owned by the surviving spouse, including any claims against the decedent's estate, that must be transferred to another or surrendered as a condition to taking the interest. *United States v. Stapf,* 375 U.S. 118 (1963); Treas. Reg. §20.2056(b)-4(b).

- The value of any income from the interest that may be utilized to pay administration expenses during the period prior to the distribution of the interest to the surviving spouse or to a trust for his benefit. Treas. Reg.

§20.2056(b)-4(a). Similarly, in valuing a vested remainder passing to the surviving spouse, the actuarial value of the outstanding income interest must be deducted. Treas. Reg. §20.-2056(b)-4(d).

• The amount of administration expenses chargeable under the will or applicable local law to a residuary bequest to the surviving spouse, even if the executor elects to deduct the expenses on the estate's income tax return. *Estate of Roney v. Commissioner,* 33 T.C. 801 (1960), *aff'd,* 294 F.2d 774 (5th Cir. 1961). *See also Ballantine v. Tomlinson,* 293 F.2d 311 (5th Cir. 1961).

The Basic Limitation

The Basic Limitation provides that the marital deduction may in no event exceed the greater of $250,000—subject to reduction in the case of community property—or one-half of the adjusted gross estate. §2056(c)-(1)(A). This formulation of the limitation, provided by the Tax Reform Act of 1976, represents a liberalization of prior law, which limited the deduction to no more than one-half of the adjusted gross estate.

Generally speaking, the 1976 provision is effective for the estates of decedents dying after 1976. For decedents dying before 1979, a special transitional rule generally continues the old law in the case of pre-1977 wills and trusts expressing bequests in terms of a maximum marital deduction formula. Tax Reform Act of 1976, §2002(d)(1)(B).

Example

D, who has not made any intervivos gifts to a spouse, dies, leaving an adjusted gross estate of $300,000. Under D's will, a qualifying interest of $200,000 passes to the surviving spouse. Prior law would have limited the marital deduction to $150,000—one-half the adjusted gross estate of $300,000. Current law allows a marital deduction of $200,000, the amount of the interest passing.

Without Community Property

If no community property is included in the decedent's gross estate, the adjusted gross estate generally equals the gross estate minus the expenses, losses, and debts deducted by the estate under sections 2053 and 2054. §2056(c)(2)(A). For marital deduction purposes, the adjusted gross estate is increased by any generation-skipping transfers of which the decedent is the deemed transferor that occur at the same time as, or within nine months after, his death. §2602(c)(5)(A).

The charitable deduction allowed by section 2055 is not subtracted in determining the adjusted gross estate. Accordingly, transfers to charitable donees made within three years of death that are brought back into the gross estate by section 2035 may serve to reduce the estate tax liability by increasing the maximum marital deduction. *Estate of Russell v. Commissioner,* 70 T.C. 40 (1978), *acq.* 1979-1 C.B. 1

Administration expenses deducted on the estate's income tax return are not subtracted from the gross estate in computing the adjusted gross estate. Rev. Rul. 55-643, 1955-2 C.B. 386. *Cf. Jackson v. United States,* 376 U.S. 503 (1964). If payable from the marital share, however, these expenses may reduce the value of the interest passing to the surviving spouse. *See Estate of Roney v. Commissioner,* 33 T.C. 801 (1960); Rev. Rul. 55-225, 1955-1 C.B. 460.

Example

The value of D's gross estate is $800,000. Deductions allowed on the estate tax return under sections 2053 and 2054 for expenses, debts, and losses total $120,000. D's will provides for a bequest of $40,000 to a charitable organization, for which a deduction is allowed under section 2055; a bequest of $400,000 to H, D's surviving spouse; and a bequest of the residue, after paying all federal and state death taxes therefrom, to S, D's surviving son. The adjusted gross estate is therefore $680,000—$800,000 less $120,000—and the Basic Limitation limits the marital deduction to $340,000—the greater of $250,000 or one-half the adjusted gross estate of $680,000. If the bequest to H were only $250,000, then the marital deduction would have been $250,000.

