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Charles F. Ailstock

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## APPORTIONMENT OF FEDERAL ESTATE TAXES IN SOUTH CAROLINA

### I. INTRODUCTION

The estate planner is vitally interested in federal estate taxes and where their ultimate burden will rest.<sup>1</sup> There are several methods of reaching this determination, each of which will vary the economic benefit enjoyed by the individual beneficiaries of the estate.

When a lawyer plans an estate or drafts a will, he must realize that apportionment of the estate tax burden is a distorting factor. In order to avoid this potential distortion and to perform his function effectively, the lawyer needs "a clearcut '*normally operative rule*' from which . . . [he] can deviate by unambiguously drawn clauses where any such deviation better serves his client's purposes."<sup>2</sup>

The two basic concepts of apportionment of federal estate taxes are denominated: (1.) *burden-on-the-residue*, and (2.) *doctrine of equitable apportionment*. The burden-on-the-residue approach assumes that the estate tax is an expense of administration to be paid out of the residuary estate like any other administrative expense.<sup>3</sup> The alternative equitable apportionment approach places the tax burden on the beneficiaries in proportion to the amounts of the estate received by them.<sup>4</sup>

The South Carolina Supreme Court has formulated its own normally operative rule for apportioning federal estate taxes in this state. The purpose of this article is to apprise the reader of the substance of this rule and its value when compared to the rules adopted in other jurisdictions.

### II. THE DIVERGENCE OF OPINION AMONG THE STATES ON THE QUESTION OF ULTIMATE BURDEN OF ESTATE TAXES

#### A. *Generally*

It is universally accepted that a testator may, in his will, fix the onus of estate tax upon any of the various funds passing

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1. In most cases the federal estate tax poses no problem for the estate planner unless the estate exceeds \$120,000 in value. Powell, *Ultimate Liability for Federal Estate Taxes*, 1958 WASH. U.L.Q. 327, n.1.

2. *Id.* at 328 (emphasis added).

3. Annot., 37 A.L.R.2d 169, 176-88 (1954).

4. *Id.* at 171-88.

under the will or on any of the various takers under the will by clearly stating in the instrument where the ultimate burden of estate tax is to lie.<sup>5</sup> In addition there are statutes in effect in a number of states which prorate the estate tax among the beneficiaries of a will in the absence of an expression of the testator's intent.<sup>6</sup> Where there is neither a controlling statute nor a provision in the will, there is a divergence of opinion in the case law of the several states as to whether the tax should be paid out of the residuary estate or equitably apportioned pro rata among the beneficiaries.<sup>7</sup>

*B. Probate Property: Charging the Residuary Estate  
v. Equitable Apportionment.*

The experience of state courts with state inheritance taxes did not prepare them for the apportionment problem presented by the federal estate tax.<sup>8</sup> Inheritance taxes imposed by state governments were ordinarily taxes on the receipt of property by the beneficiaries and were therefore self apportioning, each beneficiary being taxed on the basis of the property he received.<sup>9</sup>

The federal estate tax, however, was a tax upon the transfer as opposed to the receipt of property.<sup>10</sup> It was imposed with reference to the entire estate, was required to be paid by the administrator and was not apportioned by Congress. This led many state courts to conclude that the federal tax created a debt or charge against the estate, which as a matter of state law should be paid (like other obligations on the estate) out of the residue.<sup>11</sup>

5. *Id.* at 170; Annot., 37 A.L.R.2d 199, 203 (1954). As to the construction and effect of provisions of a will relied upon as affecting the burden of taxation see Annot., 37 A.L.R.2d 7 (1954).

6. Annot., 37 A.L.R.2d 199 (1954).

7. *Myers v. Sinkler*, 235 S.C. 162, 170, 110 S.E.2d 241, 244 (1959); Annot., 37 A.L.R.2d 169 (1954).

8. This article does not consider property passing by intestacy because generally when property passes by intestacy the estate tax is deducted before any heir's share is computed and there is therefore no question of apportionment. *E.g.*, *Hampton's Adm'r v. Hampton*, 188 Ky. 199, 221 S.W. 496 (1920). *But see Pitts v. Hamrick*, 228 F.2d 486 (4th Cir. 1955).

