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## "SPECIFIC PORTION" TRUSTS AND THE MARITAL DEDUCTION

### I. INTRODUCTION

Northeastern Pennsylvania Nat'l. Bank & Trust Co. v. United States<sup>1</sup> dealt with a trust under which the surviving spouse was given the right to income of \$300 per month and the power to appoint the entire corpus at her death. On the federal estate tax return the executor claimed the full value of the trust corpus qualified for the marital deduction. The Commissioner denied the deduction because the right of the surviving spouse to income was not expressed as a right to income from a "fractional or percentile" share of the trust.<sup>2</sup> The tax imposed was paid and suit for refund instituted in the District Court. The district court allowed the deduction,<sup>3</sup> the Circuit Court of Appeals reversed,<sup>4</sup> and the United States Supreme Court granted certiorari because of conflict among the circuits.<sup>5</sup>

A majority of the Supreme Court held that the Treasury Regulation requiring that a "specific portion" of a trust from which a surviving spouse is to receive income be expressed as a fraction or percent of the whole trust<sup>6</sup> was contrary to the intent of Congress and, therefore, invalid "in the context of this case."<sup>7</sup> Three dissenting justices contended that the majority did not give proper weight to the legislative history of the marital deduction or to the prior case law dealing with this deduction.

### II. THE STATUTORY PROVISIONS

In an attempt to provide geographic equality in estate tax treatment among common law and community property states,<sup>8</sup> Congress, in 1948, enacted marital deduction provisions<sup>9</sup> which are substantially the same as those currently in effect. Essentially, up to one-half of the adjusted

<sup>1</sup> 387 U.S. 213 (1967).

<sup>2</sup> See Treas. Reg. §20.2056(b)-5(c) (1958).

<sup>3</sup> 235 F.Supp. 941 (M.D. Pa. 1964).

<sup>4</sup> 363 F.2d 476 (3d Cir. 1966).

<sup>5</sup> 387 U.S. 213, 217 (1967).

<sup>6</sup> Treasury Regulations §20.2056(b)-5(c) (1958). The relevant part of the Regulation is as follows:

(c) Definition of "specific portion." A partial interest in property is not treated as a specific portion of the entire interest unless the rights of the surviving spouse in income and as to the power constitute a fractional or percentile share of a property interest so that such interest or share in the surviving spouse reflects its proportionate share of the increment or decline in the whole of the property interest to which the income rights and the power relate. Thus, if the right of the spouse to income and the power extend to one-half or a specified percentage of the property, or the equivalent, the interest is considered as a specific portion. On the other hand, if the annual income of the spouse is limited to a specific sum, or if she has a power to appoint only a specific sum out of a larger fund, the interest is not a deductible interest.

<sup>7</sup> 387 U.S. 213, 218 (1967).

<sup>8</sup> See S. Rep. No. 1013, 80th Cong., 2nd Sess. (1948), 1948-1 C. B. 260.

<sup>9</sup> Ch. 168, §361, 62 Stat. 117, amending Int. Rev. Code of 1939, ch. 3, §812, 53 Stat. 123.

gross estate could be deducted—could pass tax free from the decedent's estate—if it was given to the surviving spouse.<sup>10</sup> A terminable interest passing to the surviving spouse did not generally qualify for the marital deduction.

However, exceptions to the terminable interest rule recognized some of the common methods of testamentary distribution.<sup>11</sup> A trust was allowed, for example, if the spouse had an unconditional right to the *entire* income for life and the unrestricted power to appoint the *entire* corpus, either during life or at her death.<sup>12</sup> In discussing this exception to the terminable interest rule, the Senate Report used the phrase "virtual owner," which has precipitated much discussion.

The provisions of subparagraph (F) of section 812(e)(1) under the bill as it passed the House have been expanded in your committee bill. These provisions have the effect of allowing a marital deduction with respect to the value of property transferred in trust by or at the direction of the decedent where the surviving spouse, by reason of her right to the income and a power of appointment, is the virtual owner of the property. This provision is designed to allow the marital deduction for such cases where the value of the property over which the surviving spouse has a power of appointment will (if not consumed) be subject to either the estate tax or the gift tax in the case of such surviving spouse.<sup>13</sup>

The 1948 requirements that the spouse have *entire* income and power to appoint the *entire* corpus in effect required the use of two trusts if the testator wished to provide for other beneficiaries by the mechanism of a trust. If the entire estate was given in one trust, and the widow was given income from, and power to appoint, part of the trust while the children were given similar interests in the balance, no part of the trust qualified for the marital deduction. Clearly, however, if the testator had specified the creation of two trusts, for exactly the same purposes, the marital deduction would have been available as to the trust for the spouse.

