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Federal Estate Tax—Marital Deduction—Burden of Estate Taxes

Suppose a client comes into a lawyer's office, asks that the lawyer draw a will for him, and advises that he is worth upwards of one-half a million dollars.[1] The first thing that the lawyer must do is to convince the client that a will is only a part of what he needs; he needs an estate plan. This requires a different orientation of thought by both lawyer and client from the mere drawing of a will. First, it will cost the lawyer more time and the client more money. Second, it will require a much more candid and complete divulgence by the client of all the circumstances of his affairs, business, family and otherwise. Third, it is not something that the client or the lawyer can put aside when completed; it must be periodically reviewed by the client for changes in his economic and family affairs, and by the lawyer for changes in the law, especially the tax laws. Fourth, unless the lawyer can assure himself that he is adequately experienced in the field of estate planning, expert assistance will be required. The creation of an estate plan must be a serious and careful undertaking. Yet more serious is the devastation which can result to the dispositive plans of a testator if the arts of the estate planner are not utilized.

The goal of the estate planner is to achieve three interacting aims: to carry out in the most effective manner possible the dispositive wishes of the client; to avoid unnecessary litigation, either probate or tax; and to minimize taxes, where compatible with the achievement of the other objectives. The

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1. An estate plan might be necessary for an estate much smaller than this, of course. For any estate exceeding sixty thousand dollars after expenses, tax planning becomes significant. As the estate increases in size, the need for careful tax planning increases, because the estate tax rates are sharply progressive.

Another problem that should be of concern to the Bar is that of the person who needs an estate plan but never consults a lawyer, and dies intestate. An example is Pitts v. Hamrick, 228 F. 2d 486 (4th Cir. 1955), discussed in SURVEY OF SOUTH CAROLINA LAW, 9 S. C. L. Q. 145 (1956).

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first consideration is of course paramount. Tax planning is always subordinate to the wishes of the testator. Nevertheless, tax planning has brought into being the specialty of estate planning. Since the Revenue Act of 1932,[2] which greatly increased Federal estate tax rates, the need for careful tax planning for substantial estates has become obvious. The law schools have responded gradually to this need. Over the past ten years, many law schools have introduced courses in Estate Planning; the University of South Carolina has twice offered such a course.[3]

One problem in estate planning is to provide which assets of the estate will bear the burden of Federal estate taxes and State inheritance and estate taxes. This is illustrated by *Gaither v. U. S. Trust Co. of New York*,[4] an action by the executor, husband of the deceased testatrix, to construe the will of Marie T. Gaither, which will was executed on May 23, 1949. Testatrix died on July 8, 1954. The will consisted of five Items, which were in substance as follows: Item I directed the executor to pay all debts, etc., "together with all taxes, State and Federal, of whatever nature and kind" from cash "or from the sale or exchange of any bonds, stocks or debentures of which I may be seized and possessed if there is not sufficient cash." Item II bequeathed to respondent trust company "all stocks, bonds, debentures and other mixed property now in its possession and now handled by them for me under an Agency Agreement," in trust, income equally to testatrix' husband and her daughter for their respective lives, after which the income and then the corpus to be paid to the grandchildren of the testatrix. Item III bequeathed certain personal effects to the daughter. Item IV gave the residue to the husband. Item V appointed the husband executor. The estate was found to consist of securities valued at $635,795.62 held by the trust company under the Agency Agreement, and disposed of by Item II of the will; securities held by the testatrix, valued at $160,741.16; $6,303.75 in cash, real estate valued at $11,300 and personalty valued at $2,113.25. Counsel admitted in oral argument that debts, estate and inheritance taxes would amount to approximately $250,000. Thus it can be seen that if the burden of debts and taxes were to fall first

2. This imposed the so-called "Additional Estate Tax". Rates were increased in 1934, 1935, 1940 and 1941. The estate tax is now found in INT. REV. CODE OF 1954, §§ 2001-2207.
3. In Spring, 1954 and Summer, 1957.
4. 230 S. C. 568, 97 S. E. 2d 24 (1957).

on the residue, the entire residue would be eliminated.

