FEDERAL TAXATION: SUPREME COURT DISAPPROVES TREASURY REGULATION'S IMPOSITION OF FRACTIONAL OR PERCENTILE SHARE REQUIREMENT ON SECTION 2056(b)(5) MARITAL DEDUCTION

SECTION 2056(b)(5) of the Internal Revenue Code of 1954[1] provides that a bequest to a decedent's spouse of a life estate with a power of appointment qualifies for the estate tax marital deduction if the surviving spouse is entitled to all the income for life and has the general power to appoint the entire interest, or is entitled to all of the income from a *specific portion* thereof for life with the general power to appoint such *specific portion.* In *Northeastern Pennsylvania National Bank & Trust Company v. United States*[2] the Supreme Court held that a widow's right to fixed monthly payments from a testamentary trust was a deductible interest within the "specific portion" language of this section of the Code. Under decedent's will, his widow was to receive $300 per month, to be paid from the income and, if necessary, corpus of the trust. In addition, the widow was given a general power of appointment over the entire corpus. Reasoning that there was no method of evaluation available which could satisfactorily isolate the "specific portion" of the corpus from which the widow had the right to all the income, the Court of Appeals for the Third Circuit approved the Commissioner's disallowance of a marital deduction for the trust,[3] after the estate had won a refund in the district court.[4] The Supreme Court reversed, concluding that the relationship between the monthly stipend and the monthly income which would be generated by the corpus if invested at a normal rate of trust return adequately defined a "specific portion" of the corpus for section 2056 purposes.

The marital deduction was introduced into the estate tax[5] in an

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[1] INT. REV. CODE OF 1954, § 2056(b)(5).

[2] 387 U.S. 213 (1967).

[3] Northeastern Pa. Nat'l Bank & Trust Co. v. United States, 363 F.2d 476 (3d Cir. 1966), *noted in* 35 FORDHAM L. REV. 553 (1967); 55 ILL. B.J. 516 (1967); 51 MINN. L. REV. 568 (1967); 19 STAN. L. REV. 468 (1967); *and* 18 W. RES. L. REV. 996 (1967).

[4] Northeastern Pa. Nat'l Bank & Trust Co. v. United States, 235 F. Supp. 941 (M.D. Pa. 1964).

[5] Revenue Act of 1948, ch. 168, § 361, 62 Stat. 117 (now INT. REV. CODE OF 1954, § 2056).

effort to extend the advantages of two-stage taxation enjoyed by married couples in community property states to citizens in common law jurisdictions.[6] Under the provisions of section 2056, interests transferred in fee to a surviving spouse are deductible from a decedent's gross estate, as are both legal and equitable life estates, if the surviving spouse has been given the right to "all the income" from, and a general power of appointment over, the entire interest or a "specific portion" thereof.[7] This legislative allowance of the marital deduction was constricted by the Treasury Department Regulation providing that a partial interest could not qualify as a "specific portion" unless "the rights of the surviving spouse in income and as to the power constitute a fractional or percentile share of a property interest."[8] Further, if the income or power of appointment were limited to a specific sum, the interest was not deductible under explicit language of the Treasury's pronouncement.[9] This restrictive interpretation of the phrase "all the income from a specific portion" was based on the theory that the share of a surviving spouse must reflect its proportionate part of the increment or decline in the value of the property interest so that any change during the life of the surviving spouse may be reflected in the amout to be included in her gross estate at death.[10]

The threshold case dealing with the definition of "specific portion," *Gelb v. Commissioner*,[11] rejected the Treasury's fractional or percentile share requirement and indicated that "specific portion" included any designation of interest from which the deduction could feasibly be computed.[12] In *Gelb* a widow was given the entire income generated by a trust established by her deceased husband, with a testamentary power to appoint the entire corpus to

[6] *See, e.g.*, United States v. Stapf, 375 U.S. 118, 128 (1963); S. REP. No. 1013, 80th Cong., 2d Sess., pt. 1, at 26-29 (1948); H.R. REP. No. 1274, 80th Cong., 2d Sess. 24-26 (1948); C. LOWNDES & R. KRAMER, FEDERAL ESTATE AND GIFT TAXES §§ 2.4, 11.14 (2d ed. 1962). *See also* Anderson, *The Marital Deduction and Equalization Under the Federal Estate and Gift Taxes Between Common Law and Community Property States*, 54 MICH. L. REV. 1087 (1956).