With Community Property

Married residents of community property states have already accomplished a division of their community assets. In order not to give community property state residents an advantage over common law state residents, the Code prevents the further splitting of community property for marital deduction purposes by special rules applicable to the Basic Limitation.

Thus, in the case of a decedent who has held community property with the surviving spouse, the adjusted gross estate is defined as the gross estate less the sum of all community property included in the gross estate and deductions attributable to the separate property under sections 2053 and 2054, expressed algebraically as that portion of the deductions which bears the same ratio to the total deductions as the separate property in the gross estate bears to the total gross estate. §2056(c)(2)(B). Therefore, if the decedent's gross estate consists solely of community property, the adjusted gross estate will be zero.

If, however, the decedent's gross estate includes some separate property, there will be an adjusted gross estate equal to the value of the separate property less the pro rata share of the deductions under sections 2053 and 2054. In that event, either the decedent's separate property or his share of the community property may qualify for the marital deduction, but in an amount no greater than one-half of the adjusted gross estate computed according to scction 2056(c)(2)(B) or $250,000 less the community property adjustment, whichever is larger.

Example
The valuc of D's gross estate is $1,200,000, consisting of $800,000 of separate property and $400,000 of D's share of community property. Deductions allowed on the estate tax return for expenses, debts, and losses total $180,000. D leaves his separate property to his son, S, and his community property to his surviving spouse, H. D's adjusted gross estatc is $680,000, computed as follows:
The gross estate of $1,200,000 less community property of $400,000 equals $800,000. Subtracting the deductions attributable to the separate property of $120,000—$800,000 over $1,200,000 times $180,000 — leaves an adjusted gross estate of $680,000. Although D left H $400,000, the allowable marital deduction is limited to $340,000—one-half of $680,000.

In computing the adjusted gross estate, certain pre-1927 California community property is treated as separate property, and certain separate property that resulted from the conversion after December 31, 1941, of community property is treated as community property. §§2056(c)(2)(B) and (C).

The $250,000 element of the Basic Limitation is similarly modified to take account of community property by reducing this amount by the excess of the community property included in the gross estate over the deductions under sections 2053 and 2054 attributable to the community property. §2056(c)(1)(C).

Example
The value of D's gross estate is $300,000, consisting of $200,000 of separate property and $100,000 of D's share of community property. Deductions allowed on the estate tax return for expenses, debts, and losses total $45,000. D leaves the community property to his surviving son, S, and his separate property to his surviving spouse, H. The Basic Limitation for D's gross estate will bc the greater of one-half of the adjusted gross estate or $250,000 less adjustments for community property, computed as follows:
From the gross estate of $300,000, subtract $100,000 of community property and $30,000 of deductions attributable to the separate property—$200,000 over $300,000 times $45,000—for an adjusted gross estate of $170,000. The $250,000 limitation adjusted for community property is $165,000, as the $100,000 of cxcess community property minus $15,000 of deductions attributablc to the community property—$100,000 over $300,000 times $45,000—is subtracted from the initial limitation of

$250,000. The amount of the marital deduction will therefore be $165,000, since the $250,000 limitation as adjusted for community property—$165,000—is greater than one-half of the adjusted gross estate of $170,000—$85,000—but less than the net value of property passing to the surviving spouse—$200,000.

Gift Tax Limitation

In addition to liberalizing the estate tax marital deduction, the Tax Reform Act of 1976 also eased restrictions on the gift tax marital deduction. Under prior law, the gift tax marital deduction was limited to half the value of qualifying gifts made to a spouse. This limitation was changed in 1976 to provide that the first $100,000 of qualifying gifts to a spouse made after 1976 be deductible in full; the next $100,000 not be deductible at all; and gifts made above $200,000 be deductible to the extent of half their value. §2523(a). Thus, a greater gift tax marital deduction is available for gifts to a spouse that total less than $200,000, but once the aggregate gifts exceed $200,000, the gift tax marital deduction is the same under current law as before 1976.