Congress removed this two-trust obstacle with the 1954 amendments to the marital deduction provisions.<sup>14</sup> A trust is now allowed to qualify for a marital deduction, as an exception to the terminable interest disqualification, when the surviving spouse is entitled to all the income from the whole trust or from a "specific portion" of the trust, and has the power to appoint the whole corpus or a "specific portion" thereof.<sup>15</sup> This does not require that the right to income and the power to appoint relate to the same amount of corpus; if the interests are not identical,

<sup>10</sup> S. Rep. No. 1013, 80th Cong., 2nd Sess. (1948), 1948-1 C.B. 305.

<sup>11</sup> S. Rep. No. 1013, 80th Cong., 2nd Sess. (1948), 1948-1 C.B. 341.

<sup>12</sup> Revenue Act of 1948, ch. 168, §361(e)(1)(F), 62 Stat. 118.

<sup>13</sup> S. Rep. No. 1013, 80th Cong., 2nd Sess. (1948), 1948-1 C.B. 342.

<sup>14</sup> S. Rep. No. 1622, 83rd Cong., 2d. Sess., 125 (1954).

<sup>15</sup> Int. Rev. Code of 1954, §2056(b)(5).

the marital deduction is available to the extent of the smaller interest which is the "specific portion."<sup>16</sup>

The key phrase in the 1954 provision is clearly "specific portion," which is not defined in the Internal Revenue Code. The legislative history, however, did use a fraction to illustrate an application of the new provision.<sup>17</sup> The Treasury Regulation subsequently defining the term,<sup>18</sup> required that the specific portion be a "fractional or percentile share of a property interest." The Regulations further declared a benefit expressed as a specific sum (of either income or corpus) did not satisfy the marital deduction requirements for a "specific portion."

The validity of the Regulation requiring the use of a fraction or percent was challenged in several instances. The courts were of conflicting opinion as to whether the Regulation was consistent with the intent of Congress. The Second<sup>19</sup> and Seventh Circuits<sup>20</sup> concluded that the Regulation was not an accurate interpretation of congressional intent and declared it invalid as unduly restrictive. These Circuits concluded, basically, that the term "specific portion" could apply to a gift of a fixed amount of income. They further concluded that the total amount involved could be computed and the "specific portion" thus determined. These courts both adopted two important arguments. First, they argued that Congress would have used the phrase "fraction or percent" if that was what was intended; but since the term "specific portion" was used and was clearly susceptible to broader interpretations, the limitation of the Regulations was not justified.<sup>21</sup> Secondly, the courts observed that the use of actuarial computation is common in many other similar tax situations; consequently, it is hardly something that could be termed a judicial innovation.<sup>22</sup> The individual cases which might arise in which the government would lose taxes because of the assumptions inherent in such computation would be off-set in other cases by the opposite result.<sup>23</sup>

The court,<sup>24</sup> which in effect upheld the Treasury Regulations defin-

<sup>16</sup> See Treas. Regs. §20.2056(b)-5(b) (1958) and *Gelb v. Commissioner*, 298 F.2d 544, 550 (2d Cir. 1962).

<sup>17</sup> S. Rep. No. 1622, 83rd Cong., 2nd Sess. 474 (1954). The relevant language from the Senate Report is the following:

For example, if the decedent in his will provided for the creation of a trust under the terms of which the income from all or one-half of the trust property is payable to this surviving spouse with uncontrolled power in the spouse to appoint all or such one-half of the trust property by will, such interest will qualify as an exception from the terminable interest rule.

<sup>18</sup> Treas. Reg. §20.2056(b)-5(c) (1958).

<sup>19</sup> *Gelb v. Commissioner*, 298 F.2d 544 (2d Cir. 1962).

