

February 2021

## Property Surrendered by Surviving Spouse Flunks the Passing Requirement: The Tenth Circuit Denies the Marital Deduction in *Schroeder v. United States*

Deborah L. Land

Follow this and additional works at: <https://digitalcommons.du.edu/dlr>

---

### Recommended Citation

Deborah L. Land, *Property Surrendered by Surviving Spouse Flunks the Passing Requirement: The Tenth Circuit Denies the Marital Deduction in Schroeder v. United States*, 69 *Denv. U. L. Rev.* 747 (1992).

This Note is brought to you for free and open access by the Denver Law Review at Digital Commons @ DU. It has been accepted for inclusion in Denver Law Review by an authorized editor of Digital Commons @ DU. For more information, please contact [jennifer.cox@du.edu](mailto:jennifer.cox@du.edu), [dig-commons@du.edu](mailto:dig-commons@du.edu).

PROPERTY SURRENDERED BY SURVIVING SPOUSE "FLUNKS"  
THE "PASSING" REQUIREMENT: THE TENTH  
CIRCUIT DENIES THE MARITAL DEDUCTION  
IN *SCHROEDER V. UNITED STATES*

I. INTRODUCTION

*Schroeder v. United States*<sup>1</sup> was a case of first impression before the Tenth Circuit. It dealt with an important feature of estate tax law<sup>2</sup> in the United States: the "marital deduction."<sup>3</sup> In *Schroeder*, joint tenancy property and property acquired by a surviving spouse by statutory election against her husband's will were later surrendered in settlement of a controversy regarding the devolution of her husband's estate. The question at issue was whether this property actually "passed" to the widow<sup>4</sup> and thereby qualified for the marital deduction even though it was subsequently surrendered. The Tenth Circuit held in *Schroeder* that this property did *not* pass to the widow and therefore did *not* qualify for the marital deduction.

The *Schroeder* decision is significant because it diverges from the precedent set in decisions by the Second and Fifth Circuits.<sup>5</sup> In those

---

1. 924 F.2d 1547 (10th Cir. 1991).

2. 26 U.S.C. § 2001(a) (1988) provides: "A tax is hereby imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States."

3. 26 U.S.C. § 2056 (1988) provides in part:

(a) Allowance of marital deduction

For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsection (b), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

(b) Limitation in the case of life estate or other terminable interest

(1) General rule

Where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction shall be allowed under this section with respect to such interest—

(A) if an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse); and

(B) if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse; and no deduction shall be allowed with respect to such interest (even if such deduction is not disallowed under subparagraphs (A) and (B))—

(C) if such interest is to be acquired for the surviving spouse; pursuant to directions of the decedent, by his executor or by the trustee of a trust.

For purposes of this paragraph, an interest shall not be considered as an interest which will terminate or fail merely because it is the ownership of a bond, note, or similar contractual obligation, the discharge of which would not have the effect of an annuity for life or for term.

4. See 26 U.S.C. § 2056(a).

5. *Citizens & S. Nat'l Bank v. United States*, 451 F.2d 221 (5th Cir. 1971); *United*

circuits, the will contest regulation<sup>6</sup> was broadly applied to cases involving property relinquished by the surviving spouse in the settlement of a decedent's estate. The Tenth Circuit strictly construed the will contest regulation, refusing to apply it to the facts in *Schroeder*.

To establish the legal setting for *Schroeder*, this Comment will first set forth the legislative development of the marital deduction. Second, the facts of *Schroeder* will be discussed and an analysis of both the Tenth Circuit and U.S. District Court decisions will be provided. The policy reasons behind the Tenth Circuit's decision and possible future ramifications will also be examined. Ultimately, this Comment will propose that the will contest regulation be amended.

## II. LEGISLATIVE DEVELOPMENT OF THE MARITAL DEDUCTION

Upon death, an estate tax is imposed on the value of the decedent's taxable estate.<sup>7</sup> The value of certain property that "passed" during the decedent's life or "passes" at death to the decedent's surviving spouse can be deducted as a "marital deduction,"<sup>8</sup> thereby reducing the decedent's taxable estate. The marital deduction was originally enacted in 1948<sup>9</sup> and has experienced a series of legislative changes through the years.

### A. Revenue Act of 1948 — Legislative Response to Community Property System

Prior to 1948, an estate tax disparity was created between community property states,<sup>10</sup> where assets acquired during marriage were automatically owned one-half by each spouse, and common law states, where each spouse owned the assets acquired by his or her personal endeavors or by gift or inheritance. When most of the family property was owned by the first spouse to die, a greater estate tax burden was imposed in

---

States Trust Co. of N.Y. v. Commissioner, 321 F.2d 908 (2d Cir. 1963), *cert. denied*, 376 U.S. 937 (1964).

6. Treas. Reg. § 20.2056(e)-2(d) (1958), provided in pertinent part: If as a result of a controversy involving the decedent's will, or involving any bequest or devise thereunder, his surviving spouse assigns or surrenders a property interest in settlement of the controversy, the interest so assigned or surrendered is not considered as having "passed from the decedent to his surviving spouse."

7. See 26 U.S.C. § 2001.

8. 26 U.S.C. § 2056. See also 5 BORIS I. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 129.1, at 129-2 (1984) [hereinafter BITTKER]; 4 JACOB RABKIN & MARK H. JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION § 53.04 (1989) [hereinafter RABKIN & JOHNSON] (marital deduction is allowed for property included in the gross estate that passes to the surviving spouse).

9. The Revenue Act of 1948, Pub. L. No. 80-471, 62 Stat. 117, § 361(a), added the marital deduction provision to the 1939 Internal Revenue Code, 26 U.S.C. § 812(e); 26 U.S.C. § 2056 (Supp. V 1952).