9. *E.g.*, *Simmons v. South Carolina Tax Comm'n*, 134 S.C. 261, 132 S.E. 37 (1925).

10. *Plunkett v. Old Colony Trust Co.*, 233 Mass. 471, 124 N.E. 265 (1919); *In re Hamlin*, 226 N.Y. 407, 124 N.E. 4 (1919).

11. *Plunkett v. Old Colony Trust Co.*, 233 Mass. 471, 124 N.E. 265 (1919); *Wilmington Trust Co. v. Copeland*, 33 Del. Ch. 399, 408, 94 A.2d 703, 708 (1953).

Treating the federal estate tax as an administrative expense was relatively harmless when the estate tax was small in comparison to self apportioning state succession taxes. In the wake of the depression, however, the estate tax was greatly increased and correspondingly estate tax apportionment became more significant.

During the early nineteen thirties there was a sharp increase in litigation involving allocation of the estate tax burden.<sup>12</sup> By this time, however, the common law concept that the estate tax was to be paid from the residuary estate had attained varying degrees of intransigence in most states.<sup>13</sup> Courts were reluctant to depart from the burden-on-the-residue rule. This is evidenced by the fact that few, if any, of the states in which this rule had been established departed from the rule in cases involving only probate property, without statutory authorization.<sup>14</sup>

This is not to say that the burden-on-the-residue concept has been universally accepted as to property passing under a will. A number of states have enacted statutes which provide that the ultimate estate tax burden shall be prorated on the basis of beneficial interest, if the testator has expressed no plan of apportionment in the will.<sup>15</sup> In states which have enacted such statutes the courts seem to have no difficulty in finding a basis for apportionment of estate tax on a pro rata basis independent of the statute. For example, in *Wilmington Trust Co. v. Cope-*

12. Annot., 37 A.L.R.2d 199, 202 (1954).

13. Scoles & Stephens, *The Proposed Uniform Estate Tax Apportionment Act*, 43 MINN. L. REV. 907, 915 (1959).

14. Powell, *Ultimate Liability for Federal Estate Taxes*, 1958 WASH. U.L.Q. 327, 330-31.

15. The first estate tax apportionment statute was passed by New York in 1930, N.Y. DECEDENT ESTATE LAW § 124 (McKinney 1949). That statute provided for general apportionment; i.e., prorating the burden among all beneficiaries of either probate or non probate property, and served as a model for apportionment statutes in other states. Annot., 37 A.L.R.2d 199, 203 (1954).

By 1958, there were seventeen states which had adopted apportionment statutes, but three of those states had abandoned their statutes and returned to the burden-on-the-residue rule, and four had confined their statutes to apportioning a pro rata burden to non probate property. Powell, *Ultimate Liability for Federal Estate Taxes*, 1958 WASH. U.L.Q. 327, 334.

In *Riggs v. Del Drago*, 317 U.S. 95 (1942), the Supreme Court dispelled all doubt as to whether or not apportionment of federal estate taxes was a matter controlled by state law, stating:

Its [the federal estate tax] legislative history indicates clearly that Congress did not contemplate that the government would be interested in the distribution of the estate after the tax was paid and that Congress intended that state law should determine the ultimate thrust of the tax.

*land*<sup>16</sup> the Supreme Court of Delaware was presented with a constitutional challenge to the retroactive application of the Delaware apportionment statute. The Delaware court held that there was no question of retroactive application of the statute, stating: "The apportionment act did not change the law; it declared as law a principle [equitable contribution] theretofore firmly embedded in our jurisprudence."<sup>17</sup>

The rule of equitable apportionment as used to allocate federal estate taxes, therefore has been applied, primarily, in states in which an apportionment statute has been enacted. There is, however, case law from those states which declares the rule appropriate absent any statutory sanction.<sup>18</sup> This body of case law provides the basis for challenge of the "burden-on-the-residue" rule in states in which that rule is grounded in common law.<sup>19</sup>

The suggested alternative when the burden-on-the-residue rule is attacked is equitable apportionment, which is based on the equitable theory of contribution. The doctrine of equitable contribution as applied to apportionment of the federal estate tax is an application of the venerable maxim "equality is equity."<sup>20</sup> More specifically it rests on the principle that parties having a common interest in a subject should bear equally any burden affecting it and "that the right or burden should be equalized among all the persons entitled to participate."<sup>21</sup> It followed that a federal estate tax lien, being a charge against the entire estate, was a common burden which the various beneficiaries should shoulder on a pro rata basis.<sup>22</sup>

In summary, when the question of apportionment of estate taxes on probate property arises, there is a split of authority

16. 33 Del. Ch. 399, 94 A.2d 703 (1953).

