The marital deduction clause (pecuniary vs. fractional bequest)

By Donald C. Sider

In order to obtain the maximum marital deduction for an estate, practitioners frequently describe the marital deduction bequest under a will or trust by means of a formula encompassing the maximum amount permitted under the Internal Revenue Code.[1]

There are basically two types of marital bequests. The first is known as the pecuniary bequest, which refers to a specific dollar amount of property as passing to the surviving spouse. The second type of marital bequest is known as the fractional bequest, which is described as a fraction, portion or percentage of all of the assets of the deceased person's estate as passing to the surviving spouse. Either the pecuniary bequest or the fractional bequest can and will, if properly drafted, result in the maximum marital deduction available to an estate.

However, depending upon whether the assets of the estate appreciate or depreciate between the appropriate valuation date for the estate (the date of death or the alternate valuation date six months after death)[2] and the date of actual distribution to the surviving spouse, the income tax consequences of actually funding the marital bequest, and the value of the assets which actually pass to the surviving spouse will differ.

Basically, where a pecuniary bequest is used, the specific dollar amount of the marital deduction becomes fixed on the date of death or the alternate valuation date, whichever is applicable. The pecuniary marital deduction bequest is then funded with that specific dollar amount of property, based upon the value of the property actually distributed as of the date of such actual distribution to the surviving spouse.

For example, assume that a decedent dies in 1987 with a $1,000,000 estate. Assume further that such decedent has a will with a pecuniary marital deduction formula bequest,

leaving the maximum marital deduction to the surviving spouse, but also utilizing a nonmarital trust for the unified credit. Since the unified credit available to a decedent who dies in 1987 will be $600,000,[3] the marital deduction bequest will be the specific dollar amount of $400,000 ($1,000,000 - $600,000). Regardless of whether the assets of the estate appreciate or depreciate from the date of death (or alternate valuation date) to the date of actual distribution, the surviving spouse will be entitled to receive a specific dollar amount of property equal to $400,000 at the date or dates of actual distribution. Therefore, if the assets of the estate appreciate to $1,300,000 as of the date of actual distribution to the surviving spouse, the surviving spouse will only be entitled to $400,000 worth of property pursuant to the pecuniary marital bequest. The entire balance of the estate's assets ($900,000) will be placed in the nonmarital trust. Thus, the surviving spouse will receive a proportionately smaller amount than the nonmarital trust will receive, with the nonmarital trust receiving the entire benefit of the appreciation in the assets from the date of death to the date of distribution.

Recognize long-term capital gain

Additionally, to the extent that assets which have appreciated are distributed to the surviving spouse in satisfaction of $400,000 pecuniary marital bequest, the estate of the decedent must recognize long-term capital gain equal to the amount of such appreciation as of the distribution date.[4]

If, in the example, the decedent's will had provided for a fractional marital deduction formula bequest, the surviving spouse would share proportionately in all of the appreciation and depreciation in all of the estate assets from the date of death to the date of distribution. Furthermore, there would be no capital gain or loss recognized on the actual funding of the marital bequest to the surviving spouse.[5] The surviving spouse would be entitled to receive a fractional amount of the value of all assets on each date that a distribution is made. In the example given, such fractional interest would be approximately equal to 40 percent. This fraction is determined by dividing the surviving spouse's date of death marital bequest value of $400,000 by the date of death value of all of the estate's assets of $1,000,000 ($400,000 divided by $1,000,000 = 40 percent).

Each time a distribution is made actually to fund the fractional marital bequest to the surviving spouse, the assets of the estate would have to be revalued, and the surviving spouse would be entitled to 40 percent of the value of such assets on each date a distribution occurs. Therefore, if the assets appreciate from $1,000,000 on the date of death to $1,300,000 on the date of distribution, the surviving spouse would be entitled to a distribution in satisfaction of the fractional marital bequest equal to $520,000 (40 percent x $1,300,000), as opposed to the situation involving the pecuniary bequest, where the surviving spouse was only entitled to $400,000.

Although the funding of this marital bequest results in no capital gain recognition to the decedent's estate, the potential drawback of the use of the fractional bequest in this situation is that the surviving spouse's taxable estate includes $520,000 from the deceased spouse's estate, whereas, if the pecuniary bequest is

used, the surviving spouse's taxable estate would only have included $400,000 from the deceased spouse's estate.

Whichever form of describing the marital bequest formula is used, it is most important for the practitioner to describe, with clarity, whether the pecuniary or fractional share formula is intended. Where it is not clear as to whether a pecuniary bequest or fractional bequest is intended, the personal representative and attorney for the estate can be caught in a most difficult situation. If the value of the estate's assets significantly appreciates or depreciates during the period of administration, there may be inherent conflicts between the surviving spouse and other beneficiaries, depending upon whether the clause is interpreted to be pecuniary or fractional.

