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The Marital Deduction

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Prior to 1942, the estate of a married individual dying a resident of a community property state suffered a lesser burden by reason of the imposition of federal estate taxes than did the estate of a resident of a common law state, even though, in each case, the estate may have been amassed solely through the efforts of the decedent. An attempt to redress this discrimination by taxing community property much in the manner of joint property met with objections from the community property states. In response to these complaints, Congress, in 1948, repealed the scheme of taxing community property it had adopted only six years earlier and sought to achieve equality of treatment by enacting the marital deduction.

The Deduction in Brief

Section 2056(a) of the Internal Revenue Code[1] grants a decedent the privilege of a tax-free transfer to his or her spouse of up to one-half of the decedent's estate. Although the availability of the deduction is conditioned upon meeting the terms of the statute, the provision is mandatory, not elective. In other words, an executor may not waive the marital deduction even though its application proves detrimental rather than beneficial.[2] (Avoidance of the deduction would be advisable where the two spouses died within a short time of each other. Waiver of the deduction would produce a higher tax in the first estate, but might make available to the second estate a credit for prior taxes of such magnitude that the combined taxes paid by the two estates would be less than would be achieved by the normal pattern of claiming a deduction in the first estate and being taxed in full in the second.)

To qualify for the deduction:

(1) The decedent must have been a resident or citizen of the United States at the time of his death. No deduction is allowed to the estate of a nonresident alien unless a treaty or tax convention provides otherwise.[3]

(2) The decedent must have been survived by a spouse.[4]

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[1] All statutory references are to provisions of the Internal Revenue Code.

[2] Rev. Rul. 59-123, 1949-1C.B.248.

[3] Reg. § 20.2056(a)-1(a) (1958).

[4] Whether or not the surviving spouse is a nonresident alien is of no moment. What is important is that the survivor be the decedent's spouse at the date of death. S. Rep. No. 1013, 80th Cong., 2d Sess., Part 2, 6, 7 (1948). And for this purpose, the marital relationship is not terminated by either a legal separation or a nonfinal interlocutory decree of divorce. Cf. Marriner S. Eccles, 19 T.C. 1049 (1953), aff'd 208 F.2d 796 (4th Cir. 1953).

(3) An interest in property must pass from the decedent to the surviving spouse.
(4) The interest must be a deductible interest.

Interests Passing to the Surviving Spouse

Subject to the limitation that the maximum marital deduction cannot exceed fifty percent of the value of the adjusted gross estate, an estate is allowed a deduction for the value of any interest in property that passes from the decedent to the surviving spouse. In this regard, interests may pass by will or intestacy, by operation of law or by reason of inter vivos transactions in which property finds its way into the hands of the spouse, but no deduction may be had unless the interest is included in the decedent's gross estate. The discussion that follows will investigate the concept of "passing" in more detail. In so doing, it will refer to the decedent and the surviving spouse. However, it should be noted that the applicable provision, Section 2056(e), serves also to define when an interest passes to a person other than the surviving spouse.

Property Acquired by Will or Inheritance

Pursuant to the first two paragraphs of Section 2056(e), an interest is deemed to pass from a decedent to the surviving spouse if obtained by way of bequest or devise or inheritance. The disposition need not be outright. A testamentary gift of a remainder to the spouse following a life estate in another qualifies to the extent of the remainder; a gift to the spouse of a life interest with remainder to his or her estate likewise qualifies, but in this instance the entire property is treated as passing from the decedent to the spouse.[5]

Interests acquired by the spouse as the result of a controversy involving the decedent's will are regarded as passing to the surviving spouse "if the assignment or surrender [of the interest to the spouse] was a bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate."[6] According to the Regulations, such a bona fide recognition requires a decision of a local court upon the merits in an adversary proceeding following a genuine and active contest.[7] The Regulations go on to say that decrees rendered by consent or pursuant to an agreement not to contest will not necessarily be accepted as a bona fide evaluation of the rights of the spouse.[8] Presumably the existence of a valid claim on the part of the surviving spouse will suffice to qualify interests passing to the spouse pursuant to the settlement of a will contest.

