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Federal Estate Tax - Marital Deduction

chanic testifies for D. that the brakes were defectively repaired by G. garage the day of the accident. The jury finds for D. on the basis of this unexpected defense, which P. had no knowledge of before the actual trial.

Since the Statute of Limitations has now run, no action can be brought for the death of P.'s decedent against the negligent garage.

ILLUSTRATION 2. D., Administrator of the estate of the deceased driver of an automobile which collided with P., under the same set of facts as in Illustration 1., is sued by P., *except* that P., who is living, is the only person who knows of a witness who saw the entire incident and places the blame on the deceased. This witness shows up at the trial to testify for P. and hence D.'s objection is defeated; yet D. had no advance notice of the witness and therefore no time to prepare to meet this testimony.

Essentially then the trial is limited to one issue: Will the objection be sustained or not? If not, the element of surprise is surely put back into the trial of a lawsuit; justice will many times be abused; and the settlement of death actions will surely cease to occur.

FEDERAL ESTATE TAX — Marital Deduction — Effect of Revenue Procedure 64-19 on the use of the marital deduction under Pennsylvania law — Methods of preservation of the marital deduction.

Revenue Procedure 64-19, 1964 INT. REV. BUL. 19.

At least as viewed by the Internal Revenue Service, estate planners have heretofore apparently been capable of effecting a reduction in the total Federal estate tax payable from the combined estates of a decedent and his spouse by using language in the dispositive instrument providing for a pecuniary formula marital deduction bequest,[1]

1. INT. REV. CODE OF 1954, §2056 indicates in part:

"(a) Allowance of Marital Deduction — For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsections (b), (c), and (d), be determined by deducting from the value of the adjusted gross estate an amount equal in value to the value of any interest in property which passes or has passed from

to be satisfied by the Executor with property distributed in kind at values finally determined for Federal estate tax purposes. Thus, when the estate of the decedent included a large proportion of securities which had appreciated or depreciated during the period of administration from the values so determined for Federal estate tax purposes, the executor could, argues the Commissioner, distribute the depreciated assets in kind to the marital distributee, while transferring the appreciated securities to the residual distributee. The distribution at Federal estate tax values of depreciated property to the surviving spouse would ultimately produce a lower estate tax on the subsequent death of the marital distributee,[2] and therefore yield a lower combined tax on the husband and wife as grouped together for such purposes. This possible abuse of a pecuniary marital deduction formula bequest and in kind distributions at estate tax values led to the promulgation after several months of presumably considered study by The Internal Revenue Service, of Revenue Procedure 64-19.[3]

Revenue Procedure 64-19 raises the possibility of an estate losing the marital deduction if the testamentary plan requires or permits the executor to satisfy a pecuniary marital bequest in kind at values set for federal estate tax purposes in a manner which does not reflect appreciation or depreciation in the property so distributed.[4] The

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the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate. . . .

"(c) Limitation on aggregate of deductions —

"(1) General rule. — The aggregate amount of the deductions allowed under this section (computed without regard to this subsection) shall not exceed 50% of the value of the adjusted gross estate, as defined in paragraph (2).

2. In this regard it should be remembered that the property which qualifies as part of the marital deduction in the estate of one spouse will, absent interim gifts or consumpton, normally be subject to the Federal estate tax on the later death of the surviving spouse. Contrariwise, through the use normally of a trust mechanism under which the surviving spouse is given only a life estate, the property which is subject to Federal estate tax on the death of the first spouse will not be subject to a second tax on the later death of the surviving spouse.

3. Rev. Proc. 64-19, 1964 INT. REV. BUL. 15.

4. *Ibid.* The procedure will have no effect on the other three uses of the marital deduction. They are: (1) a sum certain gift to the spouse, which may or may not maximize the marital deduction, but has the advantage of ease of administration; (2) a pecuniary formula marital gift to be satisfied at date of distribution values, which maximizes the marital deduction but causes income tax on the estate which satisfies a monetary obligation with appreciated property. See Revenue Ruling 60-87, 1960—1 CUM. BUL. 286, clarifying Revenue Ruling 56-270, 1956-1 CUM. BUL. 325 (3) a fractional formula marital gift, which maximizes the marital deduction but is viewed by many corporate trust administrators as being difficult to administer. While this note concerns only the pecuniary marital gift satisfied in kind at date of death values, these alternatives should not be

marital deduction will be destroyed if the executor can satisfy the pecuniary bequest in kind, *unless* applicable state law *or* the provisions of the testamentary plan require distribution (1) at fair market value or (2) fairly representative of appreciation or depreciation in all distributed assets valued as of date of death. The Procedure applies to existing wills and trust instruments of living estate owners and those of deceased testators where the statute of limitations has not run against the Government. However, the ruling does not affect fractional share bequests which require appreciation or depriciation on distribution.[5]

