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ESTATE TAXATION

Interplay of Federal and State Law in Determining Deductible Administration Expenses

Estate of Smith v. Commissioner

For federal estate tax purposes, administration expenses allowed by the jurisdiction in which an estate is administered are deductible from the value of the gross estate.[1] One of the regulations promulgated under the applicable provision of the Internal Revenue Code of 1954, section 2053(a), however, limits the deduction to such expenses as are necessarily incurred for the benefit of the estate.[2] The interplay between the Code, the regulation, and state law has created two areas of controversy: First, the effect of a lower state court's approval of an administration expense upon subsequent federal tax litigation; and second, the validity of the additional requirements imposed by the treasury regulation. In *Estate of Smith v. Commissioner*,[3] the Second Circuit held that federal courts are not precluded from examining de novo the validity of an administration expense approved by a lower state court.[4] Although the Second Circuit did not decide whether state law, the treasury regulation, or both should be applied in the de novo inquiry, its opinion in *Smith* seems to indicate that the federal courts should apply both criteria in determining the deductibility of an administration expense.[5]

The bulk of the estate of the decedent, a professional sculptor, consisted of a collection of his own works. In view of the volatile nature of the art market, the executors instructed Marlborough-

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[1] INT. REV. CODE OF 1954, § 2053(a) provides in pertinent part:

> For purposes of the [federal estate tax], the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts—
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> . . . .
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> (2) for administration expenses,
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> . . . .
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> as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered.

[2] Treas. Reg. § 20.2053-3, T.D. 6296, 1958-2 CUM. BULL. 432, 542; *as amended*, Treas. Reg. § 20.2053-3(d), T.D. 6826, 1965-2 CUM. BULL. 367, provides in pertinent part:

> The amounts deductible from a decedent's gross estate as "administration expenses" . . . are limited to such expenses as are actually and necessarily incurred in the administration of the decedent's estate; that is, in the collection of assets, payments of debts, and distribution of property . . . . Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs . . . may not be taken as deductions . . . .

[3] 510 F.2d 479 (2d Cir.), *cert. denied*, 96 S. Ct. 44 (1975), *aff'g* 57 T.C. 650 (1972).

[4] 510 F.2d at 482-83.

[5] *Id. See* notes 15 & 29 *infra*.

Gerson Galleries to sell the sculptures in order to avoid depreciation of the estate. In the course of these sales, the estate paid a total of $1,583,544.67 in commissions, all of which were allowed by a New York surrogate. The major portion of the proceeds was paid into a trust established by the decedent in his will, and the remainder was applied to estate debts, expenses, and taxes. Rejecting the executors' attempt to deduct from the value of the gross estate the entire amount of the sales commissions approved by the surrogate, the Commissioner of Internal Revenue allowed only those commissions paid on sales necessary to satisfy all claims against the estate, administration expenses, and taxes. On a petition for redetermination, the Tax Court declared that allowability under the laws of the jurisdiction in which the estate is administered is merely a threshold requirement for deductibility.[6] Holding that any deduction must also satisfy the criteria established in the treasury regulation, the court found that the commissions on those sales used to fund the trust were not deductible since the "necessity" requirements of the regulation were not met.[7] A dissenting opinion was filed in which the treasury regulation was regarded as an invalid extension of the requirements for deductibility established by Congress in the Code.[8]

On appeal to the Second Circuit, the Tax Court's decision was, affirmed by a divided panel. Judge Anderson, writing for the majority, preferred to view the proceedings of the Tax Court as a de novo inquiry into the necessity of the expenses for the purpose of section 2053(a)[9] rather than as a refusal to approve the deduction

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[6] 57 T.C. at 661.

[7] The Tax Court decision centered around the necessity for the *sales*, rather than the necessity for the commissions, and found the sales to be unnecessary within the treasury regulation standards. The court applied Treas. Reg. § 20.2053-3(d)(2), T.D. 6826, 1965-2 CUM. BULL. 367, 368, *formerly* Treas. Reg. § 20.2053-3(d), T.D. 6296, 1958-2 CUM. BULL. 432, 544, which provides in pertinent part:

> Expenses for selling property of the estate are deductible if the sale is necessary in order to pay the decedent's debts, expenses of administration, or taxes, to preserve the estate, or to effect distribution . . . .

