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Federal Estate Tax — Marital Deduction — Effect of State Judgment

The case of *Pitts v. Hamrick*[1] holds lessons for layman and lawyer alike. To the layman it may indicate that the cost of having an estate plan is often negligible compared to the cost in increased taxes as well as unwise disposition of the assets in having no plan. The estate involved was over one million dollars; rarely does the scheme of the intestacy laws make a wise disposition in such a case. To the lawyer it should indicate that even in such a case it is sometimes possible to make a substantial tax saving if, during the proceedings in administration of the estate, counsel are aware of the tax implications of what they do.

Decedent Lyman A. Hamrick died intestate a resident of Cherokee County, South Carolina, on June 16, 1950, leaving a widow and two children and an estate of $1,139,335.15. Under the intestacy laws of South Carolina,[2] the widow was entitled to take one-third of the estate, the remaining two-thirds to be divided among the children. Under the federal estate tax law,[3] the estate was entitled to the marital deduction in "an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse," taking into account "the effect which a tax imposed by this chapter . . . . has upon the net value to the surviving spouse of such interest."[4] The marital deduction cannot exceed one-half of the "adjusted gross estate."[5] If under the law of South Carolina, the federal estate tax were payable pro tanto from the shares of the

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1. 228 F. 2d 486 (4th Cir. 1955).
2. CODE OF LAWS OF SOUTH CAROLINA, 1952 § 19-52, provides as follows:
   § 19-52. Distribution of property in case of intestacy. When any person shall die without disposing of the same by will, his estate, real and personal, shall be distributed in the following manner:
   (1) If the intestate shall leave a widow and more than one child the widow shall take one-third of the estate and the remaining two-thirds shall be divided equally among the children; but if the intestate shall leave a widow and only one child then the widow shall take one-half of the estate and the child shall take the remaining one-half of such estate.
3. INT. REV. CODE OF 1939, § 812 (e) (1) (A), now contained without substantial change in INT. REV. CODE OF 1954, § 2056 (a).
4. INT. REV. CODE OF 1939, § 812 (e) (1) (E) (i), now contained without substantial change in INT. REV. CODE OF 1954, § 2056 (b) (4).
5. INT. REV. CODE OF 1954, § 2056 (c).

widow and the children, this would reduce the amount which "passes . . . . from the decedent to his surviving spouse" by the amount of estate taxes thus borne by the widow's share, and hence under the above provisions would reduce the amount of marital deduction allowed the estate. If, however, all federal estate taxes fell upon the shares received by the children, the marital deduction would be undiminished by any amount for federal estate taxes. No provision of the statutory law of South Carolina helped in determining whether the widow's share was to bear part of the tax burden, nor was any South Carolina judicial decision helpful.[6]

The Probate Court of Cherokee County, which had jurisdiction of the proceedings in administration, entered its decree for the distribution of the estate. Among other provisions of the decree, it held that the widow was entitled to receive her share of the estate undiminished by any portion of the federal estate tax.[7] No appeal was taken from this ruling.[8] The administrator filed his federal estate tax return and took the marital deduction undiminished by any amount of federal estate tax attributable to tax paid from the widow's share, in accordance with the probate court decree. The Commissioner challenged this, assessing a deficiency of $26,220.91. The tax deficiency was paid and suit brought in the United States District Court for its recovery. Chief Judge Wyche in the district court gave judgment for plaintiff, the administrator,[9] and this was affirmed by the Fourth Circuit, in an opinion by Chief Judge Parker.

That the decision of the case is correct on the authorities does not

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6. Chief Judge Parker cited Carolina Life Ins. Co. v. Arrowsmith, 174 S.C. 161, 176 S.E. 728 (1934) for the proposition that "the South Carolina courts apply equitable principles in cases involving the incidence of the federal estate tax." 228 F. 2d 490. On the facts the case is not a close analogy.

7. Of course, sometime before a suggested decree for distributing of the assets is prepared, counsel for the administrator must point out the possible tax savings resulting if none of the federal estate tax is borne by the widow's share. After a decree has been confirmed by the probate judge and the assets distributed pursuant thereto, it is too late to look for possible tax savings.

8. Here's the rub, insofar as the Government is concerned. Can we say that this was really an adversary proceeding, rather than an amicable agreement among the heirs to reduce the total federal estate taxes payable, where no appeal was taken from the ruling of the probate court? Of course, the United States is not represented in the proceedings in administration and could not appeal this ruling. The amounts involved are substantial. My own rough computations, without viewing the tax return, indicate that if the case in the probate court were decided the other way, the widow would receive $80,990 less, the children $54,770 more, and of course, the United States would receive as additional estate taxes the difference of about $26,220.