10. Eight states currently operate under a community property system. See ARIZ. REV. STAT. ANN. § 25-211 (1991); CAL. CIV. CODE § 687 (West 1991); IDAHO CODE § 15-1-201 (1991); LA. CIV. CODE ANN. art. 2343.1 (West 1991); NEV. REV. STAT. § 123.220 (1991); N.M. STAT. ANN. § 40-3-12(A) (Michie 1991); TEX. FAM. CODE ANN. § 5.01 (West 1991); WASH. REV. CODE ANN. § 26.16.030 (West 1991).

common law states than in community property states.<sup>11</sup> The common law states taxed all of the property owned by the decedent, whereas the community property states taxed only half of the community property regardless of how much the decedent owned.<sup>12</sup>

Congress first sought to equalize this disparity by amending the Revenue Act of 1942 which taxed community property in full to the estate of the first spouse to die.<sup>13</sup> These amendments, although constitutionally upheld in *Fernandez v. Wiener*,<sup>14</sup> in effect operated to tilt the balance against community property states.<sup>15</sup> The Revenue Act of 1948 restored the pre-1942 community property system of including only one-half of the community property in the gross estate of the first spouse to die.<sup>16</sup> Also as part of the 1948 Act, Congress enacted the "marital deduction" in order to equalize the treatment of couples in common law and community property states.<sup>17</sup> It allowed up to fifty percent of the value of the decedent's gross estate to be deducted from the taxable estate if the property passed outright to the surviving spouse.<sup>18</sup> By enacting the marital deduction, Congress introduced the

11. See H.R. REP. NO. 2333, 77th Cong., 2d Sess. 35-37, 160 ("For the purpose of Federal estate taxation, husband and wife living in community-property States enjoy a preferential treatment over those living in non-community-property States.")

12. BITTKER, *supra* note 8, ¶ 125.10, at 125-33.

13. Revenue Act of 1942, Pub. L. No. 77-753, 56 Stat. 798, 941, §§ 402, 404 (codified at 42 U.S.C. §§ 811(d)(5), 811(e)(2), 811(g)(4) (1946)).

14. 326 U.S. 340 (1945). The Court stated, "We find no basis for the contention that the tax is arbitrary and capricious because it taxes transfers at death and also the shifting at death of particular incidents of property. Congress is free to tax either or both, as it may constitutionally do . . ." *Id.* at 358.

15. Professor Bittker stated:

If, for example, the first spouse to die was not the economic source of any of the community property but exercised his or her power of testamentary disposition over half of the property by leaving it to the surviving spouse, the first decedent's estate was taxed on 50 percent of the community property, and the survivor on 100 percent; by contrast, a comparable couple in a common-law jurisdiction paid no tax when the nonowner spouse died, and the property was taxed in full when the survivor died.

BITTKER, *supra* note 8, ¶ 129.1, at 129-4.

16. The Revenue Act of 1948, Pub. L. No. 80-471, 62 Stat. 116, § 351, repealed the community property amendments I.R.C. §§ 811(d)(5), 811(e)(2), 811(g)(4). See also BITTKER, *supra* note 8, ¶ 129.1, at 129-6.

17. 26 U.S.C. § 2056(c)(1) (Supp. V 1952) provided: "The aggregate amount of the deductions allowed under this section . . . shall not exceed 50 percent of the value of the adjusted gross estate . . ."

18. S. REP. NO. 1013, 80th Cong., 2d Sess. 5 (1948), reprinted in 1948 U.S.C.C.A.N. 1163, 1167, stated the legislative intent behind the repeal of the 1942 amendments and the institution of the marital deduction:

1. The 1942 amendments to the estate and gift taxes which provided special rules in the case of community property are repealed for persons dying and as to gifts made after the date of the enactment of this bill. Generally, this restores the rule by which estate and gift-tax liabilities are dependent upon the ownership of the property under State law. Thus, in community-property States, irrespective of which spouse dies first, only one-half of the community property is included in the gross estate. Similarly, a gift made out of community property is taxable one-half to the husband and one-half to the wife, since under State law each owns a one-half interest in the property.

2. Provision is made for estate- and gift-tax "splitting" of non-community property. This provision also will apply to persons dying after the date of the enactment of this bill, so that community property and noncommunity property may be placed on an equal basis at the same time. Under this provision property

new concept of "estate-splitting." Estate-splitting permitted one spouse to bequeath half of his or her property to the other spouse without tax. This concept was the culmination of the following chain of legislative reasoning: 1) income-splitting was designed to put common law residents on a par with community property residents; 2) because the 1942 estate tax amendments were unfair to community property residents, it was desirable to restore the pre-1942 law which recognized the local law property division between husband and wife; 3) the only method to place common law residents in approximate equality with community property residents for estate tax purposes was to allow estate-splitting.<sup>19</sup>

#### B. 1976 Reform Act

Congress amended the marital deduction in 1976 to allow up to \$250,000 or one-half of the decedent's adjusted gross estate to be deducted, whichever was greater.<sup>20</sup> This amendment was based on the rationale that "a decedent with a small- or medium-sized estate should be able to leave a minimum amount of property to the surviving spouse without the imposition of an estate tax."<sup>21</sup> The marital deduction continued to be an equalizer between community property and common law states, but "it was now charged with a second function: to free interspousal transfers from estate and gift taxation, albeit at a modest level."<sup>22</sup>

#### C. 1981 Economic Recovery Act — Current Legislative Rationale for the Marital Deduction

The 1981 Economic Recovery Tax Act repealed the limits set by the marital deduction provision under the 1976 Reform Act and provided for an *unlimited* marital deduction.<sup>23</sup> It broadened the rationale of the

---

passing outright in a common-law State from a decedent to the surviving spouse is deducted from the decedent's gross estate up to a limit of 50 percent of the value of the decedent's gross estate less deductions for funeral expenses, debts, and other claims against the estate. In a similar fashion husbands and wives, in common-law States, may treat their gifts as being made one-half by each spouse. Residents of community-property States may also take advantage of the estate and gift-tax splitting provisions with respect to transfers of their separate property. The same splitting effect is achieved for community property by the repeal of the 1942 amendments.

See also *United States v. Stapf*, 375 U.S. 118, 128 (1963).

