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MARITAL DEDUCTION—TERMINABLE INTERESTS—MISSOURI LAW

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Uniformity amid diversity is a recurring problem in federal taxation. The uniform application of the federal revenue laws to all the people is plainly desirable for a variety of reasons, not the least of which is simple fairness. Yet the laws of the several states in their structure and application vary greatly, and despite the many laudable efforts to promote uniformity, and some notable accomplishments, great areas of difference still remain and predictably will always be present. In an effective federal system of income and death taxation points of impact between the federal revenue laws and the local rules, particularly those relating to property, are both inevitable and innumerable, and since reference to local concepts is unavoidable, strict uniformity is impossible. It is a dogma no thoughtful critic should champion.[1]

At the other extreme there is also a dogma, equally unacceptable and unaccepted, which I will refer to as the incorporation dogma. It suggests that, absent a clear congressional direction to the contrary, when the federal tax law uses a term with a settled local meaning, that local meaning shall control. In this view the states through their courts and legislatures have a significant creative function in federal tax law making; they may decide how and when particular measures shall be applied to their residents by fixing the form of their rules and the interpretation to be placed upon them.

Recent history furnishes an excellent example of this second dogma. Employees of corporations are entitled to deferred compensation benefits not generally available to self-employed individuals and others.[2] Those unable to avail themselves of these benefits, particularly professional peo-

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1. PAUL, SELECTED STUDIES IN FEDERAL TAXATION, SECOND SERIES, *The Effect on Federal Taxation of Local Rules of Property*, p. 1 (1938); Cahn, *Local Law in Federal Taxation*, 52 YALE L.J. 799 (1943).

2. Rev. Rul. 163, 1957-1 CUM. BULL. 128; Rev. Rul. 33, 1953-1 CUM. BULL. 267; I.T. 3350, 1940-1 CUM. BULL. 64; I.T. 3268, 1939-1 CUM. BULL. 196.

ple, have complained bitterly of the unfairness of the scheme, and for years have sought relief from the Congress, but only recently did they achieve any success in this direction and even this is partial and quite unsatisfactory.[3] The incorporation dogma suggests another alternative, however. Since the benefits are available to employees of corporations the answer lies in local legislation which will authorize the professional class to form organizations designated "corporation" or "association." These organizations, however, retain those characteristics which enlightened public policy has long deemed necessary for the proper rendition of professional service, and at some crucial points these characteristics conflict with attributes traditionally associated with the corporation concept. Within a space of a few years many of the states have enacted measures of this type, with the sole and avowed object of obtaining for their residents the benefits of the federal legislation.[4] In view of the long fight in Congress and the limitations that Congress eventually imposed on benefits available to self-employed persons it is understandable that the Internal Revenue Service should express its categorical disapproval of these measures, as it recently did.[5] That view, of course, is only one, and predictions on what the courts will do with this legislation are not wanting, with the experts in sharp disagreement.[6] If Congress doesn't intervene, the courts ultimately must choose between the conflicting demands and claims advanced in the names of uniformity and incorporation, and these choices will have an important bearing on the future development of the federal income tax law.

While neither of the extremes, strict uniformity or strict incorpora-

3. Self-Employed Individuals Tax Retirement Act of 1962, 76 Stat. 809 (1962). Critical comments on the limited scope of this legislation are numerous. Among others are Joyner, Pemberton, Taylor, *Tax Dilemma of the Self-Employed Professional,* 28 Mo. L. Rev. 161 (1963); Whiteside, *Self-Employed Individuals Retirement Act of 1962,* 51 Ky. L.J. 325 (1962); and Grayck, *Tax Qualified Retirement Plans for Professional Practitioners: A Comparison of the Self-Employed Individuals Tax Requirement* [*sic*] *Act of 1962 and the Professional Association,* 63 Colum. L. Rev. 415 (1963).