9. The stipulated facts and additional findings of fact are set forth in the opinion of Chief Judge Wyche in the district court, Hamrick v. Pitts, 135 F. Supp. 835 (W.D. S.C. 1955).

admit of doubt.[10] Judge Parker's opinion gives two grounds for the decision. The first may be summarized briefly as follows. The federal estate tax law gives a marital deduction up to half of the adjusted gross estate, with reservations not here relevant, for the widow's interest. Only state law can create legal interests in the property of the intestate; the federal law then taxes the interests thus created. Hence the question is, under the law of South Carolina, does the widow's share bear any portion of the federal estate tax? This law can be determined by looking to South Carolina statutes or judicial decisions. There are no helpful statutes,[11] and the only judicial decision directly in point is the decision of the probate judge on this very estate. That decision is "based upon reason"[12] and may therefore be taken to evidence the law of South Carolina.[13]

The problem of determining state law in this type case is at least closely analogous to determining state law where *Erie R. R. Co. v. Tompkins*[14] is applicable, if it is not indeed an application of *Erie*. It is doubtful, however, that in an *Erie* situation Chief Judge Parker would have been justified in placing such controlling importance on the probate court decision.[15] It would seem that the technique of the *King* case[16] would be applicable here; the federal court should feel itself free on finding such sparse authority to deal with the question on its merits. The language of Chief Judge Parker, and his favorable discussion of the case of *Miller v. Hammond*,[17] suggest that he would have reached the same result in any event.[18]

The second ground for the decision, however, is conclusive and can best be stated in the words of Chief Judge Parker:[19]

> Whatever be the general law of South Carolina with respect

10. That the controlling cases decided by the Supreme Court of the United States were wisely decided is, in the view of the Commissioner of Internal Revenue, another matter.

11. Code § 19-52, cited in note 2, is silent on this question.

12. 228 F. 2d 490.

13. Some of the problems involved in applying state law are discussed in an excellent article by Edmond N. Cahn, *Local Law in Federal Taxation*, 52 YALE L. J. 799 (1943), esp. at pp. 816, 818.

14. 304 U.S. 64 (1938).

15. King v. Order of United Comm'l Travelers of America, 333 U.S. 153 (1948), holding that for *Erie* purposes, a decision of a Court of Common Pleas of South Carolina is not a binding precedent.

16. *Id.*

17. 156 Ohio St. 475, 104 N.E. 2d 9, cited by Chief Judge Parker, and holding on equitable principles that the share of the widow in an intestate estate would be relieved from the payment of any part of federal estate taxes. The court also cites, accord, Lincoln Bank & Trust Co. v. Huber, Ky., 240 S.W. 2d 89.

18. 228 F. 2d 490.

19. *Id.*

> to the matter, however, the decision of the probate court, which has not been appealed from, has settled the law, so far as this estate is concerned, and has vested in the widow her one-third free and clear of federal estate taxes. There is no showing that it was entered as a result of collusion or fraud or in a non adversary proceeding . . . . In other words, it fixed the amount of the widow's share of the estate; and whether this was done erroneously or in accordance with law, the amount of her share has been fixed thereby and the shares of other distributees have been decreased accordingly.

The Supreme Court of the United States has consistently held that the federal courts in tax cases are bound by decisions of state courts determining interests in property.[20] How far the lower federal courts have been willing to go in applying these decisions is indicated by *Helvering v. Estate of Rhodes*,[21] a case having far less the character of an adversary proceeding than did the instant case. In the light of these cases, it would have been difficult for the Fourth Circuit to have decided the *Hamrick* case in favor of the Commissioner.

Insolvency — Priority of Federal Tax Claims

The importance to the lawyer of federal statutes giving priority to tax claims of the United States was indicated in the last issue of this Survey.[22] Another important decision on this subject was handed down in 1955 by the Supreme Court of South Carolina, involving facts somewhat similar to those in the *Scovil* case. In *United States v. State of South Carolina*,[23] a receiver was appointed in 1953, pursuant to a decree of the Court of Common Pleas, for the real and personal property of one Edmond Caulk, an insolvent debtor. The debtor's property was sold by the receiver in that year. The real property realized $42,235 and the personalty $5,015; all property was sold free and clear of liens and of Mrs. Caulk's dower interest. Various secured and unsecured creditors filed claims with the receiver. The United States was awarded the entire proceeds of the personalty. The court determined relative priorities of these claims against the realty in the following order: (1) mortgages on the real property, totalling $7,000; (2) the dower interest of Mrs. Caulk, in the amount

20. Blair v. Comm'r., 300 U.S. 5 (1936); Sharp v. Comm'r., 303 U.S. 624 (1938); Freuler v. Helvering, 291 U.S. 35 (1934).
21. 117 F. 2d 509 (8th Cir. 1941) affirming 41 B.T.A. 62 (NA).
22. SURVEY OF SOUTH CAROLINA LAW, 8 S.C.L.Q. 130 (1955), discussing United States v. Scovil, 348 U.S. 218 (1955), reversing 224 S.C. 233, 78 S.E. 2d 277 (1953).
23. 227 S.C. 187, 87 S.E. 2d 577 (1955).