Apparently, in liberalizing the estate tax marital deduction, Congress was concerned that benefits would be duplicated unless this deduction was adjusted to take into account the liberalization of the gift tax marital deduction. Accordingly, section 2056(c)(1)(B) was added—and amended by the Revenue Act of 1978—to reduce the Basic Limitation by the excess of the gift tax marital deduction allowed to the decedent for post-1976 gifts over the gift tax marital deduction that would have been allowed to the decedent for post-1976 gifts if the deduction were limited to one-half of the value of the gifts to a spouse required to be reported on a gift tax return—the Gift Tax Limitation.

Intervivos gifts that are included in the gross estate under section 2035 are not taken into account for the purpose of computing the Gift Tax Limitation. If the post-1976 reportable marital gifts do not exceed $200,000 in the aggregate, the amount computed under the Gift Tax Limitation will reduce both elements of the Basic Limitation—the $250,000 element and the one-half of the adjusted gross estate element. Whichever element, as adjusted, is larger will be the Basic Limitation.

Examples

D dies on June 1, 1981. His only intervivos gift was a cash gift of $150,000 on February 1, 1977, to his spouse, H. D's adjusted gross estate —which does not include the intervivos gift, since it was made more than three years before death—equals $400,000. D's will leaves $300,000 to H, with the residue to his son. The Gift Tax Limitation will reduce the Basic Limitation by $25,000, as follows:

Since the gift tax marital deduction in respect of post-1976 gifts is the first $100,000 of gifts, with no further deduction until the aggregate post-1976 gifts exceed $200,000, the excess of the gift tax deduction of $100,000 over the $75,000 that would have been allowable as a gift tax marital deduction if the deduction was limited to 50 per cent of the gifts to the spouse required to be reported on a return, would be $25,000 —thc Gift Tax Limitation. The Basic Limitation as adjusted by the Gift Tax Limitation is $225,000 —the greater of $225,000 ($250,000 less $25,000) or $175,000 (one-half of the adjusted gross estate of $200,000, less $25,000). The marital deduction in respect of D's estate will be $225,000, since the Basic Limitation as adjusted by the Gift Tax Limitation—$225,000—is not more than the net value of the property passing to the surviving spouse —$300,000.

Had D died on June 1, 1977, instead of June 1, 1981, since the $150,000 intervivos gift is included in D's gross estate, there would be no Gift Tax Limitation to reduce the Basic Limitation. Assuming that the section 2035(c) gross-up is not a factor, D's adjusted gross estate would be increased from $400,000 to $550,000 as a result of section 2035(a). The Basic Limitation would be $275,000 —the greater of $250,000 or one-half of the adjusted gross estate—and since the Basic Limitation would not exceed the net value of property passing to the surviving spouse—$300,000—the marital deduction would be $275,000.

The same facts as in the previous Example, except that D makes one additional cash gift to H of $3,000 on February 1, 1978. Since the 1978 gift is not more than $3,000, no gift tax marital deduction is allowable with respect to it and D is not required to include it in a gift tax return. *See* §6019(a). Thus, that gift will have no effect on the computation of the Gift Tax Limitation.

FORM OF TRANSFER • The qualifying interest may pass to the surviving spouse either outright or, subject to the terminable interest rule, in trust. A transfer by will, whether outright or in trust, usually takes one of three forms:

- A transfer of specific property, such as a bequest of 100 shares of corporate stock or a devise of Blackacre;
- A pecuniary bequest, payable in cash or in kind, such as a bequest of $100,000; or
- A transfer of a fractional share or the entirety of a rcsiduary estate, such as a bequest of one-half of the residuary estate.

The amount of a pecuniary bequest or the size of a fractional share of the residue may be either specified or defined by a formula. A formula is frequently used to achieve a total marital deduction precisely equal to one-half of the adjusted gross estate, including nonprobate assets like life insurance and joint property that qualify for the marital deduction.