[5] Reg. § 20.2056(e)-2(b)(2)(i), (ii) (1958).
[6] Reg. § 20.2056(e)-2(d)(2) (1958).
[7] *Id.*
[8] *Id.*

Dower or Curtesy

A spouse's dower or curtesy interest or any statutory interest in lieu thereof constitutes an interest in property passing to the surviving spouse.[9] By ruling, the Service takes the position that payments made by an estate pursuant to an antenuptial agreement waiving dower qualify as well.[10]

If the spouse elects to take benefits granted under the decedent's will and thereby to relinquish dower, the interest taken under the will is the one that is treated as having passed to the surviving spouse; the relinquished dower interest is not.[11] Conversely, where an election is made against the will, the property dispositions made for the benefit of the surviving spouse do not pass to the spouse, but the elected share or interest does.[12]

Lifetime Transfers

By virtue of Section 2056(e)(4), an interest can pass to the surviving spouse even though it was the subject of an inter vivos transfer from the decedent to the spouse.[13] As we have seen deduction is conditioned upon the interest being included in the decedent's gross estate. Thus, a gift found to be in contemplation of death would qualify for the marital deduction; one made more than three years prior to death would not.

Joint Property

Property held by the decedent and the surviving spouse as joint tenants with right of survivorship or as tenants by the entirety passes from the decedent to the spouse under the provisions of Section 2056(e)(5). The degree to which the property qualifies for the deduction depends on the extent to which the interest was includible in the decedent's gross estate under Section 2040.

Interests Subject to Powers of Appointment

Interests appointed to the surviving spouse pursuant to the exercise by the decedent of a general power of appointment are considered to pass to the spouse from the decedent.[14] The same is true as to interests which the spouse takes in default on the release or nonexercise of the power. Although an interest can pass to the spouse through

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[9] § 2056(e)(3). This assumes that the interest is not a terminable interest.

[10] Rev. Rul. 68-271, 1968-1C.B. 409.

[11] Reg. § 20.2056(e)-2(c) (1958).

[12] *Id.*

[13] The spouse must receive the beneficial interest in the property. A transfer to the spouse merely as trustee or subject to a binding agreement by the spouse to dispose of the interest in favor of a third person cannot be counted as an interest passing to the spouse.

[14] § 2056(e)(6).

the exercise or nonexercise of a special power, such interests do not qualify for the deduction inasmuch as the property subject to the power is not includible in the decedent's gross estate.[15]

Insurance Proceeds

The final paragraph of Section 2056(e) treats proceeds of insurance upon the life of the decedent as passing to the person who receives them.[16] If this be the spouse, then the proceeds count for the marital deduction, provided, of course, the proceeds form a part of the decedent's gross estate pursuant to Section 2042.

Disclaimer and the "Passing" Requirement

A disclaimer by the surviving spouse of an interest that would otherwise be deemed to have passed from decedent to spouse becomes an interest that is considered to pass to the persons entitled to receive the interest as a result of the disclaimer.[17] By the same token, if, by reason of a disclaimer by a third person, the surviving spouse receives the disclaimed interest, the interest is treated as passing from the decedent to the spouse.[18] In both instances, the disclaimer must constitute a complete and unqualified refusal to accept the rights to which one is entitled; acceptance and subsequent disposal is not a disclaimer.[19] In the case of the third-party disclaimer the statute requires that such action occur prior to the due date of the estate tax return.[20] As a practical matter, a disclaimer by a spouse should also be made before that time. Otherwise, not only would an amended return be necessary, but the delay in taking action might lead to a conclusion that there had been an acceptance of the benefits conferred upon the surviving spouse.

The ability to disclaim opens interesting avenues of post-mortem estate planning. A disclaimer by the surviving spouse may lead to a reduction in the amount of the deduction, thereby having the effect of making the provision elective. In other instances, action on the part of the spouse in rejecting certain dispositions may cause a rearranging of the component parts of the deduction. Such result would obtain whenever a bequest to the spouse of an amount equal to the maximum allowance is reduced by other dispositions to the spouse and the spouse disclaims those other dispositions. Finally, renunciation by a third person can produce an increased marital deduction provided the disclaimed interest inures to the benefit of the surviving spouse.