of $7,039.17;[24] (3) a judgment held by the Darlington County Bank & Trust Company, in the amount of $2,356.67, dated October 8, 1947 and docketed on that day; (4) income tax warrants of the State of South Carolina, aggregating $15,466.53, filed with the clerk of court and entered in the judgment docket on February 24, 1950; (5) tax claims of Marlboro County and the Town of Bennettsville, for periods from 1945 to 1953, aggregating $3,839.73, and filed during various periods within those years; and (6) income tax liens of the United States, one in the amount of $86,562.61, filed in the clerk's office on February 28, 1951, the other in the amount of $4,233, filed December 20, 1951. The United States on appeal claimed priority over claims (3), (4) and (5) above, under Section 3466, Revised Statutes,[25] claiming an absolute priority regardless of the dates of docketing of the other claims. In the alternative, the United States claimed priority over the claims of South Carolina and the county and the town on the theory that the claims of those governmental entities did not become "judgments" within the meaning of Section 3672, Internal Revenue Code of 1939, and hence were inferior to the federal liens arising by virtue of Sections 3670 and 3671 of that Code.[26] The Su-

24. All parties agreed that the mortgages should be paid in full. "This doctrine seems to have been based on the theory that mortgaged property passes to the mortgagee and is no longer a part of the estate of the mortgagor." United States v. Texas, 314 U.S. 480, 484 (1941). The Court of Common Pleas held that under South Carolina law the dower interest was an interest in property and not a lien, and hence prevailed over all creditors. The United States did not appeal this point, but raised on appeal a question as to the amount of the dower interest awarded. This point was held by the Supreme Court to be not appealable, since the United States had not raised the question in the court below.

25. 31 U.S.C. 191; 31 U.S.C.A. 131, which provides as follows:

> Sec. 3466. Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority hereby established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed.

26. INT. REV. CODE OF 1939, §§ 3670 to 3672 read as follows:

> Sec. 3670. Property Subject to Lien.
>
> If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, penalty, additional amount, or addition to such tax, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.
>
> Sec. 3671. Period of Lien.
>
> Unless another date is specifically fixed by law, the lien shall arise at the time the assessment list was received by the collector and shall con-

preme Court of South Carolina held that the Darlington Bank judgment, the tax claims of South Carolina, and such of the claims of the town and the county as had been docketed prior to the date of docketing of the federal tax claims prevailed over the federal claims, insofar as the realty was concerned. The United States was held entitled to priority over such of the town and the county claims as had arisen for 1951, and for later years.

The court seems to be on sound ground in rejecting the argument of the United States based on Section 3672. That section must be read together with Sections 3670 and 3671. Those sections provide that when a tax is unpaid, a lien arises against the property of the taxpayer on the date when the assessment list is received by the Collector.[27] Mr. Justice Oxner points out that this date has not been shown in the record in the instant case, and hence the Court can only hold that the federal government's lien attached on the date when the tax liens were docketed with the clerk of court in Marlboro County. The usual rule as to liens, "the first in time is the first in right," then applies, and hence the Darlington Bank, South Carolina and the town and county liens perfected before the liens of the United States arose must prevail so far as these sections of the Code are concerned. Section 3672 on this reasoning is never reached, for it applies only where Sections 3670 and 3671 do not dispose of the case. *United States v. Scovil*[28] and *United States v. Gilbert Associates*[29] are properly distinguished on two grounds: in those cases, the contending liens were not perfected as against the lien of the United States; and in those cases, personalty was involved, not realty. In cases involving personal property, perfecting of a lien may require reducing the property to possession, or at least taking some action beyond the

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tinue until the liability for such amount is satisfied or becomes unenforceable by reason of lapse of time.

Sec. 3672. Validity Against Mortgagees, Pledgees, Purchasers, and Judgment Creditors.

(a) Invalidity of Lien Without Notice. — Such lien shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed by the collector —

(1) Under State or Territorial Laws. — In the office in which the filing of such notice is authorized by the law of the State or Territory in which the property subject to the lien is situated, whenever the State or Territory has by law authorized the filing of such notice in an office within the State or Territory; . . . .

These sections are now contained without substantial change in INT. REV. CODE OF 1954, §§ 6321, 6322 and 6323.

27. Under the 1954 Code, § 6322, the lien arises when the assessment is made.

28. *Supra* note 22.