Counsel for the executor argued that under the terms set forth in Item I, the executor was empowered absolutely to determine which assets would be sold first to pay debts and taxes, and in the alternative, that these burdens should be borne ratably by the legatees of Items II and IV, in proportion to the assets passing under those clauses. To buttress the alternative argument, counsel pointed out that the assets passing under Item IV were the only assets of the estate which qualified for the Federal estate tax marital deduction, and that if the residue of the estate were wiped out by these charges, then no assets qualifying for the marital deduction would be left in the estate. Hence counsel argued that the so-called "doctrine of equitable apportionment"[5] should be applied. The Supreme Court found no intention in the language of Item II to give the executor the power he claimed, and held that absent such intention, the usual order for selection of assets to pay debts would govern. Thus the assets covered by Item IV would have to be completely exhausted first, before Item II assets could be applied.

Despite the zealous effort of counsel to maintain[6] that the intention of the testatrix was to permit the executor absolute discretion to choose among assets from which to pay debts and taxes, the decision of the Court seems compelled by the South Carolina decisions.[7] The general rule is that, absent an apportionment statute[8] or an expression of intention of the testator to the contrary, the burden of estate taxes, like other charges, falls on the residue or the general estate.[9] A common error in the drafting of wills is to fail to consider the diminution or even elimination of the residue that can result due to the impact of taxes and other charges on the residue.[10] Clearly the draftsman of the will in the instant

5. Pitts v. Hamrick, *supra* note 1; Miller v. Hammond, 156 Ohio St. 475, 104 N. E. 2d 9 (1952).

6. The gist of appellant's argument is that Item I created a fund from which taxes were to be paid. Counsel relied heavily on the word "any" in Item I, as indicating that the Executor was authorized to select the assets which would bear the taxes.

7. The Court cites Warley v. Warley, Bailey Eq. 397 (1831); Brown v. James, 3 Strob. Eq. 24 (1849); Duncan v. Tobin, Dudley Eq. 161 (1838), as leading cases.

8. The pioneer statute providing for apportionment of Federal estate taxes is the New York statute, N. Y. DECEDENT ESTATE LAW § 124, held constitutional in Riggs v. Del Drago, 317 U. S. 95 (1942).

9. Cases cited note 6 *supra*.

10. As Professor Casner says, "The thinking required with respect to

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case did not set forth precisely the intention of the testatrix as to this problem.

The data disclosed in the Record on Appeal and the opinion of the Court is not adequate to permit a more fundamental criticism of the will, that is, to raise the question whether the maximum marital deduction should have been taken in the will. To deal with this question it would be necessary to know just what was the testatrix' attitude towards her husband and her daughter. Would she have wished to leave more property to her husband in a form that qualified for the marital deduction, if to do so would effect substantial over-all tax savings in her estate? It would be necessary also to know whether there was any substantial property not listed above which would be includible in the testatrix' adjusted gross estate for Federal estate tax purposes,[11] and whether that property itself qualified for the marital deduction. It would be necessary to know the extent of the property held by the husband in his own right. Lack of the complete picture forecloses further discussion here. It can be pointed out, however, that under the will as construed by the Court, no marital deduction is allowable after the taxes are paid. The property in Item II is clearly a terminable interest,[12] and hence does not qualify for the marital deduction; the property in Item IV, which does qualify, is extinguished by the payment of taxes. It is also apparent[13] that even if the arguments of the Executor had been accepted by the Court, the estate would be permitted far less than the maximum marital deduction that could have been obtained had the will been differently drafted.[14]

Mr. Justice Oxner summarily disposed of counsel's argument that the doctrine of "equitable apportionment" should be applied, and the taxes be paid ratably from the assets passing under Items II and IV of the will.[15] This doctrine,

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the formulation of an estate plan is incomplete if the problem of paying death taxes has not been worked out and the burden placed where, in the best interests of all concerned, it should be placed." CASNER, ESTATE PLANNING (CASES AND MATERIALS) 897, 898 (2d ed. 1956).

11. Under INT. REV. CODE OF 1954, §§ 2035-2038, 2041, 2042.

12. INT. REV. CODE OF 1954, § 2056(b) (1).

13. The maximum allowable marital deduction is one-half of the adjusted gross estate. INT. REV. CODE OF 1954, § 2056 (c).

14. It must be kept in mind when estimating possible tax savings that property that qualifies for the marital deduction in the estate of a wife will also pass through the husband's estate when he dies, and be taxed in that estate, unless he has disposed of the property during his life.

