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Federal Estate Tax-Determination of Marital Deduction in Community Property State When Surviving Spouse Elects to Take Under Decedent's Will

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FEDERAL ESTATE TAX—DETERMINATION OF MARITAL DEDUCTION IN COMMUNITY PROPERTY STATE WHEN SURVIVING SPOUSE ELECTS TO TAKE UNDER DECEDENT'S WILL—Decedent, a Texas resident, provided that if his wife elected to take under his will she would receive one-third of the total community property and one-third of his separate estate. The remaining two-thirds of decedent's total estate was devised in trust for the benefit of his children. The widow elected to take under the will, thereby allowing her interest in the community property to pass as provided in the will. The executors claimed a marital deduction for the one-third separate property passing to the widow. Since she received less under the will than the value of her relinquished community property,[1] the government disallowed the deduction. After paying the deficiency, the executors brought suit for a refund. The district court held that the bequest of one-third separate property qualified for the marital deduction.[2] On appeal, *held*, affirmed, one judge dissenting.[3] In determining the amount of the marital deduction, the value of the separate property passing to the surviving spouse is not reduced by the value of her relinquished community property passing under the will to decedent's children. *United States v. Stapf*, 309 F.2d 592 (5th Cir. 1962), *cert. granted*, 372 U.S. 928 (1963).

For the purpose of the federal estate tax, a decedent's gross estate includes any interest in property he owned at death.[4] Since each spouse has a present, existing, and equal right in community property,[5] only one-half of the value of the community property is included in the gross estate of the first spouse to die. On the other hand, in common-law states the value of the surviving spouse's dower, curtesy, or statutory substitute is considered an expectancy and is included in the decedent's gross estate.[6] The 1948 enactment of the marital deduction[7] was part of an over-all plan[8] to create

[1] The net value of the widow's community property was $111,442.68. The benefits she received under the will amounted to $106,268.18. Principal case at 594.

[2] 189 F. Supp. 830 (N.D. Tex. 1960).

[3] The principal case also held, one judge dissenting, that a deduction for the full amount of the community debts was valid since decedent provided all such debts were to be paid from his share of the community property. Since almost all of the debts were taxes imposed by law and not based on a promise or an agreement, the claim did not have to be for adequate consideration.

[4] INT. REV. CODE OF 1954, § 2033.

[5] See 1 DE FUNIAK, COMMUNITY PROPERTY § 95 (1943). Prior to 1927, the wife's interest in California community property was a mere expectancy and was included in the husband's gross estate. CAL. CIVIL CODE § 161(a); see, *e.g.*, Horst v. Commissioner, 150 F.2d 1 (9th Cir.), *cert. denied*, 326 U.S. 761 (1945).

[6] INT. REV. CODE OF 1954, § 2034; see Westfall, *Estate Planning and the Widow's Election*, 71 HARV. L. REV. 1269, 1286-87 (1958).

[7] Int. Rev. Code of 1939, § 812(e), added by ch. 168, 62 Stat. 117 (1948), as amended, ch. 512, 67 Stat. 624 (1953) (now INT. REV. CODE OF 1954, § 2056). For the legislative interpretation of the marital deduction, see S. REP. No. 1013, pt. 2, 80th Cong., 2d Sess. 2-29 (1948).

[8] The amendments provided for a marital deduction for gifts. Int. Rev. Code of

geographic tax equality[9] between the common-law and community property states.[10] In general, the marital deduction is allowed for property passing from the decedent to the surviving spouse in absolute ownership or its equivalent.[11] In common-law states the deduction is limited to fifty percent of the adjusted gross estate.[12] However, in community property states only fifty percent of a decedent's separate property can qualify.[13] A special problem in determining the amount of the marital deduction arises in a community property state when the decedent's will puts the surviving spouse to an election.

The doctrine of election[14] presents the surviving spouse with two alternatives. She can accept the benefits under the will, thus assenting to the decedent's disposition of her community property interest. Or, she can elect to take her one-half of the community property, thereby denying the decedent a right of disposition over her interest and rejecting the provisions made for her in the will. If the surviving spouse elects to take under the will, there are several tax consequences. Despite decedent's power of disposition over the total community property, only one-half is included in his gross estate.[15] However, the surviving spouse must pay a gift tax to the extent the property she relinquished exceeds the value of the benefits she

1939, § 1004(a)(3)(A), added by ch. 168, 62 Stat. 125 (1948) (now INT. REV. CODE OF 1954, § 2523). They also allowed married couples in common-law states to file a joint return. Int. Rev. Code of 1939, § 51(b), added by ch. 168, 68 Stat. 115 (1948) (now INT. REV. CODE OF 1954, § 6013).