Subject to specific exceptions, no marital deduction is allowed if the transfer to the surviving spouse is expressed as a pecuniary bequest or gift that the executor or trustee is permitted or directed to satisfy by a distribution in kind at federal estate tax values, unless either the will itself or local law provides one of several protective standards to insure that the surviving spouse will not be treated unfairly in the allocation of estate assets to his share of the estate. Rev. Proc. 64-19, 1964-1 C.B. 682. The ground stated for disallowing the deduction is that the interest passing to the surviving spouse would not be ascertainable as of the date of the decedent's death. See Polasky, *Marital Deduction Formula Clauses in Estate Planning—Estate and Income Tax Considerations,* 63 Mich. L. Rev. 809 (1965).

TERMINABLE INTERESTS • The terminable interest rule seeks to exclude from the marital deduction an interest that would not be includable in the surviving spouse's gross estate, though some interests that are includable may also be disqualified under the rule's technical provisions. *See Jackson v. United States,* 376 U.S. 503 (1964).

A "terminable interest" is an interest that will terminate or fail with the lapse of time or upon the occurrence or nonoccurrence of an event or contingency. §2056(b)(1). Examples are:

- A life estate or an estate for a term of years;
- An annuity;
- A patent or copyright;
- A widow's support allowance that would, under the applicable local law, terminate upon the widow's death or remarriage; and
- A remainder contingent upon the remainderman's surviving the income beneficiary.

The Code states that a bond, note, or similar contractual obligation whose discharge would not have the effect of an annuity for life or for a term is not a terminable interest. §2056(b)(1). The difference between a note payable in installments with interest and an annuity for a term of years is not readily apparent.

A self-liquidating mortgage is like an annuity for a term, but it is also like an installment note; consequently, it is uncertain whether it will be treated as a terminable interest. In all likelihood, any property interest that expires after a stated period or upon the occurrence of a contingency will be treated as a terminable interest, unless expressly excluded by section 2056(b)(1). Not being expressly mentioned in section 2056(b)(1), a self-liquidating mortgage will probably be considered a terminable interest. The Service has recently ruled that an installment contract is a terminable interest. Rev. Rul. 79-224, 1979-2 C.B. 334.

A statutory widow's support allowance of a specified monthly amount during the administration of the decedent's estate will constitute a terminable interest if, under local law, the allowance is terminated by the death or remarriage of the widow. However, if, under local law, the widow's support allowance indefeasibly vests on the decedent's death and is payable irrespective of the widow's death or remarriage during the statutory period for which payment is to be made, the allowance will not be a terminable interest. *Estate of Green v. United States,* 441 F.2d 303 (6th Cir. 1971). *See also Jackson v. United States,* 376 U.S. 503 (1964).

Thus, the Sixth Circuit has allowed a marital deduction for a widow's allowance because, under Miehigan law, the widow's right indefeasibly vested upon the husband's death, but it denied a marital deduction for a widow's allowance because Tennessee law does not give the widow an indefeasibly vested right to the allowance. *Compare Estate of Green v. United States,* 441 F.2d 303 (6th Cir. 1971), *with Hamilton Nat'l Bank v. United States,* 353 F.2d 930 (6th Cir. 1965).

If a widow renounces her deceased husband's will and elects to take a dower interest or a forced statutory share under state law, her share will qualify for the marital deduction if the interest she receives is not terminable. §2056(d)(3); Rev. Rul. 72-8, 1972-1 C.B. 309. In many states, a widow's dower interest in realty is a life estate, which is a terminable interest. If, under state law, a widow can elect to receive in lieu of dower a dollar amount equal to the commuted value of the dower interest, the amount paid to her will qualify for the marital deduction. Rev. Rul. 72-7, 1972-1 C.B. 308, and cases cited therein. Also, an award of a dollar amount in lieu of a widow's homestead pursuant to state law qualifies for the marital deduction. Rev. Rul. 72-153, 1972-1 C.B. 309.