The court stated that the sales were not necessary for distribution since the sculptures could have been transferred to the trust in kind. Responding to an argument that the sales were necessary to provide support for Smith's children, the court indicated that this was a responsibility of the trust rather than the estate and that, had the sculptures been transferred to the trust, the trust could have conducted the necessary sales. The court also rejected the executors' contention that the sales were necessary to preserve the estate, stating that the volatile nature of the art market does not create "an unexpectedly serious development which sometimes may make sales the sine qua non of preserving the estate." 57 T.C. at 661.

[8] 57 T.C. at 663-64 (Goffe, J., dissenting).

[9] The court stated that "there is some question as to whether some of these expenses were in fact incurred . . . in accordance with the general purposes of § 2053 . . . ." 510 F.2d at 482. It should be noted, however, that the § 2053(a) deduction requires only that an

of an administration expense allowable under the laws of New York.[10] In justifying such an inquiry, Judge Anderson reasoned:

> [F]ederal courts cannot be precluded from reexamining a lower state court's allowance of administration expenses to determine whether they were in fact necessary to carry out the administration of the estate or merely prudent or advisable in preserving the interests of the beneficiaries.[11]

Noting that both New York law and the treasury regulation require an administration expense to be necessary,[12] the Second Circuit in effect equated the Tax Court's determination that the sales commissions failed to fulfill the treasury regulation with a ruling that they failed to satisfy New York law.[13] Judge Mulligan, dissenting, considered the approval of an administration expense by the state surrogate sufficient grounds for deductibility. Declaring that allowability under state law is the sole criterion for deductibility under the Code and that state law is most appropriately applied by state courts, he concluded that the Tax Court should be bound by a prior state court decision.[14]

The Second Circuit's approval of a de novo inquiry by the Tax Court into the allowability under state law of an administration expense,[15] previously approved by a lower state court, finds strong

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administration expense be allowable under state law. *See* note 1 *supra*. Nevertheless, the *Smith* inquiry into the necessity of the administration expenses dealt with the necessity requirement found in the treasury regulation as well as that found in New York law. *See* notes 22-24 and accompanying text *infra*.

[10] [T]he Tax Court's determination that the additional sales of sculpture were not necessary to preserve the estate or to effect its distribution did not involve a refusal to follow New York law, but rather was the result of a *de novo* inquiry into the factual necessity for these expenditures.

510 F.2d at 483.

[11] *Id.* at 482-83 (footnote omitted).

[12] *Id.* at 482 ("Both [New York law] and Treas. Reg. § 20.2053-3, like most state laws concerning executors and administrators, require an administrative expense to be 'necessary' in order to be allowable.").

[13] *See id.* at 482-83. Characterizing the dispute before it as one involving a question of fact rather than a question of law, the Second Circuit affirmed the Tax Court on the grounds that its decision that the sales were not necessary was not "clearly erroneous." *Id.* at 483.

In addition to the arguments raised in the Tax Court, the executors contended on appeal that the sales were at least potentially necessary to pay taxes. They argued that since the Commissioner's original notice of deficiency indicated a tax liability greater than the total amount of sales, the sales should be considered a necessary attempt to raise sufficient funds to meet this potential obligation. The Second Circuit dismissed this contention on two grounds: First, the particular sales objected to by the Commissioner were those which took place before the notice of deficiency was issued; and second, all sales actually necessary to pay the final tax liability were approved. *Id.* at 481-82.

[14] *Id.* at 484-85 (Mulligan, J., dissenting). In arriving at his conclusion, Judge Mulligan stated that "[t]he laws of the state are interpreted and administered by the courts of the state and not by the Tax Court of the United States." *Id.* at 484.