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[15] § 2041(a)(1), (2).
[16] § 2042.
[17] § 2056(d)(1).
[18] § 2056(d)(2).
[19] § 2056(d)(2)(A); Reg. § 20.2056(d)-1(a) (1958).
[20] § 2056(d)(2)(A).

The Deductible Interest Requirement

We have already seen that no deduction can be had unless the interest passing to the surviving spouse is included in the decedent's gross estate. Nondeductibility is prescribed in three other instances:

(1) The passing of the interest from the decedent to the surviving spouse gives rise to a deduction under Section 2053,[21] as where the property passes to the spouse in satisfaction of a claim of the spouse against the estate.
(2) During settlement of the estate, the property interest becomes the subject of a casualty loss deductible under Section 2054.[22]
(3) The interest is a nondeductible terminable interest.[23]

The Nondeductible Terminable Interest Rule

The hallmark of community property is that each spouse has absolute ownership of his or her share of the property with the result that such share is taxed in the estate of the owner-spouse. Ultimately, then, the entire interest becomes subject to estate tax, albeit in separate estates. The nondeductible terminable interest rule is the means by which Congress insures that interests qualifying for the marital deduction correspond to the interest of the surviving spouse in a community property state.

A terminable interest in property is one which will terminate or fail on the lapse of time or on the occurrence or nonoccurrence of some event or contingency.[24] Such an interest becomes nondeductible in either of two instances: (1) when some other interest in the same property passes (for less than an adequate and full consideration in money or money's worth) from the decedent to a third person who may enjoy or possess the property after the termination or failure of the interest passing to the surviving spouse;[25] or (2) when pursuant to directions of the decedent, a terminable interest is to be acquired for the surviving spouse by decedent's executor or by the trustee of a trust.[26] Thus, the outright bequest of a patent owned by the decedent gives the spouse a terminable interest inasmuch as the life of the patent must end after a given period of years. Yet, the bequest qualifies for the marital deduction since no person other than the spouse can possess or enjoy the interest after termination.[27] On the other hand, the devise of a life estate to the spouse with remainder

[21] Reg. § 20.2056(a)-2(b)(2) (1958).
[22] Reg. § 20.2056(a)-2(b)(3) (1958).
[23] Reg. § 20. 2056(a)-2(b)(4) (1958).
[24] § 2056(b)(1); Reg. § 20.2056(b)-1(b) (1958).
[25] § 2056(b)(1)(A), (B).
[26] § 2056(b)(1)(C).
[27] Reg. § 20.2056(b)-1(g) Ex. (6) (1958).

over to another results in the passing of a nondeductible interest[28] as does the bequest of a sum of money with instructions to the executor to use the funds to purchase an annuity for the spouse.[29]

One type of interest that has generated controversy with respect to the terminable nature of the interest is the spouse's allowance granted by many states during the administration of an estate. The final say on the matter was had by the Supreme Court in *Jackson v. United States*.[30] The allowance will qualify provided the spouse has an indefeasible right to it as of the date of the decedent's death. If the right to the allowance can be cut off by the spouse's death or remarriage, the interest is nondeductible.

Common law dower, being merely a life estate, constitutes a nonqualifying terminable interest.[31] However, if the spouse is given the right to take a lump sum in lieu of dower and elects to do so, the sum received counts toward the marital deduction.[32] The same holds true in the instance in which the spouse elects to receive the commuted value of dower instead of dispositions made under the decedent's will[33] and, too, where the dower claim results in a dispute as to the spouse's right to dower and then in a settlement calling for outright payment to the spouse.[34]

Interest in Unidentified Assets

An extension of the terminable interest rule relates to situations in which the assets out of which a bequest to the spouse can be satisfied include nondeductible interests. In such event, the statute has the effect of treating the spouse as having received such interests, thereby reducing the amount qualifying for the marital deduction.[35]

To illustrate, suppose a decedent bequeaths one-third of the residuary estate to the surviving spouse. The property passing under the decedent's will includes a leasehold interest reserved by the decedent at the time a lifetime gift of the property was made to one other than the spouse. If the value of the spouse's one-third interest in the residuary is $100,000 and the value of the leasehold interest is $10,000, the amount of the bequest qualifying for the deduction is reduced to $90,000. This result can be avoided by an express provision in the will prohibiting the use of nondeductible interests in the funding of dispositions made for the benefit of the spouse.