17. *Id.* at 410, 94 A.2d at 709. *See also* Regents of Univ. Sys. of Ga. v. Trust Co., 194 Ga. 255, 21 S.E.2d 691 (1942); *Pearcy v. Citizens Bank & Trust Co.*, 121 Ind. App. 136, 96 N.E.2d 918 (1951); *McDougall v. Central Nat'l Bank*, 157 Ohio St. 45, 104 N.E.2d 441 (1952); *Industrial Trust Co. v. Dudlong*, 77 R.I. 428, 76 A.2d 600 (1950).

18. Annot. 37 A.L.R.2d 169, 172-75 (1954); *see* *Wilmington Trust Co. v. Copeland*, 33 Del. Ch. 399, 94 A.2d 703 (1953).

19. *E.g.*, *Gaither v. United States Trust Co.*, 230 S.C. 568, 97 S.E.2d 24 (1957) (appellant cites authorities in support of the doctrine of equitable apportionment); *Myers v. Sinkler*, 235 S.C. 162, 171-73, 110 S.E.2d 241, 244-45 (1959) (court adopts equitable apportionment as between probate and non probate property).

20. 2 J. POMEROY, POMEROY'S EQUITY JURISPRUDENCE § 405 (5th ed. 1941).

21. *Id.* § 406.

22. *Wilmington Trust Co. v. Copeland*, 33 Del. Ch. 399, 408, 94 A.2d 703, 709 (1953); Annot. 37 A.L.R.2d 169, 172, 174 (1954).

over whether to apply the rule of (1) burden-on-the-residue—formulated when estate tax was relatively insignificant, or (2) equitable contribution—sanctioned by statute and declared a part of the common law independent of the statute in a number of states.<sup>23</sup>

*C. Taxable Non Probate Property: Charging the Residuary Estate v. Equitable Apportionment.*

The federal estate tax is imposed upon the gross estate of the decedent.<sup>24</sup> The gross estate is not limited to property which the decedent owned at the time of his death, but also includes some non testamentary assets.<sup>25</sup> These non testamentary assets are not part of the decedent's estate within the ordinary lay definition of estate as the assets and liabilities of a person left at death. They are taxable, however, as part of the decedent's gross estate.<sup>26</sup> The gross estate, therefore, is a legislative fiction created to facilitate the collection of estate taxes.<sup>27</sup>

The question posed in each jurisdiction is this: Should the same rule which controls the apportionment of estate tax among testamentary beneficiaries (whether it be the burden-on-the-residue rule or the equitable apportionment approach) be followed as to non probate property included in the taxable estate by a legislative fiction? Federal statutes may govern a small area of the problem, but the question of apportionment of the estate tax is primarily one for the state.<sup>28</sup>

In states having a general statutory provision for apportionment of estate tax the rule was extended to probate and non probate property alike.<sup>29</sup> However, in several of those states, the statutes were later modified to apply only to non probate assets

23. For a categorical treatment of the positions taken in the various states see Powell, *Ultimate Liability for Federal Estate Taxes*, 1958 WASH. U.L.Q. 327, 332-36.

24. INT. REV. CODE of 1954, § 2106.

25. INT. REV. CODE of 1954, §§ 2031-44; Annot., 37 A.L.R.2d 169, 182 (1954).

26. INT. REV. CODE of 1954, § 2051.

27. See also *Myers v. Sinkler*, 235 S.C. 162, 175-76, 110 S.E.2d 241, 247 (1959).

28. See INT. REV. CODE of 1954, §§ 2206-07 (life insurance proceeds and powers of appointment); Scoles & Stephens, *The Proposed Uniform Estate Tax Apportionment Act*, 43 MINN. L. REV. 907, 908-13 (1959) (effect of conflicting state law and federal legislation affecting apportionment).