Since the Revenue Procedure 64-19 only affects pecuniary marital bequests satisfied with assets valued for Federal estate tax purposes, the distinction between marital pecuniary bequests deserves some examination. Under a pecuniary clause the marital distributee receives assets of a fixed dollar amount, determined by the maximum marital deduction.[6] Under the fraction formula clause the percentage or fraction of the maximum marital deduction over the total estate valued at date of death is applied for the purpose of making distribution of the cash or other assets of the residuary estate at the time of distribution. Under a fraction formula clause, therefore, the marital distributee shares equally in appreciation and depreciation of the estate.[7] A marital formula bequest must be interpreted as either a pecuniary dollar amount equal to the allowable marital deduction, or a gift of a fraction of the total residuary estate ta date of distribution.[8] The exact identification of a pecuniary or fractional gift depends on judicial construction.[9]

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ignored in fitting an estate plan to the needs of a particular client. In fact, special attention should be given to the fractional formula marital gift.

5. Rev. Proc. 64-19, 1964 INT. REV. BUL. 19 at .01.

6. If the appreciation of securities subject to distribution is taxable in the hands of the estate because of the use of date of distribution values, the cost basis to the distributee is the value of the property at the date of distribution. Commissioner v. Brinckeroff, 168 F.2d 436 (2d Cir. 1948). If the in kind distribution is based on estate tax values, the estate should not have a capital gain or loss, regardless of the change in value of such assets, and the distributee should take over the cost basis that the assets had in the estate of the decedent. CASNER, ESTATE PLANNING, 650 (2d Ed., 1956).

7. Rev. Rul. 60-87, 1960-1 CUM. BUL. 286 (1960). The assets will have the same cost basis in the hands of the distributee as they had in the estate of the decedent.

8. See CASNER, ESTATE PLANNING, 640-651 (2d Ed., 1956).

9. See Casner, *Estate Planning — Marital Deduction Provisions of Trusts*, 64 HARV. L. REV. 582 (1951); Smith, *Marital Deduction in Estate Planning*, 32 TAXES 15 (1964). Casner urges the following wording to create the pecuniary share, "an amount equal to the maximum estate tax marital deduction," and he recommends "that fractional share of my residuary estate which

In the sole Pennsylvania authority as to identification of such bequests, *Althouse Estate*,[10] the disputed wording reads:

> "Fifth. So much of my estate, [as] shall equal the maximum marital deduction as provided in Section 2056 of the Internal Revenue Code, . . . I give, devise and bequeath to my trustees hereinafter named, in a separate trust known as Trust A. . . ."[11]

The court construed this language to mean that the marital trust was to receive exactly the amount of assets equal to the marital deduction allowed by law, no more no less. Its holding that the above bequest was pecuniary and not fractional was voiced in clear language:

> "The testator's intention will be even clearer if we consider what would have been the result had the securities declined during the executors' administration, rather than increased in value. If such a situation had occurred and the marital trust was tendered securities which had a lesser value at date of distribution, Trust A would not receive 'so much' of testator's estate as would equal the maximum marital deduction allowed by the Internal Revenue Code. If 'so much' cannot mean 'less than', it cannot mean 'more than'.
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> "We hold that the testator's gift to the martial deduction trust known as Trust A was a gift in the *dollar* amount which was shown on (and determined by) the Federal Estate Tax Return; that this was, in effect, a pecuniary gift of that exact dollar amount, and that this amount should be paid by the executors to the trustees of Trust A with cash and/or

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will equal the maximum estate tax marital deduction" to create the fractional share gift which is outside of Rev. Proc. 64-19 CASNER *op. cit. supra* note 8 at 642. Cases holding the particular wording to be a pecuniary bequest are Althouse Estate, 404 Pa. 412, 172 A.2d 146 (1961); Estate of Kantner, 50 N.J. Super, 582, 132 A.2d 243 (1953); King v. Citizens and Southern Bank, 103 So. 2d 689 (Dist. Ct. of App. Fla. 1958); Lewis Will, 115 N.Y. S.2d 791, 802 (Surr. Ct. 1952). To the opposite result Bush's Will; 156 N.Y. S.2d 897, aff'd. 167 N.C.S. 2d 927 (Ct. App. 1957; Bing Estate, 200 N.Y.S. 2d 913 (Surr. Ct. 1960) Also see Rev Rul. 56-270, 1956-1 CUM. BUL. 325 which indicates:

