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Taxation - Federal Estate Tax - Incidence of Tax Determined by Testamentary Directive

Robert A. Smith
University of Michigan Law School

TAXATION—FEDERAL ESTATE TAX—INCIDENCE OF TAX DETERMINED BY TESTAMENTARY DIRECTIVE—An inter vivos trust created by testator and property held jointly with his wife were included in his gross estate in computing the federal estate tax.[1] Testator left his residuary estate to charity and directed in his will that the estate tax on the above inter vivos transfers be borne by the property so transferred. The government determined that the estate tax was payable out of the residue and reduced the charitable deduction[2] by the amount of the estate tax attributable to the inter vivos transfers pursuant to section 812(d) of the 1939 Internal Revenue Code.[3] The district court granted the executor a refund, deciding that the tax on the inter vivos transfers was payable out of that property as the testator directed.[4] On appeal, *held,* affirmed. Under Minnesota law the estate tax falls on the residue unless the testator, as here, indicates it is to fall on other property. *United States v. Goodson,* (8th Cir. 1958) 253 F. (2d) 900.

State law, not federal law, determines the incidence of the federal estate tax;[5] and at common law two rules vie for favor—the residue rule and the apportionment rule. The residue rule, deemed the majority view,[6] is that absent a contrary testamentary direction the tax is paid by testator's residuary estate.[7] Bases for the rule are that the testator's silence indicates his intent to rest the tax on the residue,[8] its function being to discharge the estate's debts,[9] and that specific legacies indicate testamentary intent that the legatees get their designated amounts without reduction

1 I.R.C., §§2035-2038 and 2040 include in decedent's gross estate transfers made in contemplation of death, transfers with a retained life estate, transfers taking effect at death, revocable transfers, and property held jointly by decedent with another. The court did not indicate which of the sections were applicable in the principal case.

2 I.R.C., §2055(a) provides for deduction of bequests to charitable uses.

3 Now I.R.C., §2055(c), which reduces the charitable deduction by the amount of the tax which, by either (1) the terms of the will or (2) the law of the jurisdiction, is payable out of the charitable bequest.

4 Goodson v. United States, (D.C. Minn. 1957) 151 F. Supp. 416.

5 Riggs v. Del Drego, 317 U.S. 95 (1942).

6 Principal case at 902-903. See also Sutter, "Apportionment of the Federal Estate Tax in the Absence of Statute or an Expression of Intention," 51 MICH. L. REV. 53 at 53 (1952); Fleming, "Apportionment of Federal Estate Taxes," 43 ILL. L. REV. 153 at 159 (1948).

7 Amoskeag Trust Co. v. Dartmouth College, 89 N.H. 471, 200 A. 786 (1938); Young Men's Christian Association v. Davis, 264 U.S. 47 (1924); Bemis v. Converse, 246 Mass. 131, 140 N.E. 686 (1923); Plunkett v. Old Colony Trust Co., 233 Mass. 471, 124 N.E. 265 (1919); Matter of Hamlin, 226 N.Y. 407, 124 N.E. 4 (1919), cert. den. 250 U.S. 672 (1919).

8 See Young Men's Christian Association v. Davis, note 7 supra, at 51; Bemis v. Converse, note 7 supra, at 134.

9 Amoskeag Trust Co. v. Dartmouth College, note 7 supra, at 474; Plunkett v. Old Colony Trust Co., note 7 supra, at 475-476. See also Hooker v. Drayton, 69 R.I. 290 at 295, 33 A. (2d) 206 (1943).

for taxes.[10] The judicial response of some courts to the residue rule was the development of the apportionment rule. Under this rule, absent a contrary testamentary direction, the tax is apportioned to the respective properties from which it arises.[11] In many states this rule has been established by apportionment statutes.[12] Apportionment saves the residue from obliteration or depletion by the tax,[13] thus protecting the residuary legatees, who are often the testator's dependents.[14] Each of the rules supposedly permits a testator to direct that the tax shall fall as he wishes.[15]

Testators often direct that certain portions of the *testamentary* estate shall bear the estate tax burden.[16] The principal case is one of the few in which a testator has attempted in his will to burden *non-testamentary* property with a portion of the estate tax and a court, without the aid of statute, has allowed him to do so.[17] That a testator could reach back in time, and years after a fully completed, unconditional, inter vivos transfer, command that his transferees pay an estate tax seems a startling proposition.[18] It squarely contradicts the general principle recognized in this case that ". . . once a party has disposed of his property

10 Amoskeag Trust Co. v. Dartmouth College, note 7 supra, at 473-474; In re Cole's Estate, (Ohio 1952) 111 N.E. (2d) 35.

11 In re Gallagher's Will, 57 N.M. 112 at 125-126, 255 P. (2d) 317 (1953); Industrial Trust Co. v. Budlong, 77 R.I. 428, 76 A. (2d) 600 (1950).