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28 Reg. § 20.2056(b)-1(g) Ex. (1) (1958).

29 Reg. § 20.2056(b)-1(g) Ex. (7) (1958).

30 376 U.S. 503, 84 S.Ct. 869, 11 L.Ed. 2d 871 (1964).

31 The same is true of homestead exemptions that take the form of a life estate.

32 Kennedy v. United States, 302 F. Supp. 343 (D.S.C. 1969); Bradham v. United States, 287 F. Supp. 10 (W.D. Ark. 1968); Rev. Rul. 72-153, 1972-1C.B. 309 (award in lieu of homestead); Rev. Rul. 72-7, 1972-1 C.B. 308.

33 Hawaiian Trust Co. v. United States, 412 F.2d 1313 (Ct. Cl. 1969).

34 Rev. Rul. 66-139, 1966-1 C.B. 255.

35 § 2056(b)(2).

Exception to the Terminable Interest Rule—Survivorship for a Limited Period

A common will provision precludes a spouse from taking any portions of the decedent's estate if spouse and decedent die as the result of a common disaster or under circumstances that make it impossible to determine which of them was the first to die. Such a clause, without more, would defeat the marital deduction with respect to property passing under the will inasmuch as the presence of the provision would convert the interests into nondeductible terminable interests. Section 2056(b)(3) prevents this result by decreeing that an interest will not be tainted by a requirement that the spouse survive the decedent for a period not to exceed six months, or not die as a result of common disaster, when, in fact, the failure condition does not occur.

The Regulations take a hard line with respect to the exception, making interests nondeductible if the surviving spouse's entitlement thereto is conditional upon surviving some event other than death within the prescribed period or as a result of a common disaster.[36] Nevertheless, some cases have upheld deductibility on the ground that, the will provision notwithstanding, local law vested the interest indefeasibly in the spouse at the moment of death.[37]

An interesting interplay between local law rules regarding simultaneous death and the provisions of the Internal Revenue Code concerned with jointly held property is illustrated by Revenue Ruling 66-60.[38] Pursuant to the Uniform Simultaneous Death Act, if there is no proof as to the order of death of joint tenants or tenants by the entirety, the joint interest is distributed one-half as if one had survived and one-half as if the other had survived. Section 2040 requires inclusion of jointly held property in the estate of the person furnishing the consideration for the purchase; Section 2033 requires inclusion of separately owned property in the estate of the owner. Thus, if property held jointly by a husband and wife had been purchased with funds provided solely by the husband, and the two die in a common disaster, Section 2040 requires inclusion of the total value of the property in the gross estate of the husband. But, at the same time, the Simultaneous Death Act and Section 2033 mandate inclusion of one-half the value of the property in the estate of the wife. Relief is afforded by treating the latter portion as an interest passing from

[36] Reg. § 20.2056(b)-3(b), (d) Ex. (4) (1958).

[37] E.g., Estate of Horton v. Comm'r, 388 F.2d 51 (2d Cir. 1967); Kellar v. Kaspar, 138 F. Supp. 738 (D.S.D. 1956). It should be kept in mind that a state court's declaration as to state law may not be binding in later litigation to resolve a tax controversy. Comm'r v. Estate of Bosch, 387 U.S. 456, 87 S.Ct. 1754, 18 L.Ed.2d 886 (1967).

[38] 1966-1 C.B. 221.

husband to wife, thereby allowing the interest to qualify for the marital deduction.