9 H.R. REP. No. 1274, 80th Cong., 2d Sess. 26 (1948). See 2 BEVERIDGE, FEDERAL ESTATE TAXATION § 14.01 (1956); 4 MERTENS, GIFT AND ESTATE TAXATION 138 (1959). However, complete equality has not been attained. See 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, 1088-99 (1956); De Wind, *The Approaching Crisis in Federal Estate and Gift Taxation*, 38 CALIF. L. REV. 79, 86-91 (1950); Surrey, *Federal Taxation of the Family—The Revenue Act of* 1948, 61 HARV. L. REV. 1097 (1948). For a discussion of the failure of the 1942 amendments to achieve estate tax equality, see LOWNDES & KRAMER, ESTATE AND GIFT TAXES 371-72 (1956).

10 There are eight traditional community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington.

11 Dispositions that are equivalent to absolute ownership are enumerated in INT. REV. CODE OF 1954, § 2056(b). For explanation of the "terminable interest rule," see Reilly v. Commissioner, 239 F.2d 797 (3d Cir. 1957); S. REP. No. 1013, pt. 2, 80th Cong., 2d Sess. 7-18 (1948); 2 BEVERIDGE, *op. cit. supra* note 9, §§ 14.02 & 14.03; Polasky, *Estate Tax Marital Deduction in Estate Planning*, 3 Tax Counselors Q., June 1959, pp. 17-31; Note, 107 U. PA. L. REV. 1176 (1959).

12 INT. REV. CODE OF 1954, § 2056(c)(1). The adjusted gross estate is determined by subtracting from the gross estate the expenses, debts, taxes and losses allowed by INT. REV. CODE OF 1954, §§ 2053, 2054.

13 INT. REV. CODE OF 1954, § 2056(c)(2)(B). In determining the amount of separate property that can qualify for the deduction, a proportionate share of the expenses, debts, taxes, and losses must be subtracted. INT. REV. CODE OF 1954, § 2056(c)(2)(B)(iv); see Treas. Reg. § 20.2056(c)-2(c)(4) (1958).

14 See 1 DE FUNIAK, *op. cit. supra* note 5, § 217. For a discussion of the tax aspects of election in the common-law states, see Westfall, *supra* note 6, at 1284-89.

15 Coffman-Dobson Bank & Trust Co. v. Commissioner, 20 B.T.A. 890 (1930); *accord*, Pacific Nat'l Bank v. Commissioner, 40 B.T.A. 128 (1939).

receives.[16] The marital deduction problem arises when decedent's separate property is part of the benefits passing to the surviving spouse. The statute provides that if the property devised to the surviving spouse is encumbered or the decedent imposes any obligation on the surviving spouse with respect to the passing of the property, the encumbrance or obligation reduces the value of the bequest.[17] The reduction is computed in the same manner as if the value of a gift of the property were being determined.[18] For example, if real estate valued at 10,000 dollars with a 1,000-dollar mortgage is devised to the widow, the value of the property in determining the marital deduction would be 9,000 dollars.[19]

The Treasury regulations provide that, when the surviving spouse elects to take under the will in a community property state, the value of decedent's separate property interest passing to her is reduced by the value of the relinquished community property.[20] The principal case rejects this regulation[21] on the following grounds. The value of the bequest is determined as if it were a gift. To reduce the value of a gift there must be a benefit to the donor, not merely a detriment to the donee.[22] The relinquished community property benefits legatees, not the testator. Therefore, the widow's relinquished community property is not deducted from decedent's separate property in determining the marital deduction.

There are three major objections to this analysis. First, the Senate report on the 1948 amendments to the Internal Revenue Code of 1939 makes it clear that if property is devised to the widow on the condition that she give 1,000 dollars to X, the value of the property for the marital deduction is reduced by 1,000 dollars.[23] Here the decedent receives no benefit from the widow. He merely effectuates an intended economic allocation of his property. Thus the Senate report did not contemplate the requirement of a benefit to the decedent that is imposed in the principal case. Second, assuming that there must be a benefit to the decedent, in the election situation

16 Commissioner v. Siegel, 250 F.2d 339 (9th Cir. 1957) (gift is amount of community property relinquished less widow's life estate in whole community property); *accord*, Turman v. Commissioner, 35 T.C. 1123 (1961); see Thurman, *Federal Estate and Gift Taxation of Community Property*, 1 ARIZ. L. REV. 253, 264-70 (1959).