4. Missouri enacted such a measure in 1963. The Professional Corporation Law of Missouri, c. 356 RSMo 1959 (1963 supp.).

5. Recently the Internal Revenue Service has published its proposed amendments to the income tax regulations to clarify the tax treatment of professional service corporations, associations, trusts, and other organizations. These proposals, if adopted, would make it virtually impossible for professional service organizations to qualify as corporations for federal income tax purposes. Proposed Treas. Reg. § 301.7701-1(d) and § 301.7701-2(h), 28 Fed. Reg. 13750 (1963).

6. Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments,* 17 Tax L. Rev. 1 (1961); Anderson, *Tax Aspects of Professional Corporations,* U. So. Cal. 1963 Tax Inst. 309.

tion, is acceptable or accepted, there seems to be a greater tendency on the part of the judiciary to err on the side of the latter than the former. I would like to suggest some reasons for this. The cases which come before the courts often involve narrow points of construction and interpretation, and in the heat of litigation the advocates may neglect or fail to emphasize the impact and importance of a broad policy. In many instances Congress has not clearly expressed a policy of uniformity, and if there is such a policy, the courts must find or create it with the traditional tools of statutory construction; here the form of the Internal Revenue Code makes the job extremely difficult; all the traditional linguistic and grammatical problems are magnified because of the bulk of the law and its complex internal structure. Familiarity with local law is another important factor; lawyers and judges are more comfortable when they cast their materials in familiar molds; and for a profession conditioned in the atmosphere of *Erie v. Tompkins* the notion of a uniform rule overriding local differences is a difficult one. Finally, with some judges there is the matter of antipathy to the tax collector, particularly evident in some of the federal district court opinions where a local rule may tip the scales in the taxpayer's favor. If a point of law is not settled in the local jurisprudence, a judge so disposed has the opportunity to assist the taxpayer by deciding the local law in his favor, and often the result is contrary to what most lawyers would predict if the same point were litigated in the state courts in an adversary proceeding. The consequences of this last point are far reaching; for any number of reasons there may be no appeal of the trial court's decision and as a consequence it will stand as the law in a particular state for a substantial period; if there is an appeal the upper court may be reluctant or unwilling to overturn a lower court finding on a local law point; and finally there is the practical impossibility of obtaining review by the Supreme Court.

Four recent decisions involve the relationship of certain aspects of Missouri law to the marital deduction provisions of the federal estate tax law; they exemplify many of the difficult questions I have mentioned above. In *Phelps*,[7] *Gardner*[8] and *Avery*[9] the courts decided a widow's allowance

7. Bookwalter v. Estate of Phelps, 325 F.2d 186 (8th Cir. 1963), *affirming* 210 F. Supp. 801 (W.D.Mo. 1962).
8. Estate of Gardner v. United States, 220 F. Supp. 196 (E.D.Mo. 1963).
9. Estate of Avery v. Commissioner, 40 T.C. 392 (1963), on appeal to the Court of Appeals for the Eighth Circuit.

under Missouri law was a deductible item and in *Lamar*[10] the court decided a conditional bequest was not a deductible item.

I. Conditional Bequest to Spouse

The *Lamar* case illustrates the difficulties of accommodating the terminable interest rule to local law. Here decedent husband bequeathed the residue of his estate to his wife *absolutely*, but if the wife "shall not survive the administration of my estate" the property shall pass to children and grandchildren. In fact the wife did survive and receive the property. At first blush the bequest seems a clear case of a disqualified terminable interest under the statutory definition;[11] the interest terminates if the wife dies before a certain event occurs; an interest in the property passes without consideration from the husband to children and grandchildren; and the children and grandchildren by virtue of the form of the bequest will possess or enjoy the property if the wife dies before the event takes place. Indeed, this appears to be the paradigm of a forbidden terminable interest. As if to remove all doubt in a case of this kind, Congress carefully spelled out an exception to the terminable interest rule where the spouse must survive for a limited period;[12] this exception says that the interest is not a forbidden terminable interest, where the wife in fact survives, if the will or other governing instrument passes an interest to someone other than the wife (1) under a common disaster clause or (2) if the wife should die within six months after the decedent. The condition in *Lamar* does not satisfy either alternative mentioned in the statutory exception. *Expressio unius* etc.!