> "The decedent bequeathed in trust for the benefit of his wife, an amount sufficient to utilize the marital deduction to the maximum extent authorized by section 2056 of the Internal Revenue Code of 1954 after taking into consideration any other property with respect to which such deduction is allowable . . . Held, the marital trust fund was provided for in a fixed and definite dollar amount."

10. *Supra* note 9.

11. Althouse Estate, 404 Pa. 412 at 414, 415, 172 A. 2d 146, 147 (1961).

assets valued, in the case of securities, *as of the date of distribution. . . .*"[12] [emphasis supplied]

Therefore, *Althouse* is precedent for the Pennsylvania construction of a pecuniary bequest and for the satisfaction of such a gift by stocks or securities valued at date of distribution. It is a firm directive as to the manner of distribution, i.e. market value at date of distribution being the valuation scale of in kind satisfaction of a pecuniary legacy.[13] In Pennsylvania, therefore, in the absence of a contrary direction in the governing instrument, a pecuniary marital trust, under authority of *Althouse,* must be satisfied by a distribution in kind at date of distribution values, which in and of itself satisfies the requirements of the new Revenue Procedure and preserves the marital deduction with no express wording on discretion in the instrument itself.

However, the effect in the *Althouse* situation of an express instruction in the will as to a distribution in kind being made at date of death values is open to question. *Althouse* contains no instruction to the fiduciary as to the date of valuation of the property distributed in kind, at least so far as the appellate record and report indicate. The *Althouse* case also indicates that no rule regarding wills is more settled than the general rule, that the testator's intent, if it is not unlawful, must prevail.[14] If the Pennsylvania courts would construe the express intent and direction to distribute at date of death values as unlawful and impose date of distribution values on the in kind distribution, the Revenue Procedure would be satisfied, and no additional languageas to discretion would be necessary in the will. But it is most probable that the testamentary plan, express in nature, would be upheld since it is not unlawful under Pennsylvania law. In the latter situation the fiduciary would still have the power to discriminate between the marital trust and the residuary trust by distributing depreciated assets to the former and appreciated assets to the latter, (and lose the marital deduction) unless limited in his discretion by other Pennsylvania law or by terms of the will itself.

Pennsylvania law as to a limit on this dangerous distribution discretion is sparse. The authority most helpful is that contained in

12. Id. at 422, 172 A. 2d at 151.

13. To the same effect, Furness's Estate, 16 Del. Co. 277, 3 D & C 584 (1922), 82 Pa. Super 452 (1923); Farmer's Estate, 3 D & C 584 (O. C. Delaware Co., 1923); Steubner's Estate, 16 D & C 309 (O. C. Phila. Co., 1931).

14. Pew Trust, 411 Pa. 96 (1963); Althouse Estate, 404 Pa. 412, 416, 172 A. 2d 147, 148; Cannistra Estate, 384 Pa. 605, 607, 121 A. 2d 157, 158 (1956); Britt Estate, 369 Pa. 450, 454, 87 A. 2d 243, 244 (1952); Sower's Estate, 383 Pa. 566, 570, 119 A. 2d 60, 62 (1956).

Hildreth Estate,[15] which involved an interpretation of a marital deduction clause reading . . . "distribute in cash or kind or partly in each at valuations fixed by" [the fiduciaries]. A clear, expressed intent to maximize the marital deduction was found by the court and the court indicated that any distribution by the fiduciary which resulted in the impairment of the marital trust and the loss of the marital deduction would be an abuse of discretion.[16] The court then ordered a distribution to the marital trust market value.[17] This case is strongly supported by *Hansen's Estate,* although in a slightly different context.[18] Neither of these cases face an express instruction to the fiduciary to make in kind distribution at values set for Federal Tax purposes.[19]

The probability of a Pennsylvania Court requiring a proportional distribution of appreciated and depreciated securities to the two distributees, marital and residual, is indicated by Section 734 of the Fiduciaries Act of 1949.[20]

> "The court, for cause shown, may order the estate to be distributed in kind to the parties in interest, including fiduciaries. . . . If such a request is made, the court, after such notice as it shall direct, shall *fairly divide,* [emphasis supplied] partition and allot the property among the distributees in proportion to their respective interests, . . ."