19. RABRIN & JOHNSON, *supra* note 8, § 53.04.

20. 1976 Tax Reform Act, Pub. L. No. 94-455, 90 Stat. 1854, § 2002 (codified at 26 U.S.C. § 2056 (1976)). Section 2056(c) provided, "The aggregate amount of the deductions allowed under this section . . . shall not exceed the greater of—(i) \$250,000, or (ii) 50 percent of the value of the adjusted gross estate."

21. JOINT COMMITTEE TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, H.R. REP. NO. 10612, 94th Cong., 2nd. Sess. 533 (1976), *reprinted in* 1976-3 C.B. 1, 545.

22. BITTKER, *supra* note 8, ¶129.1, at 129-6.

23. The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 403(a)(1), 95 Stat. 172, 301 (1981) (codified as amended at 26 U.S.C. § 2056(a) (1988)) repealed § 2056(c) of the 1976 Act. The Act allows for an unlimited marital deduction provided the interest received by the surviving spouse is not a terminable interest. 26 U.S.C. § 2056. See *supra* note 3.

marital deduction well beyond the "equalization" theory of the 1948 Act. Under the 1981 Act, the legislative rationale of the marital deduction was "that an individual should be free to pass his entire estate to a surviving spouse without the imposition of any additional tax."<sup>24</sup> "[A] husband and wife should be treated as one economic unit for purposes of estate and gift taxes, as they generally are for income tax purposes."<sup>25</sup>

The 1981 Act remains current law with respect to the marital deduction. The provision allows a married couple to transfer assets freely between themselves without estate tax ramifications regardless of which spouse earned, inherited or acquired the property.<sup>26</sup> There is also a correlating gift tax counterpart.<sup>27</sup> Consequently, under the current law, married couples are given a great deal of flexibility in protecting assets owned by the first spouse to die from estate tax until the survivor dies.<sup>28</sup> The marital deduction is allowed, however, only to the extent that property exempted upon the death of the first spouse will be potentially subject to gift or estate tax when the property is passed on by the second spouse, either at death or by *inter vivos* gift.<sup>29</sup> Therefore, I.R.C. § 2056 is a means of deferring, not eliminating tax liability.<sup>30</sup> The *Schroeder* decision reflects this rationale in its denial of the marital deduction to property that would have otherwise escaped estate taxation.

### III. SCHROEDER V. UNITED STATES

#### A. Factual Background

*Schroeder v. United States*<sup>31</sup> involved an action brought by the executor of the decedent's estate to claim a refund of certain federal estate taxes allegedly paid in error.<sup>32</sup> Thomas Woodmansee (Thomas) was

24. RABKIN AND JOHNSON, *supra* note 8, § 53-04, at 53-33. See S. REP. NO. 144, 97th Cong., 1st Sess. 127, reprinted in 1981 U.S.C.C.A.N. 105, 228, and in 1981-2 C.B. 461.

25. S. REP. NO. 144, *supra* note 24, at 228. The unlimited marital deduction also eliminates tax problems resulting from the joint ownership of property between spouses. RABKIN & JOHNSON, *supra* note 8, § 53-04, at 53-33.

26. BITTKER, *supra* note 8, ¶ 129.1, at 129-2 to 129-3.

27. 26 U.S.C. § 2523 (1981) provides for a broad exemption of interspousal gifts from gift tax. See also S. REP. NO. 144, *supra* note 24, at 228 ("[N]o tax should be imposed on transfers between a husband and wife.").

28. BITTKER, *supra* note 8, ¶ 129.1, at 129-3.

29. It is possible that all of part of the property could escape gift or estate taxation, even upon the second spouse's death. The second spouse could give away all or part of the marital deduction property tax-free by making use of the annual gift exclusion, the exclusion for a transfer for the benefit of a minor, or the exclusion for transfers of qualified educational or medical expenses. See I.R.C. § 2503. In this way, the property could pass out of the second spouse's estate without taxation.

30. BITTKER, *supra* note 8, ¶ 129.1, at 129-3.

Deferral, therefore, does not mean that the first spouse's property will necessarily be taxed when the surviving spouse dies—only that it will be taxed if it passes from the husband-wife unit to other beneficiaries, after taking into account the gift tax exclusions and the second unified credit made available to the survivor during the deferral period.

*Id.*

31. 924 F.2d 1547 (10th Cir. 1991).

32. *Id.* at 1549.

married to Peggy Woodmansee (Peggy) for eighteen years, and had two adult daughters from a prior marriage, Martha Schroeder (Martha) and Lou Ann Waters (Lou).<sup>33</sup> On July 6, 1981, prior to his death, Thomas set up a substantial stock account, naming himself and Peggy joint tenants with a right of survivorship.<sup>34</sup> On July 16, 1981, Thomas signed a will directing that his property be placed in a trust. The income from the trust was to go to Peggy during her life, and upon her death, the corpus of the trust was to be divided equally between the two daughters, or their issue.<sup>35</sup> Two months later Thomas died, and his will was admitted to probate. Henry Schroeder (Schroeder), Martha's husband, was named executor.<sup>36</sup> Martha and Lou learned of the joint tenancy stock account soon after their father's death. They were told that the account would not pass through their father's will because it was nonprobate property owned solely by Peggy as the surviving spouse.<sup>37</sup> Martha and Lou were advised by an attorney to negotiate with Peggy concerning the stock account.<sup>38</sup>

In February, 1982, in settlement of these negotiations, Peggy put the stock account into a trust with a neutral trustee. The principal of the trust was to be distributed to Martha and Lou, or their issue, upon Peggy's death.<sup>39</sup> During Peggy's life, quarterly income from the trust was to be divided among the three women, one-fourth to Peggy and three-fourths divided equally between Martha and Lou.<sup>40</sup> In April of 1982, Peggy filed an election to take her statutory one-third spousal share of the estate,<sup>41</sup> which had a fair market value of \$77,121. She subsequently deposited this share into the trust account.<sup>42</sup>

Schroeder filed the estate tax return, including the joint tenancy stock account and the spousal election share in the gross estate.<sup>43</sup> He

---

33. *Id.* at 1548.

34. *Id.* Neither daughter was aware of the creation of the stock account.