[7] INT. REV. CODE OF 1954, § 2056 (b) (5).

[8] Treas. Reg. § 20.2056 (b)-5 (c) (1958).

[9] *Id.*

[10] *See id.*; Note, *The Estate Tax Marital Deduction: A Procrustean Bed of Perplexities*, 34 GEO. WASH. L. REV. 319, 325 n.46 (1965).

[11] 298 F.2d 544 (2d Cir. 1962).

[12] *See generally* C. LOWNDES & R. KRAMER, FEDERAL ESTATE AND GIFT TAXES 407 (1st ed. 1956) (reached same conclusion, but before regulations were issued).

anyone or to her estate, subject, however, to discretionary invasion by the trustees of up to $5,000 each year for the benefit of the decedent's child. The court allowed a deduction of the amount of the corpus less the value of the maximum yearly invasion capitalized over the joint lives of the surviving spouse and the child. This interpretation of section 2056 (b) (5) was followed in *Allen v. United States*,[13] in which the court allowed a marital deduction where the surviving spouse was entitled to receive the entire trust income and had the power to invade the corpus to the extent of $5,000 per year. While the *Allen* court did not expressly consider the problem of computation, it did limit the deduction to $5,000, the amount which the widow had the power to appoint in the year of her death, and which would be included in *her* estate for tax purposes.[14] Against this background of explicit judicial rejection of the Commissioner's position, the Seventh Circuit decided *Citizens National Bank v. United States*,[15] a case substantially identical to that before the Supreme Court in *Northeastern*. Relying on *Gelb*, the Seventh Circuit allowed the deduction of a sum which would have provided, according to Treasury tables,[16] the stipulated monthly payments for the life expectancy of the surviving spouse. In the *Northeastern* case, however, the Third Circuit, while apparently agreeing that a "specific portion" need not be a fractional share, found no acceptable means of ascertaining the portion of the corpus from which the survivor was entitled to all the income, and, therefore, disallowed the deduction.

Considering resolution of the conflict between circuit court decisions to be "essentially a matter of discovering the intent of Congress," the Supreme Court turned to the legislative history of the marital deduction to test the validity of the Commissioner's Regulation.[17] The Court indicated that absent specific legislative authority for the "fractional or percentile share" requirement, the regulation could not stand since it was inconsistent with the general intent of Congress to provide a liberal estate-splitting possibility free from arbitary technicalities. It was argued by the

[13] 250 F. Supp. 155 (E.D. Mo. 1965). *See also* Flesher v. United States, 238 F. Supp. 119 (N.D.W. Va. 1965).

[14] *See* INT. REV. CODE OF 1954, § 2041.

[15] 359 F.2d 817 (7th Cir. 1966), *cert. denied*, 387 U.S. 941 (1967).

[16] Treas. Reg. § 20.2031-7 (f) (1958) (Table I).

[17] Treas. Reg. § 20.2056 (b)-5 (c) (1958).

Government that explicit in the Senate report's description of the surviving spouse as "virtual owner" of the deductible interest,[18] and implicit in the underlying legislative purpose to achieve equality in tax treatment in community property and common law jurisdictions, was the concept that the deduction be allowed only for the equivalent of outright ownership, one of the incidents of which is income fluctuation. In response, the Court interpreted congressional intent to require only that the surviving spouse's right to income and power over corpus be such that the unconsumed remainder of the deductible portion of the decedent's estate would ultimately be taxable to the estate of the survivor. Where, as in the instant case, this legislative requirement has been satisfied, a denial of the deduction because of difficulty in computation could only be characterized as a technical forfeiture of the type which the "specific portion" provision was designed to eliminate. Refuting the Third Circuit's conclusion that the computation could not be made because of the uncertainty of market conditions, the Supreme Court decided that in light of the widespread use of projected rates of return in the administration of federal tax laws,[19] a rate of return available to a trustee under normal investment conditions could be employed to compute the "specific portion" of the corpus necessary to produce the monthly stipend contemplated by the will. Thus, the deductible portion was to be computed by first determining the ratio of the fixed monthly stipend to the projected monthly income of the corpus invested at a normal rate of trust return; this ratio was then to be multiplied by the value of the corpus.