Internal Revenue Service audit

The interpretation of the marital bequest formula clause is also likely to arise in dealing with the Internal Revenue Service on the audit of the estate of either the first or the second spouse to die. The amount which is to pass to the surviving spouse will depend upon whether the clause is pecuniary or fractional. Generally, where the assets have appreciated in value from the date of death to the date of distribution, the Internal Revenue Service will benefit if the clause is construed to be fractional, as the surviving spouse will then be entitled to a larger amount, and upon such surviving spouse's subsequent death, the Internal Revenue Service will thus collect a greater tax.

Alternatively, if the assets have depreciated in value from the date of death to the date of distribution, the Internal Revenue Service will do better if the clause is construed to be pecuniary. If so construed, the date of death specific dollar amount must be distributed to the surviving spouse, regardless of any depreciation in value of the assets. The Internal Revenue Service will thus again collect a larger tax on the subsequent death of the surviving spouse.

The issue of whether a particular clause is interpreted to be a pecuniary or fractional type of marital bequest formula is to be based upon a factual interpretation of the governing instrument and of the testator's intent.[6] Thus, the issue becomes a matter of state law, as opposed to an interpretation of federal tax law, and the Internal Revenue Service, as well as the courts, will look to such state law for guidance in interpreting any such clause.[7]

Florida case law

Florida case law is largely undeveloped with respect to the interpretation of a marital bequest clause as being pecuniary or fractional. In *King v. Citizens and Southern National Bank of Atlanta, Georgia*,[8] the Third DCA construed the following clause:

I devise and bequeath unto my beloved wife, fifty (50%) percentum of the assets of my estate remaining after payment of administration expenses, funeral expenses, and claims against my estate, before deduction of estate or inheritance taxes. It is my intention in the instant paragraph to devise and bequeath unto my said wife fifty (50%) percentum of my adjusted gross estate as the same is defined for Federal Estate Tax purposes.

As the value of the assets substantially changed from the date of death to the date of distribution to the surviving spouse, the issue was whether the surviving spouse was entitled to share in the appreciation and required to share in the depreciation of the estate assets. The bequest was interpreted to be a pecuniary bequest, even though the bequest was expressed as a percentage of the adjusted gross estate, and the surviving spouse was, thus, not entitled to share in the appreciation of the assets subsequent to the date of death.

In the *Estate of Rose v. First National Bank of Miami*,[9] the Third DCA again ruled, in a very short opinion, that a marital bequest of "one-half (1/2) of my adjusted gross estate" was a pecuniary bequest as opposed to a fractional bequest, citing *King* as precedent.

In the *Estate of Freedman v. Kramer*,[10] the Third DCA ruled, again without a substantial opinion that, based upon New York law (as the will was to be construed in accordance with New York law), the following provision was a fractional bequest:

I direct that there shall be set aside for my wife's benefit so much, if any, of my estate as shall be required, when added to (1) the sum of $50,000 and (2) the value of all items in my taxable gross estate that shall have passed to her otherwise than under this Will and shall qualify for the marital deduction allowable in determining the Federal Estate Tax of my gross estate, to equal in value the maximum marital deduction allowable in determining the Federal Estate Tax of my gross estate. In setting apart such portion of my estate for the benefit of my wife, there shall not be included therein any property, or the proceeds of any property, which would not qualify for such marital deduction and all values used in computation shall be those finally determined in the Federal Estate Tax proceedings.

Thus, Florida case law is far from conclusive as to which interpretation Florida courts will make on marital deduction formula clauses which do not clearly state whether they are pecuniary or fractional. The decision, however, is to be based upon what the intent of the testator was.[11] Other states' courts have had greater opportunity to construe such clauses.[12]

The State of Florida has fulfilled the requirement of Rev. Proc. 64-19, by providing in §733.810(2), that the marital bequest is to be interpreted to require a distribution of assets which are fairly representative of the appreciation or depreciation in estate assets from the date of death to the date of distribution. This means that unless the governing instrument specifically provides otherwise, an ambiguous will or trust in Florida will be interpreted, pursuant to §733.810(2) to be a fractional bequest, with the surviving spouse entitled to share in the appreciation,

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or required to share in the depreciation of the assets from the date of death to the date or dates of distribution. Although the statute will protect Florida residents from the scope of Rev-Proc. 64-19, and save the marital deduction for the estate, the statute may result in unanticipated consequences where the assets significantly appreciate or depreciate from the date of death to the date of distribution.

The Florida Statutes, however, do appear to provide some guidance in the construction of such clauses. Specifically, F.S. §733.810(2)[13] provides as follows:

> When the Personal Representative, Trustee or other Fiduciary under a Will or Trust instrument is required to, or has an option to, satisfy a devise or transfer in Trust to or for the benefit of the surviving spouse, with assets of the estate or Trust in kind, at values as finally determined for Federal Estate Tax purposes, the Personal Representative, Trustee, or other Fiduciary shall satisfy the devise or transfer in Trust by distribution of assets, including cash, fairly representative of the appreciated or depreciated value of all property available for distribution in satisfaction of the devise or transfer in Trust, taking into consideration any gains and losses realized from the sale, prior to distribution of marital interest, of any property not specifically, generally, or demonstratively devised, unless the Will or Trust instrument otherwise provides.