35. *Id.* On the same day he signed the will, Thomas deeded the family farm over to Martha and Lou. Both daughters signed an affidavit stating they knew the provisions of their father's will and of his intent to keep his assets in the family. They also stated that they intended to honor their father's wishes and that he was mentally competent at all times during his life. *Id.* at 1548-49.

36. *Id.* at 1549.

37. *Id.* At the time of Thomas' death, the Fair Market Value of the stock account was approximately \$229,843. *Id.*

38. *Id.* In their affidavits, Martha and Lou stated they thought Peggy had a "moral duty" to leave the principal of the stock account to them and their children. *Id.*

39. *Id.*

40. *Id.*

41. *Id.* See OKLA. STAT. ANN. tit. 84, § 44 (West 1990).

42. *Schroeder*, 924 F.2d at 1549. By depositing her spousal share in the Trust Account, Peggy submitted the money to the terms of distribution set forth in the Trust Account.

43. *Id.* At the time of decedent's death, 26 U.S.C. § 2033 provided that, "The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death." Section 2040(a) provided in pertinent part, "The value of the gross estate shall include the value of all property to the extent of the interest therein held as joint tenants with right of survivorship by the decedent and any other person . . . in their joint names and payable to either or the survivor." 26 U.S.C. § 2040(a) (1988).

When Thomas died in 1981, § 2040(a) required the inclusion of the *entire value* of joint tenancy property in the estate of the first joint tenant to die. It is because of this specific

also claimed these assets as part of the marital deduction allowable under 26 U.S.C. § 2056.<sup>44</sup> The Internal Revenue Service (I.R.S.) issued the estate a notice of deficiency, disallowing the marital deduction with respect to the stock account and statutory elective share. Schroeder paid the deficiency and then claimed a refund, which was denied by the I.R.S.<sup>45</sup> Schroeder then brought an action to claim a refund of the taxes allegedly paid in error.<sup>46</sup> He moved for partial summary judgment,<sup>47</sup> arguing that the stock account should be included in the marital deduction,<sup>48</sup> and that the provisions of the will contest regulation did not apply.<sup>49</sup> The I.R.S. moved for summary judgment, arguing that the value of both the joint stock account and the spousal election were properly excluded from the marital deduction under the will contest regulation. The I.R.S. based its argument on the decisions in *United States Trust Co. v. Commissioner*,<sup>50</sup> and *Citizens & Southern National Bank v. United States*.<sup>51</sup>

### B. Holding

The U.S. District Court for the Western District of Oklahoma disallowed the marital deduction, granting summary judgment in favor of the I.R.S.<sup>52</sup> The district court applied Treasury Regulation § 20.2056(e)-2(d)(1) to the controversy involving Thomas' estate. The court determined that the joint tenancy and statutory election share property, which was relinquished in settlement, did not "pass" to Peggy under the regulation, and therefore was not entitled to be included in the marital deduction.<sup>53</sup>

The Tenth Circuit affirmed the district court decision.<sup>54</sup> The court

---

statutory provision that the joint tenancy property described herein was included, *in full*, in Thomas' estate.

44. *Id.* At the time of Schroeder's death on September 17, 1981, § 2056(c) under the 1976 Reform Act governed, limiting the deduction to the greater of \$250,000 or 50% of the value of the adjusted gross estate. *See supra* note 20. This section was amended in 1981, removing the limitations and providing for an unlimited marital deduction, but the amended version took effect for persons dying in 1982 and thereafter.

Had Thomas died some four months later, the marital deduction allowable in computing the value of his taxable estate would have been unlimited and only one-half of the aggregate value of property held by him and Peggy as joint tenants with right of survivorship would have been included in the gross estate.

45. *Id.*

46. The refund action was founded on 26 U.S.C. § 7422 (1988).

47. *Schroeder*, 924 F.2d at 1549-50.

48. *Id.* at 1550. The marital deduction provision which applied at the time of Thomas' death was limited under the 1976 Tax Reform Act to \$250,000 or one-half the value of the estate. *See supra* note 20. Schroeder based his summary judgment argument only on his claim for the marital deduction on the stock account because the value of the stock account together with the statutory elective share exceeded the maximum allowed deduction.

49. *Schroeder*, 924 F.2d at 1550. The executor argued that "the will contest provision only applies when the spousal property is vested after and in settlement of a controversy specifically concerning the terms of a will." *Id.*

50. 321 F.2d 908 (2d Cir. 1963).

51. 451 F.2d 221 (5th Cir. 1971).

52. *Schroeder v. United States*, 696 F. Supp. 1426, 1432 (W.D. Okla. 1988).

53. *Id.*

54. *Schroeder*, 924 F.2d 1547, 1555 (10th Cir. 1991).

did not apply Treasury Regulation § 20.2056(e)-2(d)(1), choosing not to broaden the application of the will contest regulation to the facts in this case. Instead the Tenth Circuit held that "property comprising Peggy's statutory election and the joint account did not 'pass' to her within the meaning of the marital deduction statute [I.R.C. § 2056] because Peggy surrendered her entitlement to this property in settlement of a bona fide controversy concerning her rights to the property in the decedent's gross estate for federal estate tax purposes."<sup>55</sup>

### C. Analysis

On appeal, Schroeder argued that because the Merrill Lynch stock account was held by the decedent and his wife as joint tenants with the right of survivorship,<sup>56</sup> under Oklahoma law, the surviving joint tenant becomes the whole and complete owner at the moment of death.<sup>57</sup> In *Clovis v. Clovis*,<sup>58</sup> the Oklahoma Supreme Court described the joint tenancy interest as follows: "[The] right of survivorship does not pass anything from a deceased joint tenant to the survivor since, by the very nature of joint tenancy, title of the joint tenant who dies first terminates at death and vests eo instanti in the survivor."<sup>59</sup>

Schroeder argued that the joint tenancy stock account immediately "vested" in Peggy upon Thomas' death, and under I.R.C. § 2056(a), it was eligible to be included in the marital deduction.<sup>60</sup> Schroeder pointed out that I.R.C. § 2056(d), now redesignated as § 2056(c), pursuant to the Economic Recovery Tax Act of 1981, provided:

For the purposes of this section, an interest in property shall be considered as passing from the decedent to any person if . . .  
(5) such interest was, at the time of decedent's death, held by such person and the decedent (or by them and any other person) in *joint tenancy* with right of survivorship.<sup>61</sup>

In sum, Schroeder argued that the three requirements of I.R.C. § 2056(a) were met:<sup>62</sup> first, the property *passed* from the decedent to the surviving spouse; second, the interest was includable in determining the total value of the decedent's gross estate; and third, the interest was not a terminable interest.<sup>63</sup> Therefore, the joint tenancy stock account

55. *Id.* at 1555.