Exception to the Terminable Interest Rule—Life Estate with Power of Appointment

Virtual control rather than outright ownership furnishes the theme for the second, and major exception to the nondeductible terminable interest rule. Five conditions prescribed by Section 2056(b)(5) must be met before a deduction can be secured under this exception:

(1) The surviving spouse must be entitled for life to all the income from the entire interest or from a specific portion of the entire interest, or to a specific portion of all the income from the entire interest.
(2) The income must be payable annually or at more frequent intervals.
(3) The surviving spouse must have the power to appoint the entire interest, or the specific portion, in favor of the spouse or the spouse's estate.
(4) The power in the surviving spouse must be exercisable by the spouse alone and in all events.
(5) The entire interest or specific portion must not be subject to a power in any other person to appoint any part to any person other than the surviving spouse.

Income for Life Payable Annually

A surviving spouse is entitled to all of the income of a trust, or to a specific portion thereof, if the effect of the trust is to give the spouse substantially that degree of beneficial enjoyment of the trust property during life which the principles of trust law accord a person who is unqualifiedly designated as the life beneficiary of a trust.[39] Direct restraints on the spouse's right to income, e.g., the ability of the trustee to accumulate income for the benefit of another, defeat the deduction.[40]

Indirect restrictions are not necessarily fatal. The critical question is whether the overall effect of the trust accords the surviving spouse such enforceable rights as will preserve for the spouse the requisite degree of enjoyment.[41] Therefore, disqualification is not an automatic consequence of a provision requiring that stock dividends be treated as corpus, or of one permitting the trustee to allocate receipts to

[39] Reg. § 20.2056(b)-5(f)(1) (1958). A spouse possessing a legal life estate is assumed to be entitled to all of the income therefrom. Difficulty may be encountered only if the property is unproductive.

[40] Reg. § 20.2056(b)-5(f)(7) (1958).

[41] Reg. § 20. 2056(b)-5(f)(2) (1958).

income or corpus.[42] Neither will the deduction be lost because the trustee has the power to retain investments, provided general standards of fiduciary administration require the trustee make the property productive within a reasonable time.[43]

We have seen that the income requirement of Section 2056(b)(5) is satisfied if the spouse is entitled to all of the income from a specific portion of the entire interest or to a specific portion of all the income from the entire interest. Were the Government to have its way, no partial interest would be considered a specific portion unless the rights of the spouse in income could be expressed in terms of a fractional or percentile share; annual income limited to a specific sum would not constitute a deductible interest.[44] This restrictive interpretation was disapproved by the Supreme Court in *Northeast Pennsylvania Nat'l Bank & Trust Co. v. United States*,[45] where the trust provided for fixed dollar payments to the surviving spouse. (The spouse was also given a general power of appointment over the entire corpus.) The court predicated its rejection of the narrow view pressed by the Service on the ground that it could find no indication that Congress intended such a result, nor could it perceive any apparent connection between the purposes underlying the deduction and such a limitation on its availability.

If the surviving spouse is entitled to a fractional share of the income, the deduction is limited to the same fractional value of the corpus, provided the spouse's power of appointment over the principal is as extensive. Where the spouse is given a fixed dollar income stipend, the deductible portion is determined by computing the amount of corpus required to produce the fixed sum.[46]

Power to Appoint to Self or Estate

Virtual control is achieved by coupling the spouse's life income interest with a power to appoint the trust corpus to himself or herself or to his or her estate. This makes the power general, thereby requiring inclusion of the principal in the gross estate of the surviving spouse.[47] However, it should be noted that a power to appoint to one's creditors or to the creditors of one's estate, although a general power,[48] does not conform to the requirements of the exception.

A power of invasion or power to consume may constitute a power of appointment that satisfies the statute. For this to be so, the surviving spouse must have the unrestricted power, exercisable at any

[42] Reg. § 20.2056(b)-5(f)(3), (4) (1958); Rev. Rul. 69-56. 1969-1 C.B. 224.

[43] Reg. § 20.2056(b)-5(f)(4) (1958); Rev. Rul. 66-39, 1966-1 C.B. 223.

[44] Reg. § 20.2056(b)-5(c) (1958).