29. 345 U.S. 361 (1953).

mere recording of a judgment.[30] With realty, docketing of a judgment is the classic method of perfecting a lien.[31]

Greater difficulty is met with regard to the Government's argument based on Section 3466, Revised Statutes.[32] The language of Section 3466 states flatly that "whenever any person indebted to the United States is insolvent . . . . the debts due to the United States shall be first satisfied." Nothing in the statute expressly creates an exception in favor of liens, perfected or otherwise. Nor has the Supreme Court of the United States ever created such an exception.[33] True, that Court has in many cases been careful to base its holding in favor of priority of the claim of the United States on a showing that the contending claim had not been perfected.[34] Mr. Justice Oxner found in this avoidance of the question in prior decisions of the Supreme Court of the United States some support for his view that a perfected lien must prevail against a claim by the United States under Section 3466.[35] He found further support for his position in decisions of other courts directly in point.[36] The holding of the Court is that Section 3466 should be read to impliedly except from the federal priority liens which are "specific and perfected."[37]

There is language in opinions of the Supreme Court of the United States to support an opposite decision. Two of the many cases may be noted. In *United States v. Gilbert Associates*[38] Mr. Justice Minton said for the Court:[39]

> As is usual in cases like this, the Town [of Walpole, New Hampshire] asserts that its lien is a perfected and specific lien which is impliedly excepted from this statute. This Court has never actually held that there is such an exception. Once again,

30. 31 AM. JUR., Judgments, §§ 296, 304, 308.

31. *Id.* I have stated this first argument of the Government as it was viewed by the Supreme Court of South Carolina. In its brief, the Government attempted to tie together Section 3672, INT. REV. CODE OF 1939 and Section 3466, Revised Statutes, and argued that the exceptions in Section 3672 were the only exceptions possible to any priority under Section 3466.

32. Quoted, *supra*, note 25.

33. United States v. Texas, 314 U.S. 480, 486 (1941) is illustrative of the Court's care in avoiding passing on this issue.

34. *Id.*

35. 87 S.E. 2d 580.

36. *Id.*, citing United States v. Atlantic Municipal Corporation, 212 F. 2d 709 (5th Cir. 1954); Evans v. Stewart, 66 N.W. 2d 442 (Iowa 1954); State v. Woodruff, 253 Ala. 620, 46 So. 2d 553 (1950); National Surety Corp. v. Sharpe, 236 N.C. 35, 72 S.E. 2d 109 (1952).

37. 87 S.E. 2d 581.

38. 345 U.S. 361 (1953).

39. 345 U.S. 365.

> we find it unnecessary to meet this issue because the lien asserted here does not raise the question.
>
> In claims of this type, 'specificity' requires that the lien be attached to certain property by reducing it to possession, on the theory that the United States has no claim against property no longer in the possession of the debtor. Thelusson v. Smith (US) 2 Wheat 396, 4 L. Ed. 271. Until such possession, it remains a general lien.

True, this case can hardly be considered strong authority, for (1) no appearance was made for the town in the argument in the Supreme Court, nor was a brief filed on its behalf; (2) the decision was a joint holding, mainly based on Section 3672; (3) personalty, not realty, was involved; and (4) Mr. Justice Frankfurter in dissent indicated that the case was not on its facts an appropriate one for considering the applicability of Section 3644. Similar language was applied to liens on realty by Mr. Justice Byrnes in *United States v. Texas*,[40] which case did not involve realty itself. In summing up the cases, Justice Byrnes said:[41]

> . . . . The question of whether the priority of the United States under § 3466 would also be defeated by a specific and perfected lien upon property whose title remained in the debtor was reserved in those cases (citing cases). However, it was determined that a general judgment lien upon the lands of an insolvent debtor does not take precedence over claims of the United States unless execution of the judgment has proceeded far enough to take the land out of the possession of the debtor. Thelusson v. Smith, supra (2 Wheat. (US) at 425, 426, 4 L. Ed. 278, 279).

The conclusion is warranted on the authorities that the question is still an open one. The language in the above quotations is a caveat to counsel that they cannot feel confident of defeating the federal priority unless their lien is so far perfected as to bring about a change of title or possession.

Standing to Challenge Assessments

The Supreme Court of South Carolina has held that ". . . . questions of public interest originally encompassed in an action should be decided for future guidance, however abstract or moot they may

40. 314 U.S. 480 (1941).
41. 314 U.S. 485.

have become in the immediate contest."[42] In *Stephens v. Hendricks*[43] the court invoked this rule to declare that under Sections 65-1462 to 65-1467, Code of Laws of South Carolina, 1952, no person other than the person assessed has standing to challenge a particular tax assessment.[44]

42. Ashmore v. Greater Greenville Sewer District, 211 S.C. 77, 96, 44 S.E. 2d 88 (1947).
43. 228 S.C. 458, 90 S.E. 2d 632 (1955).
44. The court relied especially on Sections 65-1466 and 65-1467.