56. Appellant's Brief-in-Chief at 16, *Schroeder v. United States*, 924 F.2d 1547 (10th Cir. 1991) (No. 88-2946).

57. OKLA. STAT. ANN. tit. 60, § 74 (West 1971); *see also* *Draughon v. Wright*, 191 P.2d 921, 923 (Okla. 1948).

58. 460 P.2d 878, 881 (Okla. 1969).

59. *Id.* at 881.

60. Appellant's Brief-in-Chief at 16, *Schroeder* (No. 88-2946).

61. *Id.* at 18 (quoting Pub. L. No. 97-34, § 403(a)(1)(A), 95 Stat. 172, 299 (1981) (emphasis added)).

62. *See* 26 U.S.C. § 2056(b).

63. *See id.* Appellant made the argument that the principle of the limitation provided in § 2056(b) is to remove property interests from the marital deduction if those interests are subject to *natural* extinction or expiration (i.e., life estates, terms of years) prior to the taxation of the estate of the recipient spouse, and where there is such a "naturally" terminable interest, the legislature has determined to tax the value of that interest, but the

should be included in the marital deduction. Schroeder also relied on the U.S. District Court of Kansas' decision in *First National Bank v. United States*,<sup>64</sup> to show that under state law, the joint tenancy property at issue "passed" when it vested in Peggy immediately upon Thomas' death.<sup>65</sup> The court in *First National Bank* found that the qualification for the marital deduction must be determined at the time of death and not as of a date established by some subsequent development.<sup>66</sup>

The Tenth Circuit, in its opinion, did not deny appellant's contention that joint tenancy property "vests" in the surviving spouse upon the date of the decedent's death. However, the court affirmed the fundamental rule that state law determines what property interests individuals hold, and federal law determines how property shall be taxed.<sup>67</sup> "[F]ederal law controls whether property 'passes' from the estate of a deceased individual for the purposes of the federal estate tax."<sup>68</sup> The court pointed out that a contrary view arguably would "transgress the Supreme Court's holding in *Lyeth v. Hoey*, . . . that federal law controls the incidence of federal taxation of property acquired under state law."<sup>69</sup> The Tenth Circuit discounted the *First National Bank* decision, which froze property rights as of the date of death. The court determined that such a ruling would preclude any consideration for federal tax purposes of any post-mortem settlement of a controversy concerning property of the decedent. The court stated that "a controversy involving the surviving spouse's entitlement to the decedent's property is by definition a post-mortem dispute. We believe that [*First National's*] approach is inconsistent with the purpose of the marital deduction."<sup>70</sup>

---

policy of the marital deduction is not offended when the surviving spouses' interest is terminated by his or her own affirmative act. Appellant's Brief-in-Chief at 24, *Schroeder* (No. 88-2946).

64. 233 F. Supp. 19 (D. Kan. 1964).

65. *Schroeder*, 924 F.2d at 1554 n.7.

66. *First Nat'l Bank*, 233 F. Supp. at 26.

67. *Schroeder*, 924 F.2d at 1552. See also *Citizens & S. Nat'l Bank v. United States*, 451 F.2d 221, 228 (5th Cir. 1971). Also, in *United States v. National Bank of Commerce*, 472 U.S. 713, 722 (1985), Justice Blackmun stated in the majority opinion that "[i]n the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayer had in the property. . . . [T]he federal statute creates no property rights, but merely attaches consequences, federally defined, to rights created under state law." (quoting *Aquilino v. United States*, 363 U.S. 509, 513 (1960); *United States v. Bess*, 357 U.S. 51, 55 (1958); *Morgan v. Commissioner*, 309 U.S. 78, 82 (1940)). See also *Estate of Goldstein v. Commissioner*, 479 F.2d 813, 816 (10th Cir. 1973) (emphasizing that federal law fixes tax incidences of property transfers generated by death, but state law determines the nature of such transfers and manner by which they are affected).

68. *Schroeder*, 924 F.2d at 1552. See also *United States Trust Co. v. Commissioner*, 321 F.2d 908, 910 (2d Cir. 1963) (vesting under state law has no bearing on interpretation of federal passing requirement).

69. 924 F.2d at 1554 (citations omitted). In *Lyeth*, the amount received by an heir in settlement of a threatened will contest was acquired "by inheritance" so as to be exempt as to him from income tax. *Lyeth v. Hoey*, 305 U.S. 188, 193-94 (1938). See also *Helvering v. Safe Deposit & Trust Co.*, 316 U.S. 56 (1942) (It is not the will, but the substituted terms of the distribution that determine what property passes to the heir or legatee from the decedent. Thus, an estate is not entitled to a marital deduction for property that the surviving spouse relinquished in settlement of a controversy regarding the decedent's estate.).

70. *Schroeder*, 924 F.2d at 1554 n.7.

The Tenth Circuit relied on the policy that the purpose of the marital deduction was to allow a deferral of taxation when property passed to a surviving spouse, but not to provide an escape from taxation. If post-mortem settlements were excluded in determining a decedent's taxable estate, a surviving spouse could feasibly pass property which had been included in a marital deduction to other individuals in a post-mortem settlement. This property would escape estate taxation altogether because it would no longer be part of the second spouse's estate. The intent of the marital deduction was that it was to be "applied in situations in which the government had the potential for a two-tiered taxing of the property."<sup>71</sup> A portion of the estate could pass tax-free by the marital deduction upon the death of the first spouse, but could potentially be taxed upon the death of the second spouse.