DISQUALIFICATIONS

Not all terminable interests are disqualified for the marital deduction. A terminable interest passing from the decedent to the surviving spouse is disqualified if:

- An interest—whether or not included in the decedent's gross estate—in the same property from which the terminable interest was created passes or has passed—

whether or not at the same time or under the same instrument—from the decedent to any person ("transferee")—whether or not ascertainable—other than the surviving spouse or his estate;

- The interest passes or has passed to the transferee for less than adequate and full consideration in money or money's worth; and

- The transferee, or his heirs or assigns, may possess or enjoy any part of the property after the termination or failure of the interest passing to the surviving spouse. §2056(b)(1)(A) and (B).

Examples

The decedent bequeathed his residuary estate to his surviving spouse for her lifetime, with a remainder over to his children surviving her. (This bequest would have qualified for the marital deduction if the surviving spouse's estate, rather than the children, was designated as the remainderman.)

The decedent bequeathed his residuary estate to his mother for her lifetime, with the remainder over to his spouse if she survived the mother. The mother survived the decedent. (This bequest of a remainder interest to the spouse would have qualified for the marital deduction if the mother had predeceased the decedent or if the spouse's remainder interest vested on the decedent's death rather than being conditioned on the spouse's surviving the mother.)

The decedent purchased a joint and survivor's annuity for himself and his spouse. The annuity contract provided that upon thc death of the survivor of the decedent and his spouse, any excess of the cost of the contract over the total annuity payments previously made shall be refunded to the then living children of the decedent. (This annuity would have qualified for the marital deduction if the contract had not provided for a refund or if the contract had provided that any refund would be payable to the estate of the survivor of the decedent and his spouse.)

The decedent gave Blackacre to his son, reserving the income therefrom for a period of 20 years and bequeathing the estate for a term of years to his surviving spouse. (The estate for a term of years would have qualified for the marital deduction had the son paid fair value for the interest acquired by him in Blackacre.)

If a surviving spouse is required by the decedent's will to survive the period of administration of the decedent's estate in order to receive a bequest, the bequest to the spouse will constitute a terminable interest and will usually not qualify for the marital deduction. *Estate of Fried v. Commissioner,* 445 F.2d 979 (2d Cir. 1971), *cert. denied,* 404 U.S. 1016 (1972).

A joint will for a husband and wife should be carefully drawn, since it may create contractual restrictions that will disqualify the surviving spouse's bequest for the marital deduction. *Compare Estate of Krampf v. Commissioner,* 464 F.2d 1398 (3d Cir. 1972), *aff'g per curiam* 56 T.C. 293, *Opal v. Commissioner,* 450 F.2d 1085 (2d Cir. 1971), *and Estate of Goldstein v. United States,* 72-1 U.S. Tax Cas. ¶12,819 (D. Minn. 1971), all of which denied a marital deduction, *with Estate of Salvatore Aquilino,* 31 T.C.M. (CCH) 906 (1972), allowing a deduction. Similarly, in drafting reciprocal or mutual wills, care must be employed not to impose any contractual restrictions that might disqualify a bequest for a marital deduction.

A terminable interest is also disqualified if it is to be acquired for the surviving spouse, pursuant to directions of the decedent, by the decedent's executor or trustee. §2056(b)-(1)(C). The disqualification occurs even though no person other than the surviving spouse acquires an interest in the property.

Example

D bequeathed $100,000 to H, the surviving spouse for whom the executor was directed to purchase a nonrefundable life annuity with this money. The bequest does not qualify for the marital deduction. The result would be the same if the executor was directed to purchase a patent, copyright, or, probably, a self-liquidating mortgage for H.

EXCEPTIONS

In order to permit certain convenient dispositive arrangements, the Code makes three exceptions to the terminable interest rule:

Death of Surviving Spouse

An interest passing to the surviving spouse is not considered a terminable interest solely because it will terminate or fail upon the death of the surviving spouse within a period not in excess of six months after the decedent's death or as a result of a common disaster resulting in the death of the decedent and the surviving spouse, if the termination or failure does not, in fact, occur. §2056-(b)(3). The proper method of computing the six-month period is discussed in Rev. Rul. 70-400, 1970-2 C.B. 196.