<sup>20</sup> *Citizens Nat'l. Bank of Evansville v. Commissioner*, 359 F.2d 817 (7th Cir. 1966).

<sup>21</sup> 298 F.2d 544, 550-551 (2d Cir. 1962); 359 F.2d 817, 821 (7th Cir. 1966).

<sup>22</sup> 298 F.2d 544, 551-552 (2d Cir. 1962); 359 F.2d 817, 821 (7th Cir. 1966).

<sup>23</sup> 298 F.2d 544, 552 (2d Cir. 1962).

<sup>24</sup> *Northeastern Pennsylvania Nat'l. Bank & Trust Co. v. United States*, 363 F.2d 476 (3d Cir. 1966).

ition of "specific portion," relied heavily upon the general history of the marital deduction. The beginning premise is that the basic intent was to equalize estate tax treatment in community property and common law states. Since the spouse in a community property state was outright owner of one-half of the estate, such spouse bore the risk of appreciation in value of the estate and of the greater taxes which would result at such spouse's death. Thus, it was reasoned, the spouse in common law property states must receive an interest subject to similar risks.<sup>25</sup>

This is the point the dissent in *Northeastern*<sup>26</sup> is making. The dissent suggests that the majority had misunderstood the use of the phrase "virtual owner" in the original marital deduction legislative history.<sup>27</sup> As the dissent reads the Senate Report, there is implicit in the term and the context, a concept of the surviving spouse acquiring an interest which will be subject to estate tax on an amount to be determined at the date of death of the surviving spouse.<sup>28</sup> This conclusion is not illogical. However, the point of the majority opinion in *Northeastern* still stands;<sup>29</sup> there is no express reference by Congress to the requirement (set forth in Regulations only) that the surviving spouse share with the government the risk of appreciation in value of the corpus.

To support the logic of its conclusion, the dissent refers to *United States v. Stapf*.<sup>30</sup> *Stapf*, the dissent contends,<sup>31</sup> supports the reasoning that a marital deduction should not be available when the spouse is not the "virtual owner" of the property—when such spouse does not share the risk of appreciation in value of the property and the result is a tax free transfer of wealth to a succeeding generation.

It is interesting to note that the majority in *Northeastern* also referred to *United States v. Stapf* as providing a discussion of the legislative history and purpose of the marital deduction provisions.<sup>32</sup> The fact situation in *Stapf* is considerably different than the facts presented in *Northeastern*.

In *Stapf*,<sup>33</sup> the testator required his wife to relinquish her community property and allow his will to govern its disposition as a condition to her taking under the will. The widow did relinquish her community property which then passed to their children. The widow then received one-third of both the separate and community property of the decedent. However, since the marital deduction must be determined by the net economic

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<sup>25</sup> *Id.* at 482.

<sup>26</sup> *Northeastern Pennsylvania Nat'l. Bank & Trust Co. v. United States*, 387 U.S. 213 (1967).

<sup>27</sup> *Id.* at 228-229.

<sup>28</sup> *Ibid.*

<sup>29</sup> *Id.* at 222.

<sup>30</sup> 375 U.S. 118 (1963).

<sup>31</sup> 387 U.S. 213, 228 (1967).

<sup>32</sup> *Id.* at 219.

<sup>33</sup> *United States v. Stapf*, 375 U.S. 118 (1963).

interest passing to the spouse,<sup>34</sup> and because the widow in fact gave up more than she received, no marital deduction was allowed.

Concededly *Stapf* contains strong language to the effect that the marital deduction provisions are not intended to effect tax free transfers to succeeding generations.<sup>35</sup> It is not necessarily inconsistent, however, for the majority in *Northeastern* to rely on this case, contrary to the suggestion of the dissent. The widow in *Northeastern* had the power to appoint the entire corpus; consequently, a tax free transfer of wealth to her children could not occur. Thus, even if the dissent is correct, and the legislative history precludes interpretation which would allow tax free transfers to succeeding generations, the issue is not raised by the facts before the court in *Northeastern*.