The application of the "will contest" regulation<sup>72</sup> to the particular facts of the *Schroeder* case was a primary issue considered by both the Tenth Circuit and district court. This regulation provides:

If as a result of a controversy involving the decedent's will, or involving any bequest or devise thereunder, his surviving spouse assigns or surrenders a property interest in settlement of the controversy, the interest so assigned or surrendered is not considered as having passed from the decedent to his surviving spouse.<sup>73</sup>

At the trial court level, the U.S. District Court of Oklahoma applied the will contest regulation in *Schroeder v. United States*<sup>74</sup> even though the case involved only a controversy arising from the devolution of the decedent's estate, and not specifically a will contest. The court said that "lawsuits are not determinative of the existence of a 'controversy' between the parties—all that is required is adversity."<sup>75</sup> The court concluded that, under the regulation, the joint tenancy and statutory election property at issue in this case did not "pass" to Peggy Woodmansee from the decedent.<sup>76</sup>

The court based its decision to apply the will contest regulation on "a cogent body of authority in support of its view that the courts have interpreted the regulation broadly to encompass any controversy arising from the devolution of the decedent's estate which results in a settlement."<sup>77</sup> The court especially relied on decisions by the Second<sup>78</sup> and

---

71. *Id.* at 1550.

72. Treas. Reg. § 20.2056(e)-2(d)(1) (1958).

73. *Id.*

74. 696 F. Supp. 1426 (W.D. Okla. 1988).

75. *Id.* at 1432. See also *Bel v. United States*, 452 F.2d 683, 694 (5th Cir. 1971), *cert. denied*, 406 U.S. 919 (1972). The *Bel* court specifically noted that "arms-length negotiations are sufficient to evidence the existence of a controversy under Treas. Reg. § 20.2056(e)-2(d)(1)." *Id.* at 694.

76. *Schroeder*, 696 F. Supp. at 1432. The court granted defendant's motion for summary judgment and denied plaintiff's motion for partial summary judgment. Plaintiff appealed this order to the Tenth Circuit.

77. *Id.* at 1429.

78. *United States Trust Co. v. Commissioner*, 321 F.2d 908 (2d Cir. 1963), *cert. denied*, 376 U.S. 937 (1964).

Fifth<sup>79</sup> Circuits where both courts rejected a "restrictive interpretation" of Treasury Regulation § 20.2056(e)-2(d).<sup>80</sup>

In *United States Trust Co. v. Commissioner*, the decedent, a U.S. citizen who owned property in both the United States and France, sought to dispose of his assets by two testamentary instruments.<sup>81</sup> Under one will, he passed all of his U.S. property to his widow and three daughters by a former marriage.<sup>82</sup> By another testamentary document, he sought to devise his French villa and other French property solely to his widow.<sup>83</sup> Under French law, however, the widow's interest was limited to one-fourth of the property unless the daughters executed certain documents with the French government.<sup>84</sup> Following arms-length negotiations between the surviving spouse and the step-daughters, the widow entered into a settlement agreement with her stepdaughters whereby she relinquished part of her interest in the U.S. property. In return, the stepdaughters agreed to allow the probate of the will devising the French realty.<sup>85</sup>

The I.R.S. disallowed the marital deduction on the relinquished property, applying the will contest provision.<sup>86</sup> Even though the appellant contended that there was no actual "will controversy," the court stated that the regulation is clear in providing that if "an agreement resolving a controversy over the decedent's property entails the assignment or surrender of property by the surviving spouse, said property is not considered as having passed from the decedent to his surviving spouse."<sup>87</sup>

In *Citizens & Southern National Bank v. United States*, the surviving spouse relinquished all her claims against her husband's estate in exchange for \$40,000, as part of a settlement agreement with her stepson.<sup>88</sup> At the time of death, the decedent owned property in both Florida and Georgia. The Florida property passed to the surviving spouse by her husband's will and the Georgia property descended to the widow by intestacy.<sup>89</sup> The Fifth Circuit ruled that Treasury Regulation § 20.2056(e)-2(d) was applicable to *all* the property devolving to the widow, and subsequently relinquished by her. Therefore, neither the Georgia nor the Florida property was entitled to the marital deduction to the extent that it was relinquished by the widow. The court held that the Commissioner of Internal Revenue had correctly limited the marital deduction to the \$40,000.<sup>90</sup>

---

79. *Citizens & Southern Nat'l Bank v. United States*, 451 F.2d 221 (5th Cir. 1971).

80. *Schroeder*, 696 F. Supp. at 1429.

81. *United States Trust Co.*, 321 F.2d at 909.

82. *Id.*

83. *Id.*

84. *Id.*

85. *Id.*

86. *Id.* at 910.

87. *Id.* at 910-11 (construing Treas. Reg. § 20.2056(e)-2(d)(1)).

88. *Citizens & S. Nat'l Bank v. United States*, 451 F.2d 221, 223 (5th Cir. 1971).

89. *Id.*

90. *Id.* at 228.

The court acknowledged that the intestate property was not addressed by the literal terms of the will contest regulation. However, the court stated its agreement with the Second Circuit holding in *United States Trust*:

The medium by which the decedent's property passes, whether it be by intestacy or by means of a testamentary instrument, is immaterial. For purposes of the regulation, we are at a loss to discern why a settlement of a controversy involving an estate, a portion of which passes by intestate succession, should be treated any differently than a settlement concerning only property which has been disposed of by means of a testamentary document. We think the Second Circuit's broad interpretation of the regulation is entirely proper, and we conclude that because the settlement agreement in the instant case "resolved a controversy over the decedent's property," the regulation requires that the property surrendered by the widow not be considered as having passed to her from the decedent.<sup>91</sup>