[45] 387 U.S. 213, 87 S.Ct. 1573, 18 L.Ed. 2d 726 (1967).

[46] This is not the same thing as computing the present value of the right to the specific payments over an actuarially determined life expectancy.

[47] § 2041(b)(1).

[48] *Id.*

time during life, to use all or any part of the property subject to the power, and to dispose of it in any manner, including the power to dispose of it by gift.[49] The difficulty in qualifying a power to consume as a Section 2056(b)(5) power is best illustrated by *Estate of Pipe v. Comm'r*,[50] where the spouse was given a legal life estate with

> "full power to use, enjoy, sell or dispose of the income and principal thereof . . . for such purposes or in such manner, as she in her uncontrolled discretion may choose, it being my desire to place no restraint on her in any respect concerning the absolute right of full disposition and use of the whole or any part of said income or principal . . . except that she shall have no power over the disposition of such part thereof as remains unexpended at the time of her death."

The Second Circuit denied the deduction for the reason that the spouse lacked the necessary power as any corpus remaining at death went to others. Such result would not obtain under the present state of the law since the Regulations now provide that a power to consume can qualify whether or not the spouse has the power to dispose of the interest by will.[51]

Whether a particular will provision constitutes an unlimited power to invade often calls for resort to rules of local law regarding the scope of the power. On occasion, principles of applicable state law have converted a broadly worded invasion clause from one that is seemingly unlimited into one exercisable only in good faith to meet the needs of the surviving spouse.[52]

If the surviving spouse has the requisite power, possession of one or more lesser powers is of no moment. Thus, an unlimited power to withdraw can be coupled with a limited testamentary power; a power to appoint to one's estate can be joined by a limited power to invade.[53]

The spouse's power of appointment can extend to the entire interest or just to a specific portion. Yet unanswered is whether, for this purpose, the specific portion must be a fractional or percentile share of the corpus.[54]

Power Exercisable Alone and in All Events

A power fails to meet the requirements of Section 2056(b)(5) unless

[49] Reg. § 20.2056(b)-5(g)(3) (1958).
[50] 241 F.2d 210 (2d Cir.), *cert. denied* 335 U.S. 814 (1957).
[51] Reg. § 20.2056(b)-5(g)(3) (1958).
[52] E.g., Comm'r v. Estate of Ellis, 252 F.2d 109 (3d Cir. 1958).
[53] Reg. § 20.2056(b)-5(g) (1958); Rev. Rul. 72-154, 1972-2 C.B. 310.
[54] The Supreme Court has called this question a "difficult matter." Northeastern Pennsylvania Nat'l Bank & Trust Co. v. United States, 387 U.S. 213, 225, 87 S.Ct. 1573, 1580, 18 L.Ed. 2d 726, 734 (1967).

it is exercisable by the surviving spouse without the consent of any person and in all events. Unconditional exercise is the sine qua non of the all events test. Thus, a power is not exercisable in all events if it can be terminated during the life of the surviving spouse by an event other than complete exercise or release, as in the case of a power that cannot be exercised after remarriage.[55] In like fashion, the all events test is failed if the power can be exercised for a limited purpose only, e.g., a power to consume to the extent necessary to support the surviving spouse.[56]

A power is not exercisable in all events unless it can be exercised immediately after the decedent's death.[57] Thus, the power does not qualify if it cannot be effectively exercised before distribution of estate assets by the executor.[58] But if the power is immediately exercisable, a delay in distribution pending completion of administration does not defeat the deduction.[59]

There is no requirement that the spouse have the ability to exercise the power both during life and by will. What is required is that a power exercisable during life be exercisable at all times during the spouse's life and that one exercisable by will be exercisable irrespective of the time of the spouse's death.[60]

No Power in Another to Appoint to Others

The final condition mandates that no one other than the surviving spouse have a power to appoint the trust corpus to a person other than the spouse. This does not preclude the decedent from granting another the power to appoint in favor of the spouse,[61] nor does it prevent the decedent from providing for takers in default of the spouse's exercise of the power.[62]

The Estate Trust

A unique way of preserving the marital deduction without giving the surviving spouse absolute ownership of the interest is by the creation of an estate trust. In essence, such a trust is nothing more than a bequest of income to the spouse for life or for a term of years followed by a remainder to the spouse's estate, or the accumulation of trust income and the payment of the accumulated fund and corpus

[55] Reg. § 20.2056(b)-5(g)(3) (1958); Cf. Starrett v. Comm'r, 223 F.2d 163 (1st Cir. 1955).

