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PRIOR STATE COURT PROCEEDINGS AS AFFECTING THE MARITAL DEDUCTION

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While state law determines the property rights and interests of parties[1] the manner in which such rights and interests shall be subjected to federal tax is determined by federal law.[2] To these principles should be added an important corollary—that the determination of such rights and interests under state law may be rejected by the Commissioner of Internal Revenue and the federal courts.[3] How these principles are applied will be shown in this article.

W, a bereaved widow, is more bereaved when she is informed that *H*, her deceased husband has left his entire estate to his children by a former marriage. Her sorrow is unbounded when she is further informed that the document she signed before her marriage to *H* is reputed to be an antenuptial agreement, and that by it, she may have no rights to *H*'s estate.[4] *W* later is advised by her attorney that she has possible grounds for having the antenuptial agreement declared invalid.

The executor of *H*'s estate is advised of the widow's apparent displeasure with the will when *W* files her election to take the allowable statutory interest.[5] The executor informs the children that settlement is advisable. An agreement is subsequently reached whereby, in consideration of *W*'s not attempting to exercise her statutory right to elect, she is to receive one-fourth of *H*'s estate outright. The executor in his petition to the probate court sets forth the proposed agreement and the fact that the antenuptial agreement may be of questionable validity. The petition also says that *H*'s children desire settlement in accordance with the proposed agreement. No argument or evidence is otherwise presented, and the probate court approves the agreement and issues its

1 Blair v. Commissioner, 300 U.S. 5, 12 (1937).
2 Morgan v. Commissioner, 309 U.S. 78, 80 (1940).
3 Estate of Arthur Sweet, 24 T.C. 488 (1955), aff'd, 234 F.2d 401 (10th Cir.), cert. denied, 352 U.S. 878 (1956).
4 Griffee v. Griffee, 108 Colo. 366, 117 P.2d 283 (1941).
5 Colo. Rev. Stat. § 152-5-5 (1953).

order permitting settlement. Will the interest which *W* receives under the settlement agreement qualify for the federal estate tax marital deduction?[6]

The legislative intent in such a situation as just presented was to disallow as a marital deduction any settlement received by the surviving spouse which did not reflect the surviving spouse's rights under state law.[7] Subsequent regulations relating to this point indicated that the Internal Revenue Service looked askance at such settlements. In effect, the Internal Revenue Service said that a settlement of this type would qualify for the marital deduction only if such settlement was a bona fide recognition of the surviving spouse's enforceable rights. A presumption of such recognition attached where the settlement was made pursuant to a state court decision decided upon the merits in an actual adversary proceeding. Settlements made pursuant to decrees obtained by consent, or made pursuant to agreements not to contest the will, or not to probate the will would not "necessarily" be accepted as a bona fide recognition of the surviving spouse's enforceable rights.[8] The proposed regulations have not departed from this view.[9]

Hence, it might appear in the example given that the executor of *H*'s estate will experience difficulty in obtaining the marital deduction for the amount given to *W*. Such would not be the case, however, if the executor can meet the standard set forth in the Tax Court case, *Estate of Gertrude P. Barrett*.[10] As long as the executor of *H*'s estate can demonstrate that *W*'s grounds for setting aside the antenuptial agreement provided him with a reasonable belief that there was a serious and substantial threat to the plan of the decedent, *H*, part of the standard is met. Then, if the settlement was the result of arms length negotiations, the criterion set forth in the treasury regulations, as interpreted by the *Barrett* case, is met, and the amount given to *W* will qualify for the marital deduction.

The result is sound law. If, in the illustration, *W*'s claim had been adjudicated on its merits, and if she had succeeded, the property interest she would have received through her election would have qualified for the marital deduction.[11] Thus, if the executor has reasonable basis for believing that the widow *W*'s claim is valid, the settlement given her for abandoning her claim is clearly in bona fide recognition of her rights under state law. To have held that there must be an actual contest on the merits would be to make the executor of *H*'s estate defend a position he reasonably believes untenable. Such an unreasonable requirement could very well result in a greater loss to the beneficiaries under *H*'s will.