29. Powell, *Ultimate Liability for Federal Estate Taxes*, 1958 WASH. U.L.Q. 327, 332.

with the burden-on-the-residue rule being restored as to testamentary property.<sup>30</sup>

In addition to the states in which equitable apportionment was sanctioned by statute, several states which adhered to the burden-on-the-residue rule as to probate property departed from this rule and adopted equitable apportionment as to non probate property.<sup>31</sup> This turn of events was apparently precipitated by the fact that the argument for equitable apportionment becomes much more cogent in the context of non testamentary property taxed as part of the estate.<sup>32</sup> It seems unfair to deplete the residue and general estate for the benefit of non testamentary property, which the decedent probably did not consider part of his estate, but which is taxed to the decedent because of the legal fiction of a gross estate and made enforceable as a lien against his estate. It seems more appropriate to invoke the doctrine of equitable apportionment in such a situation to save some vestige of the testator's plan than to allow complete distortion of the contemplated distribution.<sup>33</sup>

### III. ESTATE TAX APPORTIONMENT IN SOUTH CAROLINA

#### A. Probate Property

South Carolina adheres to the general rule that the testator may prescribe the order in which his assets are to be used for the payment of his debts.<sup>34</sup> In *Patterson v. Cleveland*<sup>35</sup> the supreme court held that this general rule was applicable to debts created by estate or inheritance taxes and that the testator could designate which gifts should be free of tax burden and which should sustain it.

South Carolina also follows the general rule that, unless the will directs otherwise, the residuary estate is first applied to the payment of debts; then general legacies and specific legacies are applied in that order.<sup>36</sup> In *Gaither v. United States Trust Co.*<sup>37</sup>

30. See *supra* note 15.

31. E.g., *Regents of Univ. Sys. of Ga. v. Trust Co.*, 194 Ga. 255, 21 S.E.2d 695 (1942).

32. Cf. *Id.* at 260, 21 S.E.2d at 695.

33. *Myers v. Sinkler*, 235 S.C. 162, 110 S.E.2d 241 (1959).

34. *Drayton v. Rose*, 7 Rich. Eq. 328 (S.C. 1855); *Pell v. Ball's Ex'rs*, Speers' Eq. 518 (S.C. 1844).

35. 165 S.C. 276, 163 S.E. 788 (1932).

36. *Brown v. James*, 3 Strob. Eq. 24 (S.C. 1849); *Duncan v. Tobin*, Dudley's Eq. 161 (S.C. 1838); *Warley v. Warley*, Bailey's Eq. 397 (S.C. 1831).

37. 230 S.C. 568, 97 S.E.2d 24 (1957), discussed in *Randall, Taxation, Survey of South Carolina Law*, 10 S.C.L.Q. 131, 132-35 (1957).

this general rule was extended to debts created by the federal estate tax. The supreme court apparently felt that its previous decisions relating to the general chargeability of debts of the estate against the residuary compelled the adoption of burden-on-the-residue rule for fixing the ultimate burden of estate tax.<sup>38</sup>

The appellant in *Gaither* asked the court to apply equitable apportionment because prorating the ultimate tax burden would facilitate the fuller use of the marital deduction (the husband of the decedent was the residuary legatee).<sup>39</sup> This argument was dismissed on the ground that the court could not properly hear it since it had not been raised in the lower court. The supreme court's dictum indicated, however, that even if properly raised the doctrine of equitable apportionment would not be applicable.<sup>40</sup>

It is clear that *Gaither* established burden-on-the-residue as the operative rule for determining the ultimate burden of estate tax on testamentary property in South Carolina.<sup>41</sup> At least one authority considered the *Gaither* decision to have established the burden-on-the-residue rule as the South Carolina approach to both testamentary and non testamentary property.<sup>42</sup> It is now apparent, however, that *Gaither* was limited to purely testamentary property.