How then did the district court conclude the *Lamar* bequest was not a forbidden terminable interest? By looking to local law. In an earlier case, *Kellar*,[13] the Court of Appeals for the Eighth Circuit had before it a similar situation; there the gift to the surviving wife of a South Dakota decedent failed unless she was "living at the time of the distribution of my estate." Concluding that the question was one of local law, the court remanded the case to the district court in South Dakota where the estate

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10. Bookwalter v. Estate of Lamar, 323 F.2d 664 (8th Cir. 1963), *reversing* 213 F. Supp. 860 (W.D.Mo. 1963); *cert. denied* —— U.S. —— (1964).
11. Int. Rev. Code of 1954, § 2056(b)(1); Treas. Reg. §20.2056(b)-3(d), Example 4 (1958), supports this view.
12. Int. Rev. Code of 1954, §2056(b)(3).
13. Kasper v. Estate of Kellar, 217 F.2d 744 (8th Cir. 1955).

prevailed.[14] In *Lamar* the estate also prevailed in the district court on the basis of local law, but the Eighth Circuit reversed emphasizing that its result was consistent with a decision by the Court of Appeals for the Tenth Circuit in *Mappes*,[15] which denied a deduction where the gift to an Oklahoma widow failed if she "should die before my estate has been administered." Significantly the Eighth Circuit in *Lamar* again relied on local law, choosing to disagree with the district judge. It distinguished the South Dakota case principally because the district court in South Dakota found that the clause "if living at the time of the distribution of my estate" was ambiguous.

As a matter of common sense, linguistic convention, and grammatical construction the clauses in the three wills in *Lamar, Kellar* and *Mappes* are similar and the result should be the same. Quite apart from obvious inequality there is no reason that residents of South Dakota should have greater latitude in making conditional bequests to spouses than those in Oklahoma and Missouri or in any other state; the difference between six months from the date of death and the period of administration of the estate is substantial. Of course, if Congress says or clearly implies it wants such a result, that is the end of the matter. But there is nothing like that in the statute or in the committee reports. Perhaps the district courts in these cases stretched a point in the taxpayers' favor, and, properly interpreted, there is no difference in the local law in the three states. But on the other hand it is possible, although unlikely, that the highest appellate courts of the states would reach contrary results on whether the language in the wills in question created vested or conditional interests in the wife. Nevertheless it seems unwarranted to allow this difference to control the interpretation of the terminable interest rule where the federal law requirements are definite and certain and uniformity is so desirable.

II. Widow's Allowance

The federal estate tax status of the widow's allowance has been unsettled since 1950. In that year Congress repealed an express provision[16] permitting the deduction partly for the reason that in practice it had led to inequality; the allowance came from state law and some states authorized

14. Estate of Kellar v. Kasper, 138 F. Supp. 738 (W.D.S.D. 1956).
15. United States v. Estate of Mappes, 318 F.2d 508 (10th Cir. 1963).
16. Int. Rev. Code of 1939, § 812(b)(5).

more liberal allowances than others.[17] Since 1950 the sole basis for claiming the deduction has been the marital deduction, and the principal battleground has been the terminable interest rule. Here, the courts, encouraged by the Internal Revenue Service,[18] have given full sway to the incorporation dogma, and the results exhibit all the differences and peculiarities of the state laws. The question is timely because the Supreme Court has recently decided a case which may go far in resolving some of the difficult questions these cases raise.[19]

The Internal Revenue Service has assumed that the widow's allowance qualifies for the marital deduction, as an interest which passes,[20] so long as the interest viewed from the standpoint of state law is not terminable.[21] While there is some language in the committee reports which may sustain this view on the passing question,[22] it is apparent that by conceding that the terminable interest question is to be determined under local law the Service introduced immediately the same problem which Congress had apparently intended to put to rest—diversity of treatment between residents of separate states. One has only to read the cases to learn the extent to which this has occurred. In one case[23] a widow had a life estate under her husband's will which presumably would not qualify for the marital deduction; under a statute authorizing support and maintenance for twelve months she received an allowance of $50,000 where the gross estate was approximately $100,000. By permitting the deduction the court in effect recognized the widow's allowance as an effective estate splitting device available after death. At the other extreme a relatively modest lump sum allowance of $12,000 from a large estate did not qualify due to the wording of the local law.[24]