[56] Reg. § 20.2056(b)-5(g)(3) (1958).

[57] Reg. § 20.2056(b)-5(g)(4) (1958).

[58] *Id.*

[59] *Id.*

[60] Reg. § 20.2056(b)-5(g)(1)(i), (ii) (1958).

[61] Reg. § 20.2056(b)-5(j) (1958).

[62] Reg. § 20.2056(b)-5(j) Ex. (1) (1958).

to the spouse's estate.[63] The disposition qualifies for the deduction since no one other than the spouse or the spouse's estate takes any interest in the property passing from the decedent to the surviving spouse. Because of this, the trust does not have to satisfy the fivefold test prescribed for the life estate with power of appointment exception. Thus, the estate trust can be funded with unproductive or underproductive assets without jeopardizing the deduction.

Exception to the Terminable Interest Rule—Life Insurance with Power of Appointment

The last exception to the nondeductible terminable interest rule, Section 2056(b)(6), becomes operative when proceeds of a life insurance policy, an endowment policy or an annuity policy are left with the insurer under an arrangement whereby the spouse is entitled to receive the proceeds in installments or interest on the proceeds during life, and has a power of appointment over any balance remaining at death. The provision has no application if the proceeds come into the hands of a trustee other than the insurer. In such case, deductibility is dependent upon meeting the conditions imposed by Section 2056(b)(5).

The requirements of the insurance exception are not unlike the fivefold test prescribed for the life estate-power of appointment exception. As set forth in the Regulations:[64]

(1) The proceeds, or a specific portion of the proceeds, must be held by the insurer subject to an agreement to pay the entire proceeds or a specific portion thereof in installments, or to pay interest thereon, and all or a specific portion of the installments or interest payable during the life of the surviving spouse must be payable only to the spouse.

(2) The installments or interest payable to the surviving spouse must be payable annually or more frequently, commencing not later than 13 months after the decedent's death.

(3) The surviving spouse must have the power to appoint all or a specific portion of the amounts held by the insurer to himself or herself or to his or her estate.

(4) The power in the surviving spouse must be exercisable by the spouse alone and (whether exercisable by will or during life) must be exercisable in all events.

(5) The amounts or the specific portion of the amounts payable under the agreement must not be subject to a power in any other person to appoint any part thereof to any person other than the surviving spouse.

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[63] Reg. § 20.2056(e)-2(b)(1)(i)-(iii) (1958); Rev. Rul. 72-333, 1972-2 C.B. 530; Rev. Rul. 68-554, 1968-2 C.B. 412.

[64] Reg. § 20.2056(b)-6(a) (1958).

One difference between the insurance exception and Section 2056 (b)(5) is the requirement that payments commence within 13 months of the decedent's death. No such condition is imposed when deduction is sought under the life estate with power of appointment exception. A second difference relates to the definition of specific portion. Here the Regulations concede that a specific dollar amount of proceeds may be the equivalent of a definite or fixed percentage of the total proceeds.[65] Finally, the term "power of appointment" need not be used in the trust, it being sufficient that the contract gives the spouse a right which is, in substance and effect, a power to appoint to self or estate.[66]

Limitations on the Allowable Deduction
The Maximum Deduction

Deduction under Section 2056 is limited to one-half the decedent's adjusted gross estate, that is, one-half of the gross estate less the deductions for debts, expenses and taxes allowed by Section 2033 and the deduction for casualty losses permitted by Section 2054.[67] (The charitable deduction has no effect on the determination of the adjusted gross estate.) This limitation sets the maximum allowance; it does not insure a deduction in that amount, for in no event can the deduction exceed the value of the deductible interests passing to the surviving spouse.