Taking a broader view of the risk of appreciation in value of the corpus, the most that can be said is that the legislative history is inconclusive. There is no language which unequivocally supports either the position of the majority or that of the dissent. The very lack of clear statements on this question may be a valid reason to limit the holding in *Northeastern* to its specific facts. This, of course, suggests that there may be difficulties in determining the extent to which the Regulation in question in *Northeastern* was in fact invalidated. It is possible that the power to appoint a "specific portion" of a trust corpus must still contain the risk of appreciation in the value of the whole.

If the majority in *Northeastern* is implying that a power to appoint a "specific portion" of the corpus may now be expressed as a power to appoint a sum certain, then the tax inequality feared by the dissent will exist. As the dissent points out,<sup>36</sup> under this interpretation of "specific portion," the surviving spouse could be given the power to appoint \$100,000, and the value of this portion of corpus could increase from \$100,000 at the death of the creator of the trust to \$300,000 at the death of the spouse. In that case, \$200,000 would pass tax free at the death of the spouse.

The dissent argues that this result is contrary to both congressional intent and judicial interpretation. They suggest that the concept of "virtual owner" really is meant to include the assumption of risk of appreciation in the value of the corpus to which the power of appointment relates. Under such an interpretation, tax free transfers would not be possible. The dissenters apparently feel, however, that such construction was not adopted by the majority as the importance of the phrase "virtual owner" was dismissed somewhat summarily.

The majority in *Northeastern* refers frequently to *Gelb v. Commissioner*.<sup>37</sup> The case is cited to the effect that Congress did not express

<sup>34</sup> *Id.* at 129.

<sup>35</sup> *Id.* at 128.

<sup>36</sup> *Id.* at 227-228.

<sup>37</sup> 298 F.2d 544 (2d Cir. 1962). The question presented in the *Gelb* case was

an intent that a surviving spouse must share the fluctuations of economic performance of the corpus in the same manner as the virtual owner to be entitled to a marital deduction.<sup>38</sup> The court, however, also makes it clear that it is not deciding the situation of *Gelb*,<sup>39</sup> which could be interpreted as a case involving a power of appointment over a specific portion of corpus.

### III. THE VALUATION PROBLEM

Once it is determined that the marital deduction provisions at least do not require a "specific portion" income interest to be expressed as a fraction or percent, there is a problem in determining how to compute the amount of the corpus to which the deduction applies. It is clear that the annuity value of the surviving spouse's right to particular amounts of income will not be considered the marital deduction "specific portion."<sup>40</sup> An annuity valuation is, of course, a calculation which considers the actuarial life expectancy of the beneficiary; consequently, the value relates to future rights. This, as the Court pointed out, is not a proper consideration when determining a marital deduction.<sup>41</sup>

Although allowing a right to a set amount of income to qualify as a "specific portion" of the trust corpus, the Court in *Northeastern* did not say exactly how that portion should be computed. Two alternative methods appear to be available.

The language of the Court suggests that a proper computation may be based on the projection of the reasonable rate of return of the entire trust corpus.<sup>42</sup> The income reasonably expected from the entire corpus is then computed and set in a ratio to the stipend required to be paid. This ratio is equivalent to the ratio between the unknown specific portion and the entire corpus. The unknown "specific portion" can be computed algebraically as follow:

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whether the interest of another in a trust could be 'carved out' and the balance applied to the marital deduction. The testator gave the widow *all* the income from the trust, and the power to invade the corpus if the income was less than \$833 a month or \$10,000 a year. She also had the power to appoint the corpus by will. The difficulty arose, however, because of a direction for the trustees to provide for the maintenance, education and upbringing of the youngest daughter of the testator by expending not more than \$5,000 annually for that purpose. The Court of Appeals determined that the amount available for the benefit of the daughter could be computed actuarially and deducted from the total trust in order to determine the "specific portion" available for the marital deduction.

<sup>38</sup> *Northeastern Pennsylvania Nat'l. Bank & Trust Co. v. United States*, 387 U.S. 213, 222 (1967).

<sup>39</sup> *Id.* at 225.

<sup>40</sup> *Ibid.*

<sup>41</sup> *Ibid.*

<sup>42</sup> *Id.* at 223, 224. The Third Circuit Court of Appeals referred to this ratio as involving the maximum income which the corpus could produce. The Supreme Court has substituted "reasonable rate of return" for "maximum income" but otherwise appears to approve this method of calculation.