### *B. Non Probate Property Taxable to the Estate*

In *Myers v. Sinkler*<sup>43</sup> the South Carolina Supreme Court was presented with the following factual situation: The testatrix created a trust in 1936 reserving to herself and other designated parties a life interest. Upon expiration of the life interest the corpus was to be held in trust for the benefit of a designated class, *per stirpes*. Although the property conveyed to this trust was subject to federal estate tax, it was not part of the probate estate. The testatrix died in 1967 leaving a will which provided

38. *Myers v. Sinkler*, 235 S.C. 162, 110 S.E.2d 241 (1959). See also Randall, *Taxation, Survey of South Carolina Law*, 15 S.C.L. REV. 217, 218 (1963).

39. *Gaither v. United States Trust Co.*, 230 S.C. 568, 576, 97 S.E.2d 24, 27-28 (1957). As to facilitating "marital deduction" see *Pitts v. Hamrick*, 228 F.2d 486 (4th Cir. 1955) (involving an intestacy).

40. *Gaither v. United States Trust Co.*, 230 S.C. 568, 576, 97 S.E.2d 24, 27-28 (1957).

41. Randall, *Taxation, Survey of South Carolina Law*, 15 S.C.L. REV. 217, 218 (1963).

42. Powell, *Ultimate Liability for Federal Estate Taxes*, 1958 WASH. U.L.Q. 327, 335 n.36.

43. 235 S.C. 162, 110 S.E.2d 241 (1959).



that all state and federal estate and inheritance taxes “imposed against *my estate* [should be paid] out of my residuary estate as an expense of administration.”<sup>44</sup>

The court concluded that the testatrix had not intended to charge the residuary estate with the burden of taxes generated by the transfer of non probate property but that she had contemplated only that the residue pay the taxes of her estate “in the everyday sense of that word;” i.e., the taxes generated by the transfer of her probate property.<sup>45</sup> Having concluded that the will made no provision for apportionment between the probate and non probate assets, the court pointed out that there was neither a controlling South Carolina statute nor applicable South Carolina decision. *Myers*, therefore, presented an issue of first impression in South Carolina; i.e., “[s]hould the ultimate burden of these (federal estate) taxes, which are imposed upon the value of both probate and non probate assets, be borne by the residuary probate estate alone, or ratably apportioned between the two estates?”<sup>46</sup>

The court noted the division of opinion in other jurisdictions on this point and articulated two questions relevant to resolution of the issue:

(1) Which is the fairer and more reasonable,—that the ultimate burden of the tax be borne solely by the beneficiaries of the residuary probate estate, or that it be apportioned ratably between them and the beneficiaries of the non-probate trust? (2) May such apportionment be decreed in the absence of statutory authority?<sup>47</sup>

As to which was fairer or more reasonable, the court stressed the point that there were two estates involved, one probate and one non probate which were lumped together under the rubric of “taxable estate.” The court also emphasized the related point that it was unlikely that the testatrix contemplated the eventuality that the assets of an *inter vivos* trust would be included as part of her estate for tax purposes and the tax burden imposed on the residuary legatees.

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44. *Id.* at 166, 110 S.E.2d at 242 (emphasis added).

45. *Id.* at 168, 110 S.E.2d at 243.

46. *Id.* at 170, 110 S.E.2d at 244.

47. *Id.*

As to the absence of statutory authority for apportionment, the court made the laconic observation that “[j]udicial application of equitable principles requires no statutory sanction.”<sup>48</sup> The court thereupon concluded that the doctrine of equitable apportionment should be applied between probate and non probate estates, “the artificial concept of the two as a single taxable estate” notwithstanding.<sup>49</sup>

In *Dial v. Ridgewood Tuberculosis Sanatorium*<sup>50</sup> the supreme court encountered a factual situation superficially similar to that presented in *Myers*. Again the question of apportionment of estate tax between probate and non probate assets was in issue. In *Dial* the husband of the testatrix created a testamentary trust which gave the testatrix the right to the income for life and the right to dispose of the corpus by her will. The testatrix provided in her will for the payment of *all* federal and state estate and inheritance taxes from her residuary estate.

The lower court relied on *Myers* and ordered apportionment of the estate tax burden between the probate and non probate assets. The supreme court reversed this decision relying not on the probate-non probate distinction but upon the *intent* of the testatrix.