This doctrine of fairness by a fiduciary during distribution finds other expression in related case law. "A trustee has no right to take sides as between the life tenants and remaindermen. If he has an election

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15. 13 F. R. 151 (O.C. of Montgomery Co., 1963).

16. Hildreth Estate, *Id.* at 152.

17. It should be remembered that the discretion extended in the *Hildreth* case was that of "valuations fixed by them" and did not involve an express date of death value as is suggested. Also, this Orphans' Court decision which has not been tested. These defects are tempered by the lower court's choice date of distribution value, which is in accord with the Supreme Court's expression in *Althouse.*

18. Hansen's Estate, 344 Pa. 12, 23 A. 2d 448 (1942) involved transfer of depreciated stock at its higher value to a maintenance trust. The trustees were held to have abused their discretion even though the transfer was made with tax saving intent. The adoption of inventory value was held to be an arbitrary and unreasonable exercise of their discretionary power which did violence to the paramount intent of the testator.

19. The *Althouse* case apparently involved a testamentary plan designed to absorb the Federal income tax on the capital gain in the estate, since it did not require distribution at values set for Federal estate tax purposes. Under the latter type of distribution, no taxable gain or loss would be recognized in the estate. See Reg. 1.661(a) (2) (F) of INT. REV. CODE of 1954; Kenan v. Commissioner, 114 F. 2d 217. (2d Cir., 1940); Suisman v. Eaton, 15 F. Supp. 113 (D.C. of Conn., 1935).

20. PA. STAT. ANN. tit. 20 §320.734 (1949).

of taking one of several courses, he must take, if possible, that which will not benefit one at the expense of the other."[21] It would appear that when there are two beneficiaries or legatees, the fiduciary has the general duty to act fairly toward both.[22] This fairness could most easily be achieved in view of an instruction for an in kind distribution at date of death values by a proportional, non discriminatory distribution.[23]

Nevertheless, faced with uncertainty as to the proper and sound use of the pecuniary marital gift employing estate tax values, the estate planner must exercise due caution. His ultimate goals are twofold. First he should obtain the maximum marital deduction to reduce Federal estate tax. Second he should avoid Federal income tax on the property while in the hands of the estate. The planner has four alternatives, varying in degrees of success and utility, in employing the marital deduction. The first is the sum certain gift of a predetermined amount to the spouse, approximating the marital deduction. It has the advantage of ease of administration, but it can fail to utilize the maximum marital deduction if the estate is capable of great value fluctuation. The second alternative would be a pecuniary formula marital deduction gift, valued at date of distribution values according to the *Althouse* doctrine. If administration time is lengthy, this could have a serious income tax effect on the property in the hands of the estate. The third alternative is a pecuniary marital gift employing express date of death values in order to avoid income tax to the estate. This is the type gift effected by the Revenue Procedure 64-19. The fourth alternative and one which should be seriously considered by the planner is the fractional formula marital gift. Although its administration may appear more complex than the pecuniary formula gift, in reality it is no more complex to administer than a pecuniary bequest which requires proportional or nondiscriminatory distribution under the new Revenue Procedure 64-19.

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21. Thompson's Estate, 262 Pa. 278, 281 (1918). See also Buist's Estate, 297 Pa. 537, 147 A.606 (1929); King Estate, 355 Pa. 64, 48 A.2d 858 (1946), dissenting opinion; Drexel Estate (No. 2), 24 D&C 2d 161 (O.C. of Phila. Co., 1961).

22. RESTATEMENT, TRUSTS §183 indicates "when there are two or more beneficiaries of a trust, the trustee is under a duty to deal impartially with them."

23. The use of words "fairly divide" in the Fiduciary Act would seem to encourage the court to employ a proportionate distribution in the suggested situation. In any event, quite contrary to the indication given by the author in the article appearing in the April 1964 issue of *Trusts and Estates*, it seems clear that a Pennsylvania court would approve any request of a fiduciary to execute the form of agreement set forth in Revenue Procedure 64-19 as applicable to instruments executed prior to October 1, 1964. But see, Lauritzen, *The Marital Deduction* TRUSTS AND ESTATES 318 (April 1964).