Valuation of the Interests Passing to the Surviving Spouse

In general the assets passing to the surviving spouse take the same values ascribed to them in computing the decedent's gross estate, namely, date of death values or alternate valuation date values. However, Section 2056(b)(4) imposes two special rules concerning valuation. The first of these requires a consideration of the effect of death taxes on the net value of the interests passing to the surviving spouse. The second involves the manner in which interests subject to encumbrances are to be taken into account in determining the extent of the deduction.

If the provisions of the will or of applicable state law place no burden of federal or state death taxes on the interests passing to the surviving spouse, the entire value of such interests qualifies for the marital deduction. On the other hand, if estate and inheritance taxes are payable out of the share to which the spouse is entitled, the deduction is reduced by the effect which such payment has on the amount to be received by the spouse. Determination of this effect

[65] Reg. § 20.2056(b)-6(c)(1) (1958).
[66] Reg. § 20.2056(b)-6(e)(4) (1958).
[67] § 2056(c)(1), (2)(A). Section 2056(c)(2)(B) sets forth a special rule for determining the adjusted gross estate where community property is involved.

involves a double unknown. The amount of death taxes depends on the size of the marital deduction; the amount of the marital deduction depends on the taxes to be paid.

Downward adjustment is also required whenever an interest passing to the spouse is subject to an encumbrance (as in the case of a devise of real property encumbered by a mortgage with respect to which the decedent was personally liable).[68] A similar reduction in the value of the spouse's interest is called for when the disposition in favor of the spouse is conditioned upon the spouse assuming an obligation. But no adjustment is called for if the terms of the decedent's will or the provisions of local law require an exoneration of the encumbrance or obligation out of other assets of the decedent's estate. (Although the statute seemingly operates in this instance, the Regulations provide that payment of the obligation by the executor constitutes an additional interest passing to the surviving spouse, thereby restoring the interest to its original value.)[69]

Pecuniary Bequests and Revenue Procedure 64-19

It is settled law that the satisfaction of a pecuniary bequest with appreciated assets results in the realization of gain to the estate. As a means of preventing this result, many decedents in the past included a provision authorizing the executor to satisfy bequests in kind at the value finally determined for federal estate tax purposes. A side consequence of such a provision was the ability of the executor to fund a pecuniary bequest in favor of the surviving spouse with assets that depreciated in value from the time they were valued for tax purposes, resulting in the spouse receiving less than the amount for which a deduction had been claimed. This possibility is now barred by the existence of Revenue Procedure 64-19.[70]

The basic thrust of Revenue Procedure 64-19 is the loss of the marital deduction whenever a pecuniary bequest to or for the benefit of the spouse can be satisfied in kind by assets valued at the value reported for estate tax purposes, and the executor has discretion to choose the assets used to fund the bequest. However, the deduction is saved if the applicable local law or the terms of the decedent's will require a distribution of assets having an aggregate fair market value on the date or dates of distribution amounting to no less than the amount of the pecuniary bequest, or of assets that are fairly representative of appreciation or depreciation in the value of all property available for distribution in satisfaction of the pecuniary bequest.

[68] If the decedent was not personally liable on the mortgage, there would be no adjustment since the property would be included in the decedent's gross estate at its net value, not its full value.

[69] Reg. § 20.2056(b)-4(b) (1958).

[70] 1964-1 (Pt. 1) C.B. 682. Query, whether local law principles of fiduciary administration have not always precluded the result.

The device that triggers Revenue Procedure 64-19 is the pecuniary bequest, whether expressed in terms of a fixed dollar amount or as a formula, e.g., an amount equal to one-half of the adjusted gross estate. Thus, it has no application in the case of specific bequests and devises or dispositions of fractional shares of the decedent's residuary estate. Nor does it decree disallowance if the pecuniary bequest must be satisfied in cash, or if the executor has no discretion in the choice of assets that may be distributed, or if the executor is required to use distribution date values in valuing the assets used to fund the bequest.