[15] The Second Circuit did not explicitly state that a de novo inquiry should involve the application of state law. Rather, the court phrased its decision in terms of an "inquiry into

support in the Supreme Court decision *Commissioner v. Estate of Bosch.*[16] In *Bosch,* the Court was faced with a similar question regarding the effect of a state trial court decree upon federal estate tax litigation. The decedent there had created a revocable inter vivos trust providing his wife with a life estate in all trust income and granting her a general power of appointment over the corpus of the trust. Prior to the decedent's death, his wife executed a release of this general power of appointment. If found valid, the release would disqualify the trust from the estate tax marital deduction.[17] A New York trial court declared the release to be a nullity, and both the Tax Court and the Second Circuit considered themselves bound by the state decree. The Supreme Court reversed, holding that "where the federal estate tax liability turns upon . . . state law, federal authorities are not bound by the determination made . . . by a state trial court."[18]

The broad language employed by the Court in *Bosch* suggests that its rationale is applicable whenever a federal court is dealing with a federal tax question requiring an interpretation of state law.[19] Not surprisingly, therefore, other courts agree with the *Smith*

the factual necessity for [the] expenditures." *Id.* at 483. *See* text accompanying notes 22-24 *infra.* The use of the regulation by the Tax Court was apparently sustained solely on the basis that its application achieved the result required by state law. *See* 510 F.2d at 482. Hence, one implication of the *Smith* rationale is that a de novo inquiry into allowability under state law is appropriate.

[16] 387 U.S. 456 (1967).

[17] Qualification of the type of trust involved in *Bosch* for the marital deduction is regulated by the INT. REV. CODE OF 1954, § 2056(b)(5). The size of the marital deduction is based in part on the amount and characterization of the property interests received by the surviving spouse, generally a matter of state law. After the state law determination is made, the provisions of the Code are applied to determine conclusively the amount deductible. *See* 10 J. MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 61.01, 61.05 (Zimet rev. 1970).

[18] 387 U.S. at 457. Prior to its decision in *Bosch,* the Supreme Court, in Freuler v. Helvering, 291 U.S. 35, 45 (1934), had indicated that a federal court is bound by a state trial court decision concerning an underlying issue of state law absent collusion in the state decree. This led to a sharp conflict among the circuits regarding exactly what was meant by collusion, with definitions varying from actual fraud to the absence of genuine adverseness in the state court. *Compare* Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955) (state decree binding absent fraud) *with* Estate of Faulkerson v. United States, 301 F.2d 231 (7th Cir.), *cert. denied,* 371 U.S. 887 (1962) (state decree not binding if state proceeding is nonadversary). For discussions of this controversy, see Braverman & Gerson, *The Conclusiveness of State Court Decrees in Federal Tax Litigation,* 17 TAX L. REV. 545 (1962); Richter, *Effect of State Court Interpretation of Wills,* N.Y.U. 24th INST. ON FED. TAX. 257 (1966); Sacks, *The Binding Effect of Nontax Litigation in State Courts,* N.Y.U. 21ST INST. ON FED. TAX. 277 (1963); Teschner, *State Court Decisions, Federal Taxation, and the Commissioner's Wonderland: The Need for Preliminary Characterization,* 41 TAXES 98 (1963).

[19] "[W]hen the application of a federal statute is involved, the decision of a state trial court as to an underlying issue of state law should *a fortiori* not be controlling." 387 U.S. at 465. The *Bosch* Court, analogizing to the situation faced by federal courts exercising diversity jurisdiction, applied the doctrine developed in Erie R.R. v. Tompkins, 304 U.S. 64 (1938), and its progeny to federal estate tax litigation and declared that a federal court is bound only by a decree of the highest court of the state and need only give "proper regard" to decisions

majority and authorize such de novo inquiries into state law. For example, in *Underwood v. United States*,[20] the Sixth Circuit indicated its approval of a de novo inquiry into the deductibility of an executor's fee as an administration expense. The state probate court had authorized an executor's fee substantially higher than that provided in the decedent's will. The federal district court disallowed the deduction of the additional fee as an improper expense under state law. Although it disagreed with the district court's interpretation of state law and approved the deduction, the Sixth Circuit clearly indicated that a de novo inquiry was proper.[21]