The difficulty facing the pecuniary formula gift can best be demonstrated by a problem. "T", testator of a will executed October 2, 1964, dies with a $200,000 adjusted gross estate, expenses being disregarded, consisting of two securities valued for Federal estate tax purposes at date of death. During administration Security "A" appreciates from $100,000 to $240,000, Security "B" depreciates from $100,000 to $60,000 and at date of distribution "A" and "B" comprise a total value of $300,000. "T's" testamentary plan provides for an in kind distribution at Federal estate tax values to a pecuniary gift marital trust and to a residuary trust. There is no limitation of discretion indicated in the instrument.

In what manner will the Pennsylvania courts permit the accomplishment of the indicated testamentary goals?

The first possible resolution of the problem by reliance on Pennsylvania law would read *Althouse Estate*[24] as authority to force a satisfaction of the marital deduction gift at date of distribution values.[25] The construction that a marital gift could *only* be satisfied by securities valued at date of distribution is not only a strained extension of *Althouse,* but also is clearly contra to the testator's expressed intent,[26] and might cause an income tax problem as to the increased value of the securities while in the hands of the estate.[27] It would, of course, satisfy Revenue Procedure 64-19. While possible, this construction would be improbable, since the court would have no compelling reason to ignore express intent as to distribution method, and the method urged by the testamentary plan is not unlawful according to Pennsylvania law.

The second possible resolution of the problem by reliance on Pennsylvania law would give effect to the express instructions to distribute acording to estate tax values, and require a proportionate division of appreciated and depreciated securities between the marital and residuary beneficiaries.[28] This would avoid Federal income tax on the estate and preserve the marital deduction under Revenue Ruling 64-19, provided that Pennsylvania law *required* such a propor-

24. 404 Pa. 412, 172 A.2d 146 (1961).

25. This would give the marital trust $100,000 and the residual trust $200,000.

26. Note 13, *supra* collects cases on the primacy of intent in Pennsylvania law.

27. Treas. Reg. §1.661(a)(2)(f) (1956).

28. This would cause distribution of securities valued at $150,000 to each trust, the in kind distribution being merely $100,000 per trust (date of death values) with the shares of stock, appreciated and depreciated, being equally divided.

tionate distribution. It is submitted that were the question presented to a Pennsylvania court for decision, such fair and nondiscriminatory requirements would be made clear as constituting Pennsylvania law.[29] However, the authorities[30] are not clear that this is the present state of Pennsylvania law. There is an indication that a limit on discretion is present to some extent, but the courts have authorized only a distribution at fair market value which would be contrary to the testator's expressed intent and best interest. In any event, whether these precedents are so clear as to *require* proportionate distribution of appreciated or depreciated assets is open to question.[31] Reliance on the possible, even probable resolution of the problem in this favorable manner by Judicial construction would not be advisable for the reliable estate planner.

Rather, it would appear that the prudent planner should avoid reliance upon the possible vagaries of state decisions, and expressly limit the fiduciary's power as to in kind distribution by the testamentary plan.[32] This would preserve the maximum pecuniary formula marital deduction under the new ruling, allow the distribution to be made at date of death values for income tax purposes, and retain control of the estate in the planner and not the courts.

However, it is submitted that a better method of accomplishing the indicated goals would be the use of the fractional formula marital gift.[33] This would maximize the marital deduction and prevent income tax consequences to the estate. It would require a fractional division of any in kind assets passed to the beneficiaries, but the cumbersome effect of such a division could easily be avoided by proper language or sensible approximation and cash differentials as property incapable of exact fractional division.[34]

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29. Stevens, *How to Draft Marital Deduction Formula Clauses Under New Rev. Proc.* 64-19, 20 *Journal of Taxation* 352, 353 (June, 1964).

30. Hildreth Estate, 13 F.R. 151 (O.C. of Montgomery Co., 1963); Hansen's Estate, 344 Pa. 12, 23 A. 2d 448 (1942).

31. It is understood that one case involving a Pennsylvania decedent, Estate of Walsh v. Commissioner, (Docket No. 3433-63) is currently pending on this point before the Tax Court of the United States.

32. For suggested forms of language, see Stevens, *supra* note 29 at 354, 355.

33. In the problem presented *supra*, this method would cause the fraction to be applied to both securities, "A" and "B", at their distribution values. If the fraction equaled ½, the securities would be equally divided, with the same effect as the proportionate distribution demonstrated in note 8.

34. For suggested language, see Stevens, *supra* note 29 at 354, 355.