15. Justice Oxner said, "It was conceded in oral argument that this question was not raised in the Court below. It is, therefore, not properly

adopted by some courts,[16] has permitted the apportionment of Federal estate taxes where a tax saving would result therefrom. Perhaps these decisions are dubious at best; the only equity discernible is the minimizing of the revenue going to the general government. However, the principle should not be applied to testate estates. As Respondent argued herein, " . . . legislation is the appropriate means to accomplish this purpose."[17] The rule that the residue must first bear charges against the estate is a rule of property in South Carolina, and there is no way of knowing that the testatrix did not rely upon it in drawing her will. Especially is this true in a case in which the Record is as sparse as in the instant case; whether the marital deduction would be advantageous to the testatrix even from the tax planning point of view requires knowledge of the factors set out in the preceding paragraph which the Record herein does not reveal. To ask the application of the doctrine of "equitable apportionment" in a testate case is to ask the Court to set up an estate plan after the death of the testatrix.

Corporate Re-organization—Tax-Free Spin-Off

Beard v. South Carolina Tax Commission[18] involved the highly technical question whether certain securities received by shareholders pursuant to a reorganization constituted taxable income under the South Carolina Income Tax. Prior to September 18, 1953, members of the Beard family owned, in the proportions indicated below, all of the capital stock of three South Carolina corporations. Beard's Oil Corporation (capital $5,000, surplus $30,400) was owned 50% by H. E. Beard, Sr. and 50% by Mary E. Beard; Beard Appliance Company (capital, $15,000, surplus, $24,500) was owned 50% by H. E. Beard, Sr., and 50% by H. E. Beard, Jr.; and Camden Petroleum Company (capital, $5,000, surplus, $10,225) was owned 2% by H. E. Beard, Sr. and 98% by E. B. Beard. On August 19, 1953, an "Agreement for Corporate Merger, Consolidation and Reorganization" was entered between these three corporations and the incorporators of a proposed new

before us. It may be added, however, that there is nothing in this will to indicate an intent to provide a pro rata contribution and it is doubtful in those states having apportionment statutes whether same would be applicable under this will. See Baylor v. National Bank of Commerce of Norfolk, *supra*, 194 Va. 1, 72 S. E. 2d 282."

16. Cases cited note 4 *supra*.
17. Brief of Respondent, p. 17.
18. 230 S. C. 357, 95 S. E. 2d 628 (1956).

corporation, to be called Camden Equipment Company, Inc. Under this Agreement the three pre-existing corporations would be merged into a new corporation, Beard Oil Company, the stock of the new corporation to be distributed to the shareholders of the merged corporations in direct ratio to the composite value of their respective shares in the three merging corporations, valued according to an audit as of August 31, 1953. This Agreement provided that simultaneously with the merger, and as an integral part thereof, all the depreciable assets of the former corporations should be transferred "as a 'spin-off'" to Camden Equipment, and the shares of the latter issued to stockholders of Beard Oil in the ratio of one share of Camden for each share of Beard Oil held by each stockholder. This Agreement was duly carried out on August 19, 1953. Pursuant thereto, taxpayer E. B. Beard received 80 shares of Beard Oil and 40[19] shares of Camden Equipment stock.

The Tax Commission determined that the shares of Camden Equipment constituted a distribution of a portion of the surplus of Beard Oil Company, and that the receipt of it by E. B. Beard constituted taxable income in the amount of $10,113.11, for which the taxpayer was assessed taxes in the amount of $448.07, together with interest. Taxpayer paid under protest and sued to recover. The Tax Commission argued that the reorganization must be viewed as consisting of two separate steps: (1) the merger of Beard's Oil, Beard Appliance and Camden Petroleum into Beard Oil; and (2) the transfer of the depreciable assets of Beard Oil to Camden Equipment, and the distribution of the shares of the latter to the taxpayer and other stockholders.[20] The second step, in the opinion of the Tax Commission, involved a distribution of taxable income.

The Supreme Court held that whether viewed as one step or as two, the transfer of shares of Camden Equipment to the shareholders was an integral part of the reorganization and was free from income tax, under CODE OF LAWS OF SOUTH

19. Camden Equipment was capitalized at $100 Par Value per share, instead of $50 as had been originally contemplated; hence each shareholder received one share of Camden Equipment for each two shares held of Beard Oil.

20. The Tax Commission argued that South Carolina corporate law did not authorize the merger of three corporations into two, and that hence the transaction could only have been carried out in two steps.