The Missouri statute authorizing a widow's allowance,[25] typical of

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17. H.R. Rep. No. 2319, 81st Cong., 2d Sess., 1950-2 Cum. Bull. 380, 424; S. Rep. No. 2375, 81st Cong., 2d Sess., 1950-2 Cum. Bull. 483, 525.
18. Rev. Rul. 83, 1953-1 Cum. Bull. 395; Treas. Reg. §20.2056(e)(2)(a) (1958).
19. Estate of Jackson v. United States, 375 U.S. 894 (1964); 64-1 U.S.T.C. ¶12221, *affirming* 317 F.2d 821 (9th Cir. 1963).
20. *Supra* note 18.
21. *Ibid.*
22. H.R. Rep. No. 2319, *supra* note 17, 1950-2 Cum. Bull. 380, 478; S. Rep. No. 2375, *supra* note 17, 1950-2 Cum. Bull. 483, 576.
23. Estate of Edmonson v. United States, 63-1 U.S.T.C. ¶12142, Civil No. 965, D. Ga., March 28, 1963.
24. United States Nat'l Bank v. United States, 188 F. Supp. 332 (D. Ore. 1960).
25. § 474.260, RSMo 1959.

many such provisions, specifies that the surviving spouse *and* the unmarried minor children are entitled to a reasonable allowance for their maintenance for a one year period after the death of the husband, according to their previous standard of living and taking into account the condition of the estate. Payment may be in a lump sum or installments, and the wife receives the payment for her use and the use of the unmarried minor children unless the court directs a separate allowance for the children. Another section of the statute,[26] added in 1955, provides that if the widow dies no allowance shall be made for her for any period after her death.

The threshold question, whether an award under such a statute is an interest passing from the husband to the wife, has been answered in the affirmative by the Internal Revenue Service[27] and apparently the Supreme Court has also adopted this view.[28] But quite apart from the passing question there are a number of problems under the terminable interest rule. If there is a single award for the widow and unmarried minor children (as the statute apparently contemplates) and the widow dies while the minor children remain unmarried, do the minor children have an interest in the part of the award, if any, which remains? If so, the award probably does not qualify.[29] If the widow should die before entry of the order, is her interest terminable by virtue of the express wording of the 1955 addition to the law? The answer to this question will depend upon how the courts resolve the terminability question.[30] Should the deduction depend upon the promptness of the personal representative in obtaining the order? And since the order may call for either lump sum or installment payments, should the deduction depend upon the form of the order?

In the three recent decisions involving the application of Missouri law the courts have allowed the deduction. In each case the order specified a lump sum award to the widow, and apparently there were no unmarried

26. § 474.300, RSMo 1959.
27. Revenue Ruling and regulation cited *supra* note 18.
28. Estate of Jackson v. United States, *supra* note 19.
29. Estate of Hailey v. Commissioner, 36 T.C. 120 (1961).
30. The committee report accompanying the Revenue Act of 1948 states flatly that in determining whether an interest in property is terminable the situation is viewed as at the date of decedent's death. S. Rep. No. 1013, 80th Cong., 2d Sess., 1948-1 Cum. Bull. 285, 338. Nevertheless the courts have not been consistent on this question. One approach illustrated in United States v. Estate of Quivey, 292 F.2d 252 (8th Cir. 1961), follows the view expressed in the senate report; the other approach illustrated in United States v. First Nat'l Bank & Trust Co., 297 F.2d 312 (5th Cir. 1961), is to view the matter at the date of the award. As pointed out, *infra* note 41, the Supreme Court in the *Jackson* case held that terminability is to be judged as of the date of death not the date of the order.

minor children so the question of terminability on that ground was not present. Also in none of these cases was the widow the residuary beneficiary of the estate.[31] The government contested the deduction on the basis of the 1955 addition to the probate law,[32] urging that under that section death was an event which caused the interest to fail and pass to another, a position sustained by other courts. The district court in the *Phelps* case[33] rejected this argument and for reasons suggested by the district judge, the court of appeals in *Phelps*,[34] the district court in *Gardner*[35] and the Tax Court in *Avery*[36] followed suit. The district court in *Phelps* relied on a decision of the St. Louis Court of Appeals[37] under the pre-1955 Missouri probate law to the effect that the estate of a surviving spouse could collect the statutory allowance where the spouse died before the entry of an order. Referring to commentaries on the 1955 addition to the law the court concluded that the legislation did not change the prior law.