Because of the risk that a condition that the spouse must survive for a period of six months might not comply with section 2056(b)(3) as a consequence of the manner in which the period is measured under local law, conservative drafting practice will limit a survivorship requirement to no more than five months.

Examples

D, by will, leaves to H, the surviving spouse, a life estate in Greenacre, with the remainder to X. D's will provides that H shall have no interest in Greenacre if he dies within five months after D. H, in fact, survives D by more than five months. Since the contingency specified in the survivorship clause—death within five months—did not, in fact, occur, the survivorship clause does not prevent qualification for the marital deduction. However, the failure of the contingency to occur cannot convert an otherwise nondeductible terminable interest—a life estate with a remainder over to a third person—into a deductible interest. Thus, H's interest in Greenacre does not qualify for the marital deduction.

D and his spouse, W, were injured in an automobile accident. As a result of injuries sustained, D died one week after the accident and W died a week after him. D's will left his entire estate to W, with a proviso that if both D and W "die in a common disaster," the entire estate shall pass to D's son. Under the applicable local law, a husband and wife are deemed to have died in a common disaster if they both died within 30 days after a common accident and injuries sustained in the accident contributed to their death. No marital deduction is allowed in D's estate, since the contingency specified in the common disaster clause did, in fact, occur. If, however, W had recovered from her injuries, she would have received D's estate, and the bequest to her would have qualified for the marital deduction.

The marital deduction will be disallowed if, at the time of the final audit of the decedent's return, the surviving spouse may possibly be deprived of the interest passing to him that is subject to a common disaster provision—as distinguished from the six-month survivorship provision—because of the construction of the common disaster provision under applicable local law. Treas. Reg. §20.2056(b)-3(c). For this, and other reasons, a common disaster clause frequently is a poor drafting tool.

Power of Appointment

An interest, whether passing outright or in trust, will not be treated as a terminable interest if:

- The surviving spouse is entitled for life to all the income from the interest, or from a specific portion thereof, payable annually or at more frequent intervals;
- The surviving spouse has the power, exercisable by him alone and in all events, to appoint the entire interest, or a specific portion thereof, to himself or to his estate; and
- There is no power in any person other than the surviving spouse to appoint any part of the interest to any person other than the surviving spouse. Treas. Regs. §§20.2056(b)-5(a)(1), (2), (4), and (5); Rev. Ruls. 66-38, 1966-1 C.B. 212, 66-39, 1966-1 C.B. 223.

The surviving spouse's general

power of appointment may be exercisable during lifetime or by will, or both. A surviving spouse who possesses the requisite power of appointment may also hold lesser powers without disqualifying the trust. Treas. Reg. §20.2056(b)-5(g)(5). A person other than the surviving spouse may hold a power of appointment over the interest, provided that this power is exercisable solely in favor of the surviving spouse.

Example

The decedent bequeathed $500,000 in trust for the benefit of the surviving spouse. The trustee was directed to pay to the spouse all the trust income, at least annually, for life and to apply principal in amounts sufficient to meet expenses of illness or other emergencies. In addition, the trustee was authorized to pay or apply such additional amounts of principal as the trustee determined to be in the best interest of the spouse. In any year in which trust income was less than $20,000, the spouse had the right to draw from the principal of the trust the difference between the trust income from that year and $20,000. The spouse was given the power to appoint by will to the spouse's estate or to any other appointee any trust principal remaining at the spouse's death. To the extent that the spouse did not exercise this power, the remaining trust principal was to be distributed to the children of the decedent surviving the spouse.