CAROLINA, 1952 §§ 65-251 and 65-275.[21] Writing for the Court, Mr. Justice Legge said:[22]

> Our search is for substance, not form,—for the realities of the transaction, and not book entries. And from the record here the conclusion is inescapable that the actual result of the "reorganization, consolidation and merger" was that each holder of stock of any of the three merging corporations (which stock in each case included an interest in a substantial earned surplus) received in exchange therefor stock of Beard Oil Company and of Camden Equipment Company, Inc., in proportion to and equal in value to his holdings in the composite valuation of the merging corporations. . . .
>
> This conclusion does not conflict with *Wilson v. South Carolina Tax Commission,* 220 S. C. 171, 66 S. E. 2d 698. In that case there was in reality no reorganization; a corporation, in order to insulate its real estate (which was earned surplus) from liability, had conveyed it to a newly formed corporation, the stock of which was distributed among the stockholders of the old corporation. The corporate existence and functions of the old corporation were not impaired, and its stockholders had given nothing in exchange for the stock of the new corporation, which was accordingly held taxable as dividends.[23]

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21. These sections provide as follows:

65-251. Gross income defined.

The words 'gross income' mean the income of a taxpayer derived from salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, business, commerce, sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property, and also from interest, rent, dividends, securities or the transaction of any business carried on for gain or profit and income derived from any source whatsoever. The amount of all such items shall be included in the gross income of the income year in which received by the taxpayer unless, under the methods of accounting permitted under this chapter, any such amounts are to be properly accounted for as of a different period.

10-275. No gain or loss on corporate reorganizations generally.

In a reorganization, consolidation or merger the exchange of stock or property for stock of a corporation a party to the reorganization, consolidation or merger shall not be deemed to result in gain or loss.

22. 230 S. C. at 370, 95 S. E. 2d at 635.

23. Under Federal tax law, this reorganization, occurring in 1953, would be governed by INT. REV. CODE OF 1939, §§ 112 (b) (11) and 113 (a) (23), added by 65 Stat. 317 (1951). These sections permitted "spin-offs" without recognition of gain or loss, unless it appeared that (1) any corporation a party to the reorganization was not intended to continue the active conduct of a business, or (2) the corporation whose stock was distributed was being used as a device for the distribution of earnings.

Compensatory Use Tax—Contract to Reimburse Vendee

The South Carolina Code[24] imposes a 3% sales tax on retail sales within the State. The Code[25] also provides for a compensatory use tax on the storage, use or other consumption in the State of personal property purchased at retail; however, the user is relieved of liability for the use tax on property upon which a sales tax has been paid. Thus the use tax is a device for indirectly taxing sales to persons within the State by out-of-State vendors, so that sellers within the State will not be subject to competitive disadvantage as against interstate sellers.[26]

In *McJunkin Corp. v. City of Orangeburg*,[27] McJunkin, a West Virginia corporation, contracted to supply the City with pipe for a municipal water system. In making payment to McJunkin, the City deducted 3% of the contract price, which the City paid to the State of South Carolina for the use tax on the pipe. McJunkin sued in the Federal District Court, E. D. S. C., to recover this amount. The City claimed that withholding this amount was proper because the contract incorporated certain specifications which the City had prepared and issued in inviting bids, including the following specification:[28]

> All Federal, State and local taxes due or payable during the time of contract on materials, equipment, or labor in connection with this work must be included in the amount bid by the Contractor and shall be paid to proper authorities before acceptance.

Other provisions of the contract also referred to taxes. The Court held, in an opinion by Judge Sobeloff affirming a decision by Judge Wyche, that under the contract the vendor was required to include the use tax in his bid, and the deduction of this amount by the City was proper.[29] One strong

Hence the Federal statutory treatment of the situation is much more detailed than is found in the South Carolina provisions. See note 19 *supra*. Neither briefs of counsel nor the opinion refer to the Federal analogy.

24. CODE OF LAWS OF SOUTH CAROLINA, 1952 § 65-1401.
25. CODE OF LAWS OF SOUTH CAROLINA, 1952 §§ 65-1421, 1422, 1425.
26. The constitutionality of such statutes under the Commerce Clause of the Federal Constitution was upheld in Henneford v. Silas Mason Co., 300 U. S. 577 (1937). See also General Trading Co. v. Tax Commission, 322 U. S. 335 (1944) and cases cited therein.
27. 238 F. 2d 528 (4th Cir. 1956).
28. 238 F. 2d at 530.
29. Since this is primarily a question of construing the relevant documents under the law of contracts, it is not treated at length here.

reason suggested by the Court which compels this construction of the contract is that the City in issuing invitations to bid obviously wished to place interstate and intra-state bidders on the same competitive basis, so that the City could judge which bid was lowest.[30]

McJunkin argued that as an out-of-State vendor not doing business within the State it could not be subjected to South Carolina use taxes.[31] The Court held that this issue was not raised by the record. The vendor is bound by the contract to reimburse the City for the amount paid as use taxes. Hence no question is raised of the State attempting to collect the taxes from McJunkin; the sole controversy relates to the terms of the contract.