17 INT. REV. CODE OF 1954, § 2056(b)(4)(B).

18 *Ibid.*

19 See S. REP. No. 1013, pt. 2, 80th Cong., 2d Sess. 6 (1948).

20 Treas. Reg. § 20.2056(b)-4(b)(3) (1949).

21 Principal case at 597. However, since the same regulation was in effect under the Int. Rev. Code of 1939 (Treas. Reg. 105, § 81.47c(b)(2)(iii) (1949)), the court should have assumed that "Congress was familiar with the construction put upon the section by the Treasury and was satisfied with it." Taft v. Commissioner, 304 U.S. 351, 357 (1938) (dictum).

22 Commissioner v. Wemyss, 324 U.S. 303 (1945). "To allow detriment to the donee to satisfy the requirement of 'adequate and full consideration' would violate the purpose of the statute and open wide the door for evasion of the gift tax." *Id.* at 307-08. However, if the strict requirement of a benefit to the donor is adhered to in the election situation, the door is opened for evasion of the estate tax statute. See text accompanying note 26 *infra*.

23 S. REP. No. 1013, pt. 2, 80th Cong., 2d Sess. 6 (1948).

the surviving spouse confers upon the decedent the only property benefit possible: the power of testamentary disposition over her property.[24] Finally, geographic tax inequalities would result from the analysis in the principal case. The intended consequence of the marital deduction was that qualifying property would be subject to taxation in the estate of the surviving spouse.[25] In common-law states this objective is achieved. For example, assume that *H*, having an estate of 600,000 dollars, dies leaving *W* 300,000 dollars. After the marital deduction *H*'s estate would be 300,000 dollars and *W*'s estate would be 300,000 dollars, or a total of 600,000 dollars in both estates. In community property states the effect is otherwise. If the principal case is followed,[26] the relinquished community property escapes both gift and estate taxation because it is not deducted from the decedent's separate property passing to the surviving spouse. For example, assume *H* and *W* have community property worth 200,000 dollars and *H* has a separate estate of 400,000 dollars. *H* dies leaving *W* 200,000 dollars of his separate estate provided *W* allows her community property to pass under his will. Absent the election, *H*'s gross estate would be 500,000 dollars (100,000 dollars community and 400,000 dollars separate), and *W*'s estate would be 100,000 dollars (one-half of the community), or a total of 600,000 dollars in both estates. After the election *H*'s estate is only 300,000 dollars (500,000 dollars less 200,000 dollars marital deduction) and *W*'s estate is 200,000 dollars (benefits received under the will) or only 500,000 dollars in both estates. Thus 100,000 dollars which would be subject to taxation in common-law states escapes taxation in community property states.

The proper analytical approach to the problem is to recognize the economic reality of the election transaction. The surviving spouse makes the ultimate choice to take under the will and thereby allows her non-qualifying community interest to pass as provided by the decedent. Thus the marital deduction should not be allowed for that which she chose to exchange for her non-qualifying property.[27] To hold otherwise creates the unequal tax burdens which the Treasury regulation[28] seeks to avoid. When interpreting statutory language, the courts should bear in mind that geographic tax equality is the purpose of the marital deduction.[29]

Jon E. Denney

24 In a common-law state, a decedent might retain testamentary control over the surviving spouse's property through the utilization of joint and mutual wills. A marital deduction would be allowed on the theory that, during the lifetime of the surviving spouse, the latter would have the power to consume or dispose of the property. Awtry v. Commissioner, 221 F.2d 749 (8th Cir. 1955). However, the widow's estate would be increased by the amount of the marital deduction, which is not the case in the community property election situation. See text accompanying note 26 *infra*.

25 Estate of Pipe, 23 T.C. 99, 104 (1954) (dictum), *aff'd*, 241 F.2d 210 (2d Cir.), *cert. denied*, 357 U.S. 814 (1957); see 2 BEVERIDGE, *op. cit. supra* note 9, at 182-83.

26 Principal case at 598.

27 *Cf.* principal case at 608 (dissenting opinion).

28 Treas. Reg. § 20.2056(b)-4(b)(3) (1949).

29 See authorities cited note 9 *supra*.