It would appear as though F.S. §733.810(2) was adopted for purposes of protecting Florida residents from the pitfalls and traps resulting from the issuance of Internal Revenue Procedure 64-19 by the Internal Revenue Service in 1964.[14] Rev. Prov. 64-19 basically states that when a pecuniary bequest is involved, and the personal representative has authority to distribute assets in kind, either the governing instrument or applicable local law must require that assets distributed in satisfaction of such bequest be fairly representative of the appreciation or depreciation of all of the assets of the estate. Alternatively, the Revenue procedure provides that either the governing instrument or applicable local law must require that such marital bequest be funded with assets valued "as of the date of distribution."

F.S. §733.810(3)[15] may provide an escape from the interpretation of the clause as a fractional marital deduction bequest under §733.810(2), if all beneficiaries under the governing instrument so agree. Accordingly, the section states that:

> With the consent of all beneficiaries affected, a Personal Representative or a Trustee is authorized to distribute any distributable assets, non-pro rata among the beneficiaries entitled thereto.

This statute may be interpreted to mean that if all beneficiaries consent, the governing instrument can be treated as a pecuniary marital deduction bequest, notwithstanding the requirements of F.S. §733.810(2). At the time of this article, there have been no cases interpreting the interrelationship of F.S. §§733.810(2) and 733.810(3).

Depending upon whether the clause is interpreted to be pecuniary or fractional, the effects of the marital bequest formula clause under a will or trust can thus be totally unanticipated, and sometimes very costly. Florida case law, to date, is far from exhaustive on the subject. However, the Florida Statutes tend to require an interpretation as fractional where the clause is ambiguous, with a possible escape to the pecuniary interpretation if all beneficiaries consent. Accordingly, in order to avoid the potential pitfalls, it is most important for practitioners to describe marital bequest formula clauses with clarity. □

[1] §2056(a). All references to section numbers refer to the Internal Revenue Code of 1954, *as amended*.

[2] I.R.C. §§2031 and 2032(a).

[3] I.R.C. §2010.

[4] Suisman v. Eaton, 15 F.Supp. 113 (D. Conn. 1935), *aff'd* 83 F.2d 1019 (2d Cir.), *cert. denied* 299 U.S. 573 (1936); Rev. Rul. 60-87, 1960-1 C.B. 286; *cf.* United States v. Davis, 370 U.S. 65 (1962).

[5] Rev. Rul. 60-87, 1960-1 C.B. 286.

[6] *Estate of Smith*, (78,174 P-H Memo TC 738-78 (1978)); Rev. Pro. 64-19, 1964-1, C.B. 682; FLA. STAT. §732.6005(1); Pancoast v. Pancoast, 97 So.2d 875 (Fla. 2d D.C.A. (1957)).

[7] Flitcroft v. Comm., 328 F.2d 449 (9th Cir. 1964); *Estate of Nissen*, 345 F.2d 230 (4th Cir. 1965).

[8] King v. Citizens and Southern National Bank of Atlanta, Georgia, 103 So.2d 689 (Fla. 3d D.C.A. 1958).

[9] Estate of Rose v. First National Bank of Miami, 165 So.2d 226 (Fla. 3d D.C.A. 1964).

[10] Estate of Freedman v. Kramer, 347 So.2d 790 (Fla. 3d D.C.A. 1977).

[11] Estate of Freedman v. Kramer, 347 So.2d 790 (Fla. 3d D.C.A. 1977); King v. Citizens and Southern National Bank of Atlanta, Georgia, 103 So.2d 689 (Fla. 3d D.C.A. 1958); Estate of Rose v. First National Bank of Miami, 165 So.2d 226 (Fla. 3d D.C.A. 1964); *Estate of Smith*, (78,174 P-H Memo TC 738-78 (1978)).

[12] *Estate of Kanter*, 143 A.2d 243 (N.J. Super. Ct. App. Div. 1958); *Althouse Estate*, 172 A.2d 146 (Pa. 1961); *Estate of Parker*, 180 N.W. 2d 82 (Mich. App. 1970); Hanna v. Hanna, 619 S.W.2d 655 (Ark. 1981); Smail v. Smail, 617 S.W.2d 889 (Tenn. 1981); *Estate of Nicolai*, 373 P.2d 967 (Or. 1962).

[13] FLA. STAT. §733.810(2).

[14] Rev. Prov. 64-19, 1964-1 C.B. 682.

[15] FLA. STAT. §733.810(3).