In *Dial* the testatrix had been informed by her attorney that the trust assets would be taxed to her estate. Knowing this, she had provided in her will that the residue sustain all the tax burden. Thus, the court deduced from this testamentary provision and the attendant circumstances that it was the testatrix's intention that her estate bear this whole cost.

The *Dial* decision does not alter the substantive law established in *Myers*, but does demonstrate the fact that the doctrine of equitable apportionment applies to non probate assets only where the testator has failed to express a contrary intention.<sup>51</sup> If it can be shown that the testator relied on the fact that non probate assets were taxable as part of his estate and provided for payment of all taxes from the residue, then the residue will bear the burden.

48. *Id.* at 175, 110 S.E.2d at 247.

49. *Id.* at 175-76, 110 S.E.2d at 247.

50. 240 S.C. 64, 124 S.E.2d 598 (1962).

51. Randall, *Taxation, Survey of South Carolina Law*, 15 S.C.L. REV. 217, 219 (1963).

## IV. CONCLUSION

The “normally operative rule” of apportionment of estate tax in South Carolina might be summarized as follows: With minor statutory exceptions<sup>52</sup> South Carolina follows the burden-on-the-residue rule when the question is one of apportionment involving only probate property.<sup>53</sup> With respect to apportionment between probate and non probate assets taxed as part of the estate, South Carolina will apply to the doctrine of equitable apportionment and apportion the estate tax burden.<sup>54</sup> These rules are of course subject to suspension by the manifestation of a contrary intent by the testator.<sup>55</sup>

As the introduction to this article indicated, *any* “normally operative rule” which prescribes what will happen when the testator fails to provide for estate tax apportionment is desirable because it provides a precise point of departure from which the estate planner may proceed to draft documents to accomplish the desired result. However, aside from the fact that any “normally operative rule” is valuable per se, the question arises as to the relative merits of the rule fashioned by South Carolina’s judiciary.

One authority suggests the quality to be desired in any such rule, other than preciseness which gives the draftsman his point of departure, is the quality of most nearly coinciding with what a majority of persons making wills and trusts would desire, were they able to make their desires known when the question eventually arises.<sup>56</sup> Applying that test to strict burden-on-the-residue and strict doctrine of equitable apportionment rules, the same authority comes to this conclusion:

It is the considered judgment of this writer that disposers of property, who are well advised, infrequently desire apportionment of federal estate taxes as to the assets passing outside their wills; but rather commonly desire such apportionment as to the assets passing out-

52. INT. REV. CODE of 1954, §§ 2205-07. As to the South Carolina statute which affects only a small area of the apportionment question of the state estate tax see Randall, *Taxation, Survey of South Carolina Law*, 14 S.C.L.Q. 105, 106 (1961).

53. *Gaither v. United States Trust Co.*, 230 S.C. 568, 97 S.E.2d 24 (1957).

54. *Myers v. Sinkler*, 235 S.C. 162, 110 S.E.2d 241 (1959).

55. *Dial v. Ridgewood Tuberculosis Sanatorium*, 240 S.C. 64, 124 S.E.2d 598 (1962).

56. Powell, *Ultimate Liability for Federal Estate Taxes*, 1958 WASH. U.L.Q. 327, 328.

side their wills. Thus the "normally operative rule" should embody these attitudes, so that, if the will contains no applicable tax clause, the desires commonly present will be made effective. Any special circumstance, basing a desire to have a different rule applied, can then be cared for by a tailor-made special clause. The need for such clauses in most wills would be thus eliminated.<sup>57</sup>

From this point of view, the South Carolina rule is the type of "normally operative rule" which is most functional. It appears that the South Carolina judiciary has not only provided a rule for apportionment of estate tax which reflects the desires of the lay testator, but provides the requisite precision for effective estate planning as well.<sup>58</sup>

CHARLES F. AILSTOCK

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<sup>57</sup> *Id.* at 338.

<sup>58</sup> For view that a federal or uniform approach would be desirable see Scoles & Stephens, *The Proposed Uniform Estate Tax Apportionment Act*, 43 MINN. L. REV. 907 (1959).