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of lower state courts. 387 U.S. at 465. Courts have since applied this principle to a wide variety of tax cases. *See, e.g.*, Wolder v. Commissioner, 493 F.2d 608 (2d Cir.), *cert. denied*, 419 U.S. 828 (1974) (surrogate's decision characterizing as bequest testamentary transfer in lieu of payment for services not binding); *In re* Estate of Abely, 489 F.2d 1327 (1st Cir. 1974) (probate court's approval of "widow's allowance" not binding); Greene v. United States, 476 F.2d 116 (7th Cir. 1973) (state decree that estate taxes should be paid from a particular portion of estate not binding); Risher v. United States, 465 F.2d 1 (5th Cir. 1972) (probate court decision that widow entitled to more than half of estate not binding); Cheng Yih-Chun v. Federal Reserve Bank, 442 F.2d 460 (2d Cir. 1971) (surrogate's decision that beneficial use of estate had vested in particular individual not binding); Kasishke v. United States, 426 F.2d 429 (10th Cir. 1970) (probate court's approval of claim against estate not binding); Cox v. United States, 421 F.2d 576 (5th Cir. 1970) (state decision establishing widow's share of estate not binding); Estate of Leggett v. United States, 418 F.2d 1257 (3d Cir. 1969) (state court decision that life tenant not a debtor with respect to remainderman not binding); *In re* Estate of McCoy, 374 F. Supp. 1321 (W.D. Tenn. 1974), *aff'd*, 511 F.2d 1090 (6th Cir. 1975) (state court interpretation of charitable bequests not binding); Lewis v. United States, 485 F.2d 606, 614 n.10 (Ct. Cl. 1973) (state decree that stock margin account had passed to estate not binding).

This application of the *Erie* doctrine to federal tax litigation has been criticized by several commentators who primarily rely upon the differences between diversity and federal tax cases. In the typical diversity case, no prior decision has been rendered by a state court on the particular dispute before the federal court. In *Bosch*-type tax litigation, however, the precise dispute before the federal court has previously been decided by a state court. For general discussions of the implications of *Bosch*, see Browne & Hinkle, *Tax Effects of Non-Tax Litigation:* Bosch *and Beyond*, N.Y.U. 27TH INST. ON FED. TAX. 1415 (1969); Scharf, *State Law in the Tax Court —Controlling Precedents*, 26 TAX LAW. 293 (1973); Wissbrun, Bosch *and its Aftermath, The Effect of State Court Decisions on Federal Tax Questions*, 114 TRUSTS & ESTATES 8 (1975); Comment, *State Court Determinations in Tax Litigation: A New Era*, 41 S. CAL. L. REV. 197 (1968); Note, Bosch *and the Binding Effect of State Court Adjudications upon Subsequent Federal Tax Litigation*, 21 VAND. L. REV. 825 (1968); 21 SW. L.J. 540 (1967).

Judge Mulligan, dissenting in *Smith*, sought to distinguish *Bosch* by pointing out that in *Bosch* "there was no act of Congress . . . ceding jurisdiction to the state [courts] . . . ." 510 F.2d at 484 n.1 (Mulligan, J., dissenting). It is submitted, however, that this distinction only beclouds the issue. The validity of the release in *Bosch* was as much a matter of state law as was the allowability of the commissions in *Smith*. INT. REV. CODE OF 1954, § 2053(a) does not cede jurisdiction to state courts, but rather provides only for the application of state law in determining the deductibility of an administration expense. Federal courts are often called upon to apply state law, and this does not involve a ceding of jurisdiction to state courts. *See, e.g.*, Erie R.R. v. Tompkins, 304 U.S. 64 (1938) (federal courts required to apply state law in diversity of citizenship cases absent a controlling federal statute); *In re* Crosstown Motors, Inc., 272 F.2d 224 (