It should be mentioned that the settlement which the surviving spouse receives must be an interest which meets the other requirements of section 2056 of the 1954 code in order to qualify for the marital deduction.[12] In our illustration, if the agreement had been that *W* would not

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[6] Int. Rev. Code of 1954, § 2056.

[7] U.S. Code Cong. Serv., 80th Cong. 2d Sess. 1226 (1948).

[8] U.S. Treas. Reg. 105, § 81.47(g) (1949).

[9] Proposed U.S. Treas. Reg. § 20.2056(e)-2(d) (1956). The language used in the proposed regulation is the same as that used in U.S. Treas. Reg. 105, § 81.47(g) (1949).

[10] Estate of Gertrude P. Barrett, 22 T.C. 606 (1954), acq., 1954-2 Cum. Bull. 3.

[11] Id. at 611; U.S. Treas. Reg. 105, § 81.47(f) (1949); Proposed U.S. Treas. Reg. § 20.2056(e)-2(c) (1956).

[12] Int. Rev. Code of 1954, § 2056(b) which states that a life estate or any other similar interest which will terminate upon the occurrence of some event or lapse of time will not qualify.

receive the property outright, but would take it in trust and receive all the income for life, with a remainder to *H*'s children, the settlement would not qualify.[13] Similarly, if widow *W* ostensibly receives the property outright, but with the understanding that she immediately create an irrevocable trust reserving to herself the income for life, with a remainder to *H*'s children, that settlement would not qualify.[14]

Estate of Arthur Sweet[15] is an example of the kind of a state court proceeding which is not binding on the Commissioner and the federal courts. In that case, the decedent had created a revocable trust. In 1948, he amended the trust in an attempt to qualify it for the marital deduction. After his death and upon revaluation of the trust assets, it appeared that the decedent's wife would not receive the full marital deduction unless some portion of the revocable trust qualified. The Commissioner refused to allow any portion of the trust to qualify because the general power to appoint, given to the wife by the 1948 trust amendment, did not extend to the whole trust. The Commissioner rejected the trustee's contention that there were two trusts.[16]

The trustee brought suit in the Utah state court against the decedent's wife and remaindermen, seeking construction of the trust instruments and instructions as to its duties thereunder. In its complaint the trustee *suggested* that two trusts had been created by the 1948 amendment to the trust. At the hearing the trustee presented arguments and other evidence, but the defendants, having failed to answer or otherwise plead, did not appear. Default judgments were rendered against the defendants that same day, and the court immediately rendered its opinion (which followed much of the language in the trustee's complaint) and ordered the trustee to separate the trust estate into two trusts.

In its decision the Tax Court noted the following sequence of events. The state court proceeding was instituted after the Commissioner refused to recognize the two trusts. The trustee's complaint suggested

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13 Ibid.; Estate of Hyman Kleinman, 25 T.C. 1245 (1956), aff'd per curiam, 245 F.2d 235 (6th Cir. 1957).

14 Cf. Estate of Thomas W. Tebb, 27 T.C. 671 (1957); Comment, 43 Va. L. Rev. 740 (1957).

15 See note 3 supra.

16 The case arose under Int. Rev. Code of 1939, § 812 as amended by 62 Stat. 117 (1948) which permitted such a trust to qualify for the marital deduction only if the surviving spouse could exercise the general power to appoint the whole trust. Under the present law, Int. Rev. Code of 1954, § 2056, a general power to appoint just a specific portion of a trust would qualify.

that two trusts were created. Default judgments were rendered against the defendants after they failed to answer, plead, or appear. The state court's opinion was rendered the same day as the hearing in almost the same language as the trustee's complaint. Finally, the trustee had not complied with the state court's order regarding the separation of the trust estate into two trusts. The state court's decree was rejected by the Tax Court as not being determinative of interests in property under state law.[17] The Court of Appeals for the Tenth Circuit, in affirming the Tax Court decision, concluded that the state court proceeding had been brought with the concurrence of the trustee and the trust beneficiaries solely to circumvent the Commissioner's contention. "The (state) court decree," the court of appeals said, "was obtained by collusion for the purpose of maintaining the claim for marital deduction. And it therefore is not binding in this proceeding."[18] Once collusion or fraud is found in cases involving state determination of property rights, the Commissioner and the federal courts will find that they are not bound by the state court proceeding.