Allowance of the marital deduction in the present case, where the unconsumed trust property will be taxed to the widow's estate by virtue of her general power of appointment over the entire corpus,[20] not only comports with Congress' intent to provide a liberal estate-splitting possibility for persons in common law states,[21] but also fully satisfies the rationale of the administrative regulation: any change in property value during the widow's life will be reflected in the estate tax incurred at her death. Furthermore, the result enables estate planners to guarantee the surviving spouse's income

[18] S. REP. No. 1013, 80th Cong., 2d Sess., pt. 2, at 16 (1948).
[19] *See* Gelb v. Commissioner, 298 F.2d 544, 551 n.7 (2d Cir. 1962).
[20] INT. REV. CODE OF 1954, § 2041.
[21] Authorities cited note 6 *supra*.

regardless of investment conditions, while achieving the maximum benefits of the marital deduction.[22] Requiring closer scrutiny is the method of computation employed by the Court. The annuity valuation used by the district court,[23] and by the Seventh Circuit in *Citizens*,[24] to determine the amount of the deduction was summarily dismissed by the Supreme Court in *Northeastern* as "incorrect." Because this method anticipates dissipation of the *entire* fund over the life expectancy of the beneficiary, it produces a result seemingly not contemplated by the decedent, despite the will provision allowing invasion of corpus if trust income should ever be insufficient to provide the fixed stipends. Similarly, the annuity concept is inconsistent with section 2056 (b) (5) which allows a deduction for the "specific portion" of corpus from which the spouse is entitled to regular payments of "all the income." Since annuity payments include elements of both income and principal, annuity valuation is not relevant to a determination of what "specific portion" of corpus would produce a specified *income* per month.

While the annuity valuation method concerns itself with the present value of the widow's interest in receiving a fixed income for life, the *Northeastern* method computes the amount of the corpus over which the widow possesses the requisite characteristics of fee ownership. Only this latter method can produce a conceptually satisfactory valuation; for under section 2056(b) (5) it is not the value of the widow's rights, but the specific portion of the corpus over which she may exercise those rights that qualifies for the deduction. The method here approved is not an innovation of this Court but finds judicial precedent in estate tax cases[25] involving transfers with retained life estates.[26] In these cases the courts, like the Supreme Court in *Northeastern*, have been concerned with valuation of the portion of a trust necessary to produce periodic payments of a fixed amount, situations sufficiently analogous to the instant case to furnish significant support for the Court's choice of method. Neverthe-

[22] 19 Sw. L.J. 426, 427 (1965). *See generally* Lovell, *Marital Deduction Simplified*, 93 TRUSTS & ESTATES 760, 761-62 (1954).

[23] 235 F. Supp. at 944 n.4.

[24] 359 F.2d 817, 819 (7th Cir. 1966), *cert. denied*, 387 U.S. 941 (1967). See notes 15-16 *supra* and accompanying text.

[25] *In re* Estate of Uhl, 241 F.2d 867 (7th Cir. 1957); *see* Industrial Trust Co. v. Commissioner, 165 F.2d 142 (1st Cir. 1947).

[26] INT. REV. CODE OF 1954, § 2036.

less, the potential significance of this case is limited by its failure to furnish a generally applicable replacement for the disapproved administrative definition of "specific portion." Instead, by refusing to consider the "quite different problem" of possible tax avoidance that would be presented by an extension of this method to situations involving a power of appointment over a fixed dollar amount,[27] the Supreme Court has left the door open to yet another round of interpretive litigation in the lower courts.

[27] 387 U.S. at 225-28 (Stewart, Black, & Harlan, JJ., dissenting).