1. Rate of return X Total corpus	=	Total Income
2. <i>Specific portion</i>	=	<i>Stipend</i>
Total corpus		Total income
3. Specific portion	=	<i>Stipend</i> X (Total corpus)
		Total income

This method of computation, however, may be subject to several difficulties. In a footnote,<sup>43</sup> the Court suggests that agreement on a reasonable rate of return depends upon, and requires, "reasonable investment conditions." The Court further suggests that such conditions may not exist when there are specific restrictions on the power of the trustee to invest. Consequently, a testamentary trust which is designed to keep certain property in the family, such as stock in a closely held corporation, might be precluded from a marital deduction as a "specific portion."

Another method of computation of the "specific portion" which may be inferred from the language of the Court is somewhat simpler than the above.<sup>44</sup> First, a reasonable rate of return is decided upon; this apparently is a rate reasonably to be expected from trust investments generally, and would not involve the particular property in the particular trust in question. Knowing the rate of return, and the stipend to be produced, the amount necessary to produce the stipend can be computed. This amount is then the "specific portion" to which the marital deduction applies.<sup>45</sup>

1. (Specific portion) X (Rate of return) = Stipend
2. Specific portion = *Stipend*

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Rate of return

At the writing of this article, there were no Treasury Regulations which expressly accept or reject either method of computation. However, there is a decision from the Seventh Circuit which in fact computed the "specific portion" by the latter method suggested by the *Northeastern* case.

*Citizens Nat'l Bank of Evansville v. United States*<sup>46</sup> involved a trust under which the widow was entitled to \$200.00 per month up to a specific date and \$300.00 per month thereafter for life. She also had

<sup>43</sup> *Id.* at 224.

<sup>44</sup> The language from which this method of computation is inferred is the following:

It should not be a difficult matter to settle on a rate of return available to a trustee under reasonable investment conditions, which could be used to compute the "specific portion" of the corpus whose income is equal to the monthly stipend provided for in the trust.

*Id.* at 224.

<sup>45</sup> These computations are, of course, subject to a maximum value of one-half the adjusted gross estate of the decedent which is allowable as a marital deduction.

<sup>46</sup> 359 F.2d 817 (7th Cir. 1966).





inaccurate under the particular circumstances. By analogy, then, a rate for specific portion computation could probably be challenged if the taxpayer could show circumstances such as (1) provisions in the governing instrument limiting the investment to particular classes of property on which the return has been substantially more or less than the rate suggested in the Regulation;<sup>53</sup> (2) past history of the property held in fact, even though the instrument does not require it to be held;<sup>54</sup> (3) the record as a whole, including the speculative nature of the investment.<sup>55</sup>

In a situation where it was necessary to value the life estate which preceded a charitable remainder, the Tax Court concluded<sup>56</sup> that the computation should be based on the actual yield of the estate (rather than the tables provided by the Regulations) and the physical condition of the life beneficiary (rather than her actuarial expectancy). The "yield" was defined as the percentage of return on the investment. This was computed on the basis of the dividends actually paid and the market price at the date of the decedent's death (rather than the par value of the stock at that time).<sup>57</sup> The formula used was:

$$\text{Rate of return on investment} = \frac{\text{dividends actually paid}}{\text{market price}}$$

The yield (or rate of return) was, in fact, somewhat less than  $3\frac{1}{2}\%$ , but this figure was used for convenience of computation. The government's contention that the 4% rate of the Regulations should be used was overruled. This method of computation of a rate return may be useful in computing the marital deduction specific portion. It is arguably prima facie reasonable since it was adopted by the Tax Court. It would appear to offer something of a precedent on which original computations or challenges to existing rates could be based. Although it may be limited to situations where stock is involved, it would appear to be useful in those circumstances.

#### IV. CONCLUSIONS

A marital deduction for a "specific portion" of a trust is available when the surviving spouse is entitled to a set amount of income for life.<sup>58</sup> Such specific portion can apparently be computed in either of two ways, but the simplest method seems to be to divide the stipend to be produced

F. Supp. 73 (Ct. Cl. 1945); *Huntington Nat'l. Bank v. Commissioner of Internal Revenue*, 13 T.C. 760 (1949).

<sup>53</sup> *Havley v. United States*, 63 F. Supp. 73 (Ct. Cl. 1945).