The Missouri statute, in common with most others, permits either a lump sum allowance or one payable in installments. The possibilities for the form of the order are numerous; a lump sum payable in cash or in property; a lump sum payable in installments; installments payable monthly or less frequently for a specified period; and a combination of a lump sum and installment payments. A cursory glance at the cases indicates the importance of form. With a few exceptions the lump sum orders have fared well,[38] while most of the cases in which the government has prevailed involve installment payment orders.[39] Unquestionably, it is easier to find a vested indefeasible interest where the widow receives or has the right to receive a single lump sum amount.

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31. Where the widow takes as residuary beneficiary there is no terminable interest problem since no interest passes to anyone other than the widow. Rev. Rul. 26, 1956-1 CUM. BULL. 447.

32. *Supra* note 26.

33. Estate of Phelps v. Bookwalter, 210 F. Supp. 801 (W.D.Mo. 1962).

34. Bookwalter v. Estate of Phelps, 325 F.2d 186 (8th Cir. 1963).

35. Estate of Gardner v. United States, 220 F. Supp. 196 (E.D.Mo. 1963).

36. Estate of Avery v. Commissioner, 40 T.C. 392 (1963).

37. Monahan v. Monahan's Estate, 89 S.W.2d 153 (St. L. Mo. App. 1936).

38. These include: United States v. First Nat'l Bank & Trust Co., 297 F.2d 312 (5th Cir. 1961); Estate of Edmonson v. United States, *supra* note 23; Estate of Molner v. United States, 175 F. Supp. 271 (N.D.Ill. 1959); Estate of Gale v. Commissioner, 35 T.C. 215 (1960); Estate of Rudnick, 36 T.C. 1021 (1961); and Estate of Rensenhouse v. Commissioner, 31 T.C. 818 (1959).

39. These include: Estate of Cunha v. Commissioner, 279 F.2d 292 (9th Cir. 1960); Estate of Jackson v. United States, *supra* note 19; United States v. Estate of Quivey, 292 F.2d 252 (8th Cir. 1961); and Estate of Darby v. Wiseman, 323 F.2d 792 (10th Cir. 1963).

Heretofore timing has also been important. If there is a risk of disallowance where an order specifies installment payments, perhaps it is better to wait for several months and obtain a lump sum order, particularly if the question of terminability is to be viewed from the time of the entry of the order and not from date of death, an interpretation rejected by the Supreme Court in the *Jackson* case.[40] As a practical matter both form and timing are under the control of the personal representative.

In the *Jackson* case the Supreme Court decided that no part of a widow's allowance under California law qualified for the marital deduction in these circumstances: the husband died May 27, 1951; the wife obtained an order on June 30, 1952 authorizing payments to herself of $3,000 a month beginning on the date of death for a period not to exceed two years; and in fact the wife did receive $72,000 for the two year period. The court's decision rests primarily on a point of federal law, that terminability for purposes of the marital deduction is to be determined as of the date of death and not the date of the order authorizing the allowance, and two points of California law: (1) the right to a widow's allowance is not vested and nothing accrues before the order granting it; and (2) even after an order is entered the right to future payments is lost if the widow dies or remarries. In deciding that the question of terminability should be judged as of the date of death, the Supreme Court in *Jackson* adopted the view expressed in the committee reports[41] and emphasized the undesirability of a rule which made timing of an installment order determinative of the deduction.