Whether or when a state court proceeding is binding on the Commissioner and the federal courts seems to be a continuing problem. It has arisen in other types of cases affecting the marital deduction. Thus, should the widow's portion under the will bear the proportionate share of taxes attributable to that share under state law?[19] Can the widow elect to take her statutory interest in lieu of the interest given to her under a joint and mutual will?[20] Do certain insurance policies qualify for the marital deduction?[21]

Moreover, that there is variance of opinion as to the effect of some of these state court proceedings may be gathered by the following language in the case of *Merchants Nat'l Bank and Trust Co. v. United States*:[22]

> "it is apparent that both sides agree, that if the probate court final decree was entered by consent of the parties or in a non-adversary proceeding, it is not binding upon defendants in this Federal estate tax litigation. It is, therefore, unnecessary for us to pass upon the validity of that proposition of law and we are relieved of any obligation to consider and reconcile a number of seemingly conflicting Federal courts of appeals cases."[23]

Although this article does not attempt to reconcile the seeming conflict in the circuit courts, certain conclusions may be gleaned from

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[17] Estate of Arthur Sweet, 24 T.C. 488, 495 (1955).

[18] Estate of Arthur Sweet, 234 F.2d 401, 404 (10th Cir. 1956) (parenthetical matter added).

[19] Merchants Nat'l Bank and Trust Co. v. United States, 246 F.2d 410 (6th Cir), cert. denied, 78 Sup. Ct. 148 (1957), in which the circuit court found the Indiana state court's decision permitting the widow to take her portion under the will free from taxes was not binding. But see Pitts v. Hamrick, 228 F.2d 486 (4th Cir. 1955).

[20] Estate of Charles Elson, 28 T.C. No. 48 (May 24, 1957). The court held that the Iowa state court's order approving the widow's election against the joint and mutual will was not binding. Compare with Awtry v. Commissioner, 221 F.2d 749 (8th Cir. 1955), reversing 22 T.C. 167 (1954).

[21] Estate of William Walker Wynekoop, 24 T.C. 167 (1955), which held that the Illinois state court's decision regarding insurance policies was a binding one, and the policies qualified for the marital deduction.

[22] Merchants Nat'l Bank and Trust Co. v. United States, 246 F.2d 410 (6th Cir. 1957).

[23] Id. at 417

the cases involving the determination of property rights in a prior state court proceeding. These conclusions may be of some help in analyzing similar situations affecting areas of federal taxation, including the marital deduction.

It would seem that where there has been a determination of property rights under state law, which is binding on the parties, the state court proceeding should be binding on the Commissioner and the federal courts as long as the state court determination was not tainted with fraud or collusion. Even though the proceeding may be nonadversary, the parties friendly, and a tax saving effected, these factors alone should not be enough to permit the Commissioner and the federal courts to reject the state court's determination and substitute his or their own finding.[24] If state law, as interpreted by the state court proceedings, is to determine property rights and interests of the parties, those proceedings should be binding on the Commissioner and federal courts.

A different conclusion is reached where the federal government has established a criterion as to the taxability of a property right, or the qualifying of such property right for a deduction under federal law. In this case, the state court proceedings should be binding on the Commissioner and the federal courts only if the criterion as established by the federal government is met. Hence, whether a property right received in settlement of a will controversy will qualify for the marital deduction will be determined by the criteria set forth in Treasury Regulation 105, § 81.47 (f), and Proposed Treasury Regulation § 20.2056 (e) -2 (c).

Whether or not the criteria are met, of course, will be determined by the Commissioner. It is in cases involving some federally established criterion that variable factors become very important. These factors may be the relationship of the parties, the reasonableness of the issues or claims, how the issues or claims are adjudicated or settled, and the tax consequences. The attorney may feel that he can take little solace in cases involving this problem since the Commissioner will determine whether the criterion has been met in the state court proceeding. However, as long as the claims or issues involved are bona fide and reasonable, and as long as the settlement or adjudication in the state court proceeding is bona fide and reasonable, the Commissioner should be bound. This proposition was affirmed in the case of *Estate of Gertrude P. Barrett* and to this extent, should give attorneys some consolation.

[24] Gallagher v. Smith, 223 F.2d 218, 226 (3rd Cir. 1955).