<sup>54</sup> *Estate of Irma Green v. Commissioner of Internal Revenue*, 22 T.C. 728 (1954).

<sup>55</sup> *Estate of Milton Sills*, 35 B.T.A. 815 (1937).

<sup>56</sup> *Huntington Nat'l. Bank v. Commissioner of Internal Revenue*, 13 T.C. 760 (1949).

<sup>57</sup> *Id.* at 771.

<sup>58</sup> *Northeastern Pennsylvania Nat'l. Bank & Trust Co. v. United States*, 387 U.S. 213 (1967).

by the rate of return reasonably to be expected. This method has been followed in fact by the Seventh Circuit.<sup>59</sup>

The problem of determining what is a reasonable rate of return may be subject to further difficulty. It is likely that a Treasury Regulation will be promulgated establishing the rate to be used. However, if it is not, there seems to be other methods available by which it can be determined. One court has determined a reasonable rate of return by reference to the rate used in annuity valuation tables in the Treasury Regulations.<sup>60</sup> Another has determined the rate of return on the basis of the market price of the stock involved and the dividends in fact paid by such stock.<sup>61</sup> Still other courts have refused to accept Treasury Regulation determination of a general rate of return to be used, when the facts of the particular case indicate a far different rate was in fact earned or to be expected.<sup>62</sup> In one case, where the governing instrument restricted the types of investments to be made, the court seemed to find something akin to a restriction on the amount of income to be produced;<sup>63</sup> this suggests that an instrument governing a marital deduction trust might require investment at a given rate of return and that this requirement might be the reasonable rate of return on which to base the computation of the deduction. This suggestion, however, may run afoul of the statement by the Supreme Court in *Northeastern* that a reasonable rate of return presupposed lack of restrictions on the investments.<sup>64</sup>

The availability of a specific portion marital deduction for a set sum of income does not necessarily imply that the power to appoint a set sum of the corpus will also qualify for the deduction. Factually, this situation has not been before the Supreme Court. Although the legislative history is not conclusive on this question, and indeed did not even deal with such a fact situation, the Supreme Court did say in *Northeastern* that "specific portion" did not *per se* require that the spouse share with the government the risk of fluctuation in value.<sup>65</sup> However, the Court, in another case, has also emphatically stated that the marital deduction was not intended to allow tax free transfers of wealth to succeeding generations.<sup>66</sup> There is nothing in the facts of *Northeastern* to suggest that the Court is reversing this prior position; there is language which

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<sup>59</sup> *Citizens Nat'l. Bank of Evansville v. United States*, 359 F.2d 817 (7th Cir. 1966).

<sup>60</sup> *Ibid.* See Treas. Regs. §20.2031-7 (1961).

<sup>61</sup> *Huntington Nat'l. Bank v. Commissioner of Internal Revenue*, 13 T.C. 760 (1949).

<sup>62</sup> *Estate of Milton Sills*, 35 B.T.A. 815 (1937); *Havley v. United States*, 63 F. Supp. 73 (Ct. Cl. 1945).

<sup>63</sup> *Havley v. United States*, *supra* note 62.

<sup>64</sup> *Northeastern Pennsylvania Nat'l. Bank & Trust Co. v. United States*, 387 U.S. 213, 224 (1967).

<sup>65</sup> *Id.* at 222.

<sup>66</sup> *Stapf v. United States*, 375 U.S. 118, 128 (1963).

strongly indicates that the Court is not deciding this question at this time.<sup>67</sup> Considering the necessity of long-range planning in this area of the law, it would perhaps be wiser not to rely on the "tax advantage" suggested by the dissenters in *Northeastern*; they may prove to be right, and the power to appoint a specific sum also may satisfy the "specific portion" requirements, but this is neither necessarily nor conclusively established either by legislative history, by the statutes themselves, or by prior judicial interpretation.

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<sup>67</sup> *Northeastern Pennsylvania Nat'l. Bank & Trust Co. v. United States* 387 U.S. 213, 224-225 (1967).