Execution for Delinquent Taxes—De Facto Officeholder

McCutchen v. Hinnant[31a] was an action to recover possession of an unimproved lot of land which had been sold under execution for delinquent county property taxes. The tax collector had employed an assistant, an office not authorized by statute,[32] and the assistant had levied on the lot, pursuant to which the sale was made. The Court held that the sale was ineffectual to convey title, and that it could not be upheld by the doctrine of *de facto acts*. In order to have a *de facto* officeholder, the Court holds, there must be an office duly authorized by statute which the officer claims to hold.[33]

Standing to Sue for Taxes of Another Taxpayer

In *Watson v. City of Orangeburg*[34] plaintiff, a property owner and taxpayer of the City, sued 24 other property owners, joining the City and certain of its officials. The action was brought to recover from the property-owner defendants for the City certain taxes, with interest and penalties, which plaintiff alleged these defendants owed the City. The plaintiff claimed that these defendants were being exempted from taxes by virtue of certain ordinances which he alleged were unconstitutional and therefore void. The Court held that the

30. 238 F. 2d at 531, 532.
31. Citing Miller Bros. Co. v. Maryland, 347 U. S. 340 (1954).
31a. 229 S. C. 448, 93 S. E. 2d 462 (1956).
32. CODE OF LAWS OF SOUTH CAROLINA, 1952 §§ 65-2601-2609 provides that delinquent taxes are collected by "one discreet person to be known as tax collector."
33. The Court distinguished Commercial Bank of Augusta v. Sandford, 103 F. 98 (C. C., D. S. C., 1900).
34. 229 S. C. 367, 93 S. E. 2d 20 (1956).

plaintiff could not maintain the action. Unless a statute provides otherwise, only the taxing sovereign can sue to collect taxes due it. The Court left open the question whether mandamus would lie to compel the City officials to proceed against the exempted property owners.

Irregular Tax Sale—Laches

Houtson v. International Paper Company[35] involved a condemnation proceeding instituted in 1952. Plaintiffs filed therein a claim to part of the compensation, alleging that they had owned the property in 1934 and that it had been sold at a tax sale in that year. The sale was allegedly irregular in that the property had been listed in the tax sale proceedings in the name of the deceased prior owner rather than in the names of his heirs, the plaintiffs. The Fourth Circuit affirmed decision of Judge Timmerman that the plaintiffs' claim was barred by laches.

Legislation

A few statutes worthy of mention under this topic of the survey were enacted during the past year. One deals with the valuation of certain leaseholds for tax purposes, and the important language therein provides as follows:[36]

> SECTION 1. Certain conveyed leasehold estates to be valued for tax purposes as real estate.—When any leasehold estate is conveyed for a definite term by any grantor whose property is exempt from taxation to a grantee whose property is not exempt, the leasehold estate shall be valued for property tax purposes as real estate.

Two others deal with tax liens on personal property. The first, enacted June 20, 1957, provides:[37]

> SECTION 1. The liens effected for the South Carolina Tax Commission, pursuant to authority vested in the Commission, shall attach to and become a lien upon the title to and interest in personal property or chattels defined as personal property of the taxpayer against whom it is issued. The lien shall attach when duly filed and recorded in the office of the clerk of the county in which the taxpayer resides or possesses such property. No such lien shall operate so as to prevent a merchant from sell-

35. 233 F. 2d 69 (4th Cir. 1956).
36. Act No. 79 of Acts and Joint Resolutions, Adv. Sheet No. 2, 89.
37. Act. No. 404 of Acts and Joint Resolutions, R603, § 674.

ing items from his stock of goods in trade for a fair consideration in the normal and ordinary course of business until and unless a levy shall have been made thereupon. As used herein, the word 'merchant' includes a retailer, a wholesaler, or a jobber.

The other statute, signed into law two days earlier, on July 18, 1957, provides:[38]

> SECTION 1. The lien for unpaid taxes on personal property shall also attach to any personal property subsequently acquired by the delinquent taxpayer.

The other sections of these statutes provide for repeal of inconsistent statutes, and for the effective date of the Acts, in each case, the date of signing by the Governor.

38. Act. No. 368 of Acts and Joint Resolutions, R603, § 223.