12 See, e.g., Cal. Probate Code (Deering, 1953) §970; N.J. Stat. Ann. (1953) tit. 3A:25-30 to tit. 3A:25-38; 13 N.Y. Consol. Laws (McKinney, 1949) §124, 1958 Pocket Part 145. Objections to the apportionment statutes have been that they breed administrative difficulties and interpretative litigation. 30 IND. L. J. 217 at 237-238 (1955); Mitnick, "State Legislative Apportionment of the Federal Estate Tax," 10 MD. L. REV. 289 (1949). But most new statutes' meanings become settled after a time. 19 CONN. B. J. 6 at 17 (1945). Because they tax completed inter vivos transfers, their unconstitutionality has also been urged, but the statutes have usually been upheld. See, e.g., In re Ryle's Estate, 170 Misc. 450 at 453-454, 10 N.Y.S. (2d) 597 (1939); Matter of Scott, 158 Misc. 481 (1936), affd. In re Scott's Will, 249 App. Div. 542, 293 N.Y.S. 126 (1937), affd. per curiam Matter of Scott, 274 N.Y. 538, 10 N.E. (2d) 538 (1937).

13 See, e.g., Jeffery's Estate, 32 Pa. D. & C. 5 (1938), affd. Jeffery's Estate, 333 Pa. 15, 3 A. (2d) 393 (1939). There the total tax on the gross estate, including certain inter vivos trusts, was $4,000 compared with a testamentary estate of $2,000.

14 Sheffield, "Notes on Equitable Apportionment of Federal Estate Taxes—A Consideration of the New York Statute," 19 CONN. B. J. 6 at 15 (1945); 30 IND. L. J. 217 at 228 (1955); 4 INTRA. L. REV. 121 (1949).

15 Principal case at 903; Plunkett v. Old Colony Trust Co., note 7 supra, at 475-476; In re Gallagher's Will, note 11 supra, at 126; and see statutes cited note 12 supra.

16 37 A.L.R. (2d) 13 (1954) and cases there cited; 15 A.L.R. (2d) 1216 at 1224 (1951) and cases there cited.

17 The court's decision was based on its interpretation of applicable Minnesota law. Recent cases giving effect to such a testamentary direction pursuant to an apportionment statute are Matter of Slade, 4 Misc. (2d) 616, 158 N.Y.S. (2d) 719 (1956) and Matter of Ruth, 206 Misc. 423, 132 N.Y.S. (2d) 650 (1954).

18 Other writers have noted the dearth of decisions on such a testamentary directive but have thought it sustainable. See Fleming, "Apportionment of Federal Estate Taxes," 43 ILL. L. REV. 153 at 167-168 (1948); Karch, "The Apportionment of Death Taxes," 54 HARV. L. REV. 10 at 36-45 (1940).

without reservation he can subsequently exercise no control over such property."[19] There thus appears to be no basis in property law for the assertion of the principal case that it is "not unreasonable" to allow the testator to burden such property with its estate tax.[20] Moreover, the possibility that a subsequent testamentary directive may burden an inter vivos grantee's property with its estate tax makes uncertain the quantum of the gift. But counterbalanced against these problems are those arising from failure to allow the testator to direct the tax burden. An unvarying application of the apportionment rule would eliminate uncertainty, but it might also create harmful inflexibility by depleting specific legacies which the testator may want to pass undiminished.[21] The damage from a uniform application of the residue rule is even greater when the residuary legatees are the testator's dependents.[22] The court could have alleviated this inflexibility while being consistent with property notions by indicating that a testamentary directive would be permissible if the testator at the time of the inter vivos transfer had informed his grantee that his property was subject to the burden of a portion of the estate tax if the testator later so willed. The testator would then have effectively reserved some control over the property. But the court did not make any distinction between revocable and irrevocable transfers.[23] Instead it chose to allow unbounded testamentary freedom, with perhaps some justification. Since the testator has legal control over some types of non-testamentary property—e.g., revocable trusts—he can as a practical matter always make such property bear its tax.[24] As to non-testamentary property over which the testator has retained no control—e.g., a gift in contemplation of death—the very fact that it was included in his taxable estate affords some basis for the testator's burdening it with a portion of the estate tax. Inter vivos transfers which are substitutes for testamentary transfers are included and taxed "as if" they were testamentary.[25] A testamentary directive, furthermore, does no more damage to traditional property concepts than does an apportionment rule or statute. The directive in the principal case operated, like apportionment, to protect the residuary legatees. But the directive left specific legacies untouched, whereas apportionment would

19 Principal case at 905.

20 Ibid.

21 Sheffield, "Notes on Equitable Apportionment of Federal Estate Taxes—A Consideration of the New York Statute," 19 CONN. B. J. 6 at 15 (1945).

22 See note 14 supra.

23 The appellate record shows that the trust in the principal case was irrevocable. But the testator retained considerable control over the corpus, inasmuch as he was both a trustee and a beneficiary and had the reserved power, together with the other beneficiaries, to distribute the trust property among them.

24 The testator could revoke the trust, bequeath the corpus to the beneficiary, and make the corpus bear its tax.

25 Ericson v. Childs, 124 Conn. 66, 198 A. 176 (1938).

have depleted them. Thus the directive is less abusive to willed property than apportionment, embracing its benefit but not its fault.

The principal case does suggest an unfortunate possibility. It could arguably be used as authority for a testator to direct that his inter vivos transferees should bear the *entire* estate tax. A vindictive testator might take advantage of such a rule to destroy his inter vivos transfers by taxation. Probably such a decision would go too far. Although there is nothing in the court's reasoning in the principal case to indicate a valid basis for so limiting the testator's discretion, perhaps even this court would not allow a testator to burden the inter vivos property beyond its proportionate share of the tax.

Robert A. Smith