The grant of administrative powers to the trustee of a marital trust may disqualify bequests to the trust if the exercise of the powers could deprive the surviving spouse of the beneficial enjoyment required by the statute. *See* Treas. Reg. §20.2056(b)-5(f)(4); Rev. Rul. 69-56, 1969-1 C.B. 224. Several cases decided under the tax law prior to the Tax Reform Act of 1969 denied a charitable deduction for a remainder interest in a trust bequeathed to a qualified charity because of the administrative powers granted the fiduciary, such as the unrestricted power to allocate receipts between income and corpus combined with a power to invest in mutual funds or in wasting assets without establishing a reserve or sinking fund. *Detroit Bank & Trust Co. v. United States*, 72-2 U.S. Tax Cas. ¶12,886 (6th Cir. 1972); *Atwell v. United States*, 339 F. Supp. 425 (S.D. Tex. 1972).

Nonetheless, if the fiduciary's administrative powers are sufficiently restricted under local law to preclude him from manipulating the trust income to the detriment of the surviving spouse, the administrative powers should not adversely affect the claim for a marital deduction. *Cf. Estate of Toulmin v. United States*, 462 F.2d 978 (6th Cir. 1972). Still, great care should be taken drafting the administrative powers granted the fiduciary under the testator's will.

The testator's will should include a provision stating his intention that the bequest to the surviving spouse qualify for the marital deduction. Then, should the bequest to the spouse be made in trust and fail to qualify for the marital deduction under one interpretation of an ambiguous clause in the trust but not under another, the statement of the testator's intent might well induce a court to adopt the more favorable construction as reflecting his probable intent.

Thus, in *Virginia Nat'l Bank v. United States,* 443 F.2d 1030 (4th Cir. 1971), the court relied on parol evidence of the testator's intent to qualify a bequest for the marital deduction, even though a forfeiture provision in the trust that would have disqualified the bequest for a marital deduction was thereby invalidated. Earlier, however, the Fourth Circuit had declined to give any weight to the testator's intention to qualify a bequest for the marital deduction. *Estate of Pierpont v. Commissioner,* 336 F.2d 177 (4th Cir. 1964). *See Guiney v. United States,* 425 F.2d 145 (4th Cir. 1970); *Frank v. Frank,* 253 Md. 413, 253 A.2d 377 (1969).

Insurance or Annnity Proceeds

An interest in the proceeds of a life insurance, endowment, or annuity contract will be treated as passing solely to the surviving spouse if, under the contract, while the proceeds are being held by the insurer, the surviving spouse has the right to the interest on, or the installment payments of, the proceeds for life and the right to appoint to himself or to his estate the unpaid proceeds or installment payments. §2056(b)(6).

These requirements concerning the spouse's income interest and general power of appointment are substantially the same as the requirements under section 2056(b)(5). For the effect of formal limitations on the surviving spouse's right of withdrawal, *compare Estate of Jennings v. Commissioner,* 39 T.C. 417 (1962), *acq.* 1964-1 C.B. 4, *and Estate of Cornwell v. Commissioner,* 37 T.C. 688 (1962), *acq.* 1964-1 C.B. 4, *with Werbe's Estate v. United States,* 273 F.2d 201 (7th Cir. 1959).

The life estate power of appointment exceptions to the terminable interest rule are considered in great detail in Treas. Regs. §§20.2056(b)-5 and 6. They should be studied before attempting to draft a will or a trust provision complying with section 2056(b)(5) or giving an opinion on whether the settlement provisions of a life insurance, endowment, or annuity contract meet the requirements of section 2056(b)(6). Furthermore, whether the provisions of a will, trust, or contract meet the requirements of sections 2056(b)(5) or (6) must be determined by construing the provisions according to the applicable local law and in the context of the entire instrument.

SPECIFIC PORTIONS

A specific portion of an interest

may qualify under sections 2056(b)(5) or (6). The term "specific portion" means a specified fractional share, as distinguished from a specified amount. Treas. Reg. §20.2056(b)-5(c).