The district court, in *Schroeder*, also pointed out that other "federal district courts have endorsed a broad reading of [Treasury Regulation § 20.2056(e)-2(d).]"<sup>92</sup> For example, in *Pastor v. United States*,<sup>93</sup> the court rejected the plaintiff's argument that because the surviving spouse's settlement involved intestate property, the will contest regulation was inapplicable. Relying on the Second Circuit's decision in *United States Trust* and the Fifth Circuit's decision in *Citizens & Southern National Bank*, the *Pastor* court held that "these authorities make it clear that the widow is entitled to a marital deduction *only* as to the value of the property interest [actually] received [in settlement], and not to the value of the property she might have received had she not settled her dispute."<sup>94</sup> In denying the marital deduction to the joint tenancy and statutory election property relinquished in *Schroeder*, the district court followed the established precedent of applying the will contest provision broadly. The decision reflects the court's underlying purpose of protecting the government from "circumstances in which property might pass untaxed to the next generation by means of an agreement between the surviving spouse and other beneficiaries."<sup>95</sup>

On appeal, the Tenth Circuit affirmed the district court's result. The court ruled that the joint property and statutory elective share property did not pass to Peggy, and accordingly the marital deduction was properly disallowed.<sup>96</sup> However, the Tenth Circuit declined to reach this result by applying a broad reading of the will contest regulation. The court acknowledged that the Second and Fifth Circuits in

---

91. *Id.* at 227 (quoting *United States Trust Co. v. Commissioner*, 321 F.2d at 910-11).

92. *Schroeder v. U.S.*, 696 F. Supp. 1426, 1430 (W.D. Okla. 1988).

93. 386 F. Supp. 106 (E.D.N.Y. 1974).

94. *Id.* at 107. *See also* *Waldrup v. United States*, 499 F. Supp. 820, 824 (N.D. Miss. 1980).

95. *Schroeder v. United States*, 924 F.2d 1547, 1550 (10th Cir. 1991); *see also* *Schroeder*, 696 F. Supp. at 1429-30.

96. *Schroeder*, 924 F.2d at 1548.

*United States Trust* and *Citizens & Southern* “invoked policy to expand the reach of [Treasury Regulation § 20.2056(e)-2(d)(1)] well beyond its plain language.”<sup>97</sup> The court noted that the will contest regulation was *not* dispositive, and stated:

Unlike the district court and the courts in *United States Trust* and *Citizens & Southern*, we believe the will contest regulation is inapplicable to property passing to a surviving spouse by statutory election or under the law of survivorship because the regulation speaks only in terms of a controversy involving a bequest or devise under decedent’s will.<sup>98</sup>

In declining to apply the will contest regulation to property that did not involve a bequest or devise under a will, the Tenth Circuit diverged from the path previously blazed by the Second and Fifth Circuits. The Tenth Circuit clearly indicated its belief that the regulation should be strictly construed by its plain meaning and should not be applied to situations which do not involve a bequest or devise under a decedent’s will.<sup>99</sup>

The Tenth Circuit, in agreement with the district court, concluded that the legislative intent of the marital deduction would be violated if it were allowed to be applied to the property Peggy relinquished. The purpose of the marital deduction is to protect interspousal transfers and not transfers that ultimately end up in the hands of other beneficiaries as a result of a settlement involving the decedent’s estate.<sup>100</sup> The Tenth Circuit stated, “The marital deduction was designed to eliminate the ‘double-taxation’ that would result when the same property became subject to tax upon the death of each spouse. Once property passes outside of the interspousal unit, however, this exception no longer applies.”<sup>101</sup>

The Tenth Circuit’s decision was greatly influenced by its interpretation of the congressional policy and intent behind the marital deduction.<sup>102</sup> In order to accomplish the legislative goal of denying the marital deduction to the joint tenancy and statutory election property surrendered in *Schroeder*, *without* applying the will contest regulation, the Tenth Circuit looked to I.R.C. § 2056.<sup>103</sup> The court considered whether the “*rationale* for the Secretary’s regulatory gloss on the passing requirement in the context of a will contest mandate[d] a similar result based on an analysis of the term ‘passes’ in the marital deduction statute.”<sup>104</sup> In holding that it did, the Tenth Circuit found that “the rea-

---

97. *Id.* at 1553. The court in *Citizens* defined “the decedent’s will, or . . . any bequest or devise thereunder” to include transfers of property at death under intestacy statutes or spousal election. Both *Citizens* and *United States Trust* expanded the terms “will contest” or “controversy” to include arms-length negotiations conducted between parties who have potentially adverse positions. *Id.*

98. *Id.* at 1554.

99. *Id.*

100. *See id.* at 1554 (“[T]he transfer comprising the settlement could altogether escape taxation applying to gratuitous transfers of wealth.”).

101. *Id.* at 1555.

102. *See id.* at 1551.

103. *See* 26 U.S.C. § 2056 (1988).

104. *Schroeder*, 924 F.2d at 1553.

sons those courts [*United States Trust and Citizens & Southern*] articulated to broaden the reach of the regulation [are] persuasive in our own analysis of what Congress intended by the 'passing' requirement in the marital deduction statute."<sup>105</sup> The Tenth Circuit determined that under *United States Trust and Citizens & Southern*, the courts "defined 'passing' to mean property to which the surviving spouse retains her rights after resolution of all disputes concerning the decedent's property."<sup>106</sup> Adopting this definition of "passing," the Tenth Circuit held that the joint tenancy property and the statutory election property did not "pass" to Peggy within the meaning of I.R.C. § 2056.<sup>107</sup>

The court pointed out that over the years, Congress has liberalized the marital deduction, finally removing the maximum deduction limitation in 1981 by enacting an unlimited marital deduction.<sup>108</sup> The Tenth Circuit noted that while the 1981 provisions did not apply to Thomas' estate, "the legislative history of the 1981 provisions does explain in greater detail why the code provisions applicable to Thomas' estate did not comport with congressional intent and were changed."<sup>109</sup> While acknowledging that "[i]n creating the marital deduction, Congress envisioned a scheme in which *interspousal* transfers of wealth would not result in a taxable event,"<sup>110</sup> the Tenth Circuit considered further what Congress intended by the "passing" requirement in the marital deduction statute.<sup>111</sup> The court determined:

To the extent a surviving spouse surrenders her share of the decedent's property to other beneficiaries not entitled to the marital deduction to avoid litigation concerning her rights, it defies common sense to conclude that this property "passed" to the sur-

---

105. *Id.* at 1554.