In assessing the impact of the *Jackson* case on future cases one must consider several things. First and most important is the decision that the date of death is the point of time to measure terminability. This point alone will be sufficient to dispose of many cases. But as the court takes pains to point out, the importance of local law remains. Significant differences in local law may lead to different results; this is to say that terminability for purposes of the federal statute is first of all a question of local law; the interest which passes is an interest created and shaped by local law. Thus an installment type order under the laws of another state may qualify for the deduction if the terminability test viewed from the date of death is satisfied. Moreover, the fact that the *Jackson* case involved an

40. *Supra* note 19.
41. *Supra* note 30.

installment type order suggests that in some instances there may be a basis for distinguishing lump sum orders. As mentioned before,[42] most of the cases in the lower federal courts where the widow has prevailed have involved lump sum orders. Here again the local law will be important, and if the award, viewed from the date of death, is terminable under local law the award will not qualify for the deduction.

The decision in the *Jackson* case probably calls for a reassessment of the decisions involving Missouri law in *Phelps, Gardner* and *Avery*.[43] Now, presumably, for an award under Missouri law to qualify for the deduction the right must be vested or fixed as of the date of death. Arguably this requirement is satisfied by the reasoning of the lower court in the *Phelps* case to the effect that death before entry of an order does not destroy the right, which is transmissible to the estate of the decedent.[44] In this respect Missouri law as interpreted by the district court in *Phelps,* differs from California law as interpreted by the Supreme Court in the *Jackson* case. But the *Jackson* opinion may require that vesting of the right is not sufficient unless the amount itself which is claimed as a deduction is also vested as of the date of death. In view of the 1955 addition to the Missouri Probate Code—that no allowance shall be made for maintenance after death of the wife—this may be a difficult point for taxpayers to sustain. The decision in the *Monahan* case,[45] which the lower court in *Phelps* relied on so heavily, does not stand for that proposition.

III. Some Concluding Comments

In both situations—the conditional bequest cases and the widow's allowance cases—the incorporation dogma poses the same fundamental problem—differences in results based on real or supposed differences in state laws. California law may lead to a different result than Missouri law, even though in their significant features the laws are similar.[46] When Congress in the marital deduction used terms such as "interest," "property," "pass," "terminate," and "fail," quite clearly it made some reference to local law. Basically it has legislated with regard to property interests which originate in local law, and at one level reference to local law is

42. *Supra* note 38.
43. *Supra* notes 33, 34, 35 and 36.
44. *Supra* note 33.
45. *Supra* note 37.
46. These features are summarized in Estate of Jackson v. United States, *supra* note 19.

necessary. Yet on another level it is perfectly appropriate for Congress to use the term "property" and "interest" more broadly or more narrowly than local usage would suggest.[47] The term "passing" is defined in the statute;[48] it has a peculiar federal meaning; yet on one level it too is referable to state law. The terms "fail" or "terminate" have a local reference—either to provisions found in wills, trusts, life insurance policies and the like or to provisions of local law; yet the reference at this level, as the *Jackson* case indicates, should be the beginning point not the end. Whether a particular item, a conditional bequest or a widow's allowance, fails or terminates should finally be a question of federal not local law.[49] There are two things at stake in these cases: a tax deduction to a particular taxpayer and the administration of a law national in scope. As recently as four years ago the Supreme Court recognized that local rules need not govern the former.[50] In this article I have emphasized the importance of the latter and have suggested that in the rapidly developing field of marital deduction law the Internal Revenue Service and the courts have in some instances not recognized the impact which uniformity should have on the law.

47. Some of the most interesting problems in the tax law involve these admittedly vague concepts. Among many examples one may point to the definitional problems in the capital gain area and the anticipatory assignment of income question.

48. INT. REV. CODE OF 1954, § 2056(e).

49. Of particular interest in the estate tax field are the decisions of the Supreme Court in Morgan v. Commissioner, 309 U.S. 78 (1939) and United States v. Stapf, 375 U.S. 118 (1963). In the *Morgan* case the court rejected the proposition that the meaning of the undefined term "general power of appointment" in the federal estate tax law was determined by local law. Recently in the *Stapf* case the court decided that the provisions of a will did not govern the deductibility of a claim against the estate even though the statute permitting a deduction for claims against the estate specifically refers to local law and the item in question was a personal liability of the decedent under local law.

50. Commissioner v. Lester, 366 U.S. 299 (1960).