In *Northeastern Nat'l Bank,* 387 U.S. 213 (1967), the Court invalidated the regulatory definition of "specific portion" as applied to the requirement under section 2056(b)(5) that the surviving spouse be granted all the income from a specific portion of the property passing from the decedent. The decedent had made a testamentary bequest to a trust under the terms of which his widow was to receive $300 a month for the rest of her life. Upon the widow's death, she was empowered to appoint the entire corpus of the trust by will. The Court held that a determination should be made of the amount of trust principal that would produce an income of $300 per month on the basis of a reasonable rate of return. That amount of principal, though unspecified in the will, would qualify for the marital deduction. The case was remanded to the district court to select a proper rate of return and to compute the amount of the deduction. *Accord, Citizens Nat'l Bank v. United States,* 359 F.2d 817 (7th Cir. 1966); *Gelb v. Commissioner,* 298 F.2d 544 (2d Cir. 1962).

There is a difference between granting the surviving spouse the income from a fractional share of a trust and granting an unvarying amount of income. In the first situation, the spouse's income may fluctuate as the trust assets appreciate or decline in value, while in the second situation the spouse is not affected by the rise and fall in the value of the trust assets. The Supreme Court, however, rejected the argument that Congress was concerned with this distinction when it enacted the marital deduction provision.

Section 2056(b)(5) also permits the decedent to grant the surviving spouse a power of appointment over a specific portion of the trust assets. If the term "specific portion" refers only to a fractional share, as the Treasury Regulations provide, the value of the assets subject to the power will fluctuate according to changes in market value, and in view of the present inflationary spiral, the amount included in the surviving spouse's gross estate at his death will probably be larger than the amount of the deduction granted the decedent. But if the term includes a power over a dollar amount of assets, the value to be included in the surviving spouse's gross estate on his death will be equal to the deduction granted the decedent.

In *Northeastern Nat'l Bank v. United States,* 387 U.S. 213, 224-25 (1967), the Court noted that the construction of the term "specific portion" for purposes of the power of appointment requirement might differ from the construction adopted by the Court for purposes of applying the current income requirement. The Court did not need—and it expressly deelined—to resolve that question, since the widow in *Northeastern* had a testamentary power to appoint the entire trust corpus. Consequently, the meaning of "specific portion" remains unsettled as to the power of appointment provision.

Examples

D made a testamentary transfer of $200,000 to a trust which provided that D's spouse, H, was to receive $300 a month for the rest of his life and have a testamentary general power of appointment over the entire corpus. The amount of trust corpus that will produce income of $300 a month determined at some appropriate rate of return will qualify for the marital deduction, but the rest of the trust assets will not.

D made a testamentary transfer of $200,000 to a trust which provided that D's spouse, H, was to receive all the income from the trust, payable monthly, for the rest of his life. H was also granted a testamentary general power of appointment over $100,000 of trust assets. Treas. Reg. §20.2056-(b)-5(c) denies any marital deduction to D's estate for this bequest, and the validity of this Regulation is not resolved.

NONQUALIFYING ASSETS • If the interest passing to the surviving spouse may be satisfied out of assets that would not have qualified for the marital deduction had they passed specifically from the decedent to the surviving spouse, then, for the purpose of computing the marital deduction, the value of the interest passing to the surviving spouse must be reduced by the value of the nonqualifying assets. §2056(b)(2).

Example

D bequeathed one-half of the residuary estate, worth $80,000, to H, the surviving spouse. Included in the residuary estate is an estate for a term of years, worth $20,000, that was reserved by D in a lifetime gift to his son. If, under the will and applicable local law, D's executor could allocate the entire estate for a term of years to H, then, whether or not the executor allocates that estate for a term of years to H, for purposes of the marital deduction, the value of the bequest to H must be reduced by $20,000 to $60,000. If, under the will and applicable local law, the executor could allocate to H only an undivided one-half interest in the estate for a term of years, then the value of the bequest would be reduced by $10,000 to $70,000.

On the other hand, if D's will had directed that any interests not qualifying for the marital deduction should not be allocated to H's share of the estate, then no reduction would have been required. Treas. Reg. §20.2056(b)-2(d).