106. *Id.* at 1553-54.

107. *Id.* at 1555.

108. *Id.* at 1551.

109. *Id.* Because Thomas died in 1981, the 1976 version of the marital deduction statute applied. *See supra* note 20. The legislative history to the 1981 provisions stated:

Because the maximum estate tax marital deduction generally is limited, under present law, to one-half of a decedent's adjusted gross estate, the estate of a decedent who bequeaths his entire estate to his surviving spouse may be subject to estate taxes even though the property remains within the marital unit. When the surviving spouse later transfers the property (often to their children), the entire amount is subject to transfer taxes. The cumulative effect is to subject their property to tax one and one-half times, i.e., one-half upon the death of the first spouse and again fully upon the death of the second spouse. This effect typically occurs in the case of jointly held property. Because this additional tax falls most heavily on widows, it is often referred to as the "widow's tax."

Although the committee recognizes that this additional tax can be minimized through proper estate planning, it believes that an individual should be free to pass his entire estate to a surviving spouse without the imposition of any additional tax. For similar reasons, the committee believes it appropriate to permit unlimited lifetime transfers between spouses without the imposition of any transfer taxes.

.....

The committee believes . . . that tax consequences should not control an individual's disposition of property.

*Schroeder*, 924 F.2d at 1551 (quoting H.R. REP. No. 201, 97th Cong., 1st Sess. 158-164 (1981)).

110. *Id.* at 1554-55 (emphasis added).

111. *Id.*

living spouse. Not only is the *ultimate recipient of the property a person other than the surviving spouse*, but the transfer comprising the settlement could altogether escape taxation applying to gratuitous transfers of wealth.<sup>112</sup>

The Tenth Circuit noted that Congress designed the marital deduction to eliminate the double-taxation resulting under a system where the same property is subject to tax upon the death of each spouse, but once the property passes outside the interspousal unit, this exception no longer applies.<sup>113</sup> "Congress clearly did not intend to replace double-taxation with tax avoidance."<sup>114</sup> Therefore, in the *Schroeder* case, when Peggy Woodmansee relinquished the joint tenancy and statutory election property to the directives of the trust fund, the property passed outside of the interspousal unit and was not entitled to the marital deduction.

#### IV. CONCLUSION

In declining to construe the will contest provision broadly, as did the Second and Fifth Circuits,<sup>115</sup> the *Schroeder* court created a tension between the circuits regarding its application. This tension reflects an uncertainty and lack of predictability with respect to the application of the will contest regulation to fact situations illustrated by *Schroeder* and begs the attention of the Department of the Treasury. The *Schroeder* court, in order to preserve the intent of the marital deduction, looked to I.R.C. § 2056<sup>116</sup> and concluded that the joint tenancy and statutory election property relinquished by the surviving spouse "flunked" the "passing" requirement. Although the Tenth Circuit's *result* was correct (the marital deduction was denied in *Schroeder*), the court's application of I.R.C. § 2056 was unsatisfactory. The statute provides no clearer solution with respect to estate tax treatment of property that has "passed" to a surviving spouse, *but is later relinquished*, than does the will contest regulation.

Consequently, to provide clear authority with respect to estate tax treatment in such situations, the Department of the Treasury should amend the will contest regulation. As the Tenth Circuit indicated in the

---

112. *Id.* (emphasis added). "Peggy paid no gift tax upon the transfer of the property into the trust and did not report the transfer as a sale on her income tax returns." *Id.* at n.8.

113. *Id.* at 1555. *See also* United States v. Stapf, 375 U.S. 118, 125-29 (1963) ("The purpose [of the marital deduction] is only to permit a married couple's property to be taxed in two stages and not to allow a tax-exempt transfer of wealth into succeeding generations. . . . What the statute provides is a 'marital deduction'—a deduction for gifts to the surviving spouse—not a deduction for gifts to the children or a deduction for gifts to privately selected beneficiaries. The appropriate reference, therefore, is not to the value of the gift moving from the deceased spouse but to the net value of the gift received by the surviving spouse.").

114. *Schroeder*, 924 F.2d at 1555.

115. Citizens & S. Nat'l Bank v. United States, 451 F.2d 221 (5th Cir. 1971); United States Trust Co. v. Commissioner, 321 F.2d 908 (2d Cir. 1963), *cert. denied*, 376 U.S. 937 (1964).

116. 26 U.S.C. § 2056(a).

*Schroeder* decision, the regulation stops short of dealing with circumstances which do not involve a will contest. The amendment should apply the regulation, and thereby deny the marital deduction, to situations where property which otherwise qualifies for the marital deduction is relinquished or surrendered by the surviving spouse in a settlement of *any controversy*, as a result of the devolution of a decedent's estate.

In order to ensure predictability, fairness to both the government and the taxpayer, and clear application of the regulation, the amendment should impose a time restriction. With respect to property that is relinquished before the filing of the Estate Tax Return,<sup>117</sup> the marital deduction should simply not be available and estate tax liability should attach to the surrendered property. With respect to property relinquished after the Estate Tax Return is filed, any marital deduction previously allowed on such property should be disallowed and an estate tax deficiency<sup>118</sup> should be assessed on the relinquished property. However, once the statute of limitations period<sup>119</sup> has run, any relinquishment of property to which the marital deduction was previously allowed on the Estate Tax Return should be treated as a gift by the surviving spouse to the transferee, and gift tax liability<sup>120</sup> should attach.

*Deborah L. Land*

---

117. Estate Tax Returns must be filed within nine months after the date of the decedent's death. 26 U.S.C. § 6075 (1988).

118. See 26 U.S.C. § 6211 (1988).

119. See 26 U.S.C. § 6501, which provides for a three year statute of limitations (after the date of filing) on the assessment of Estate Tax.

120. See 26 U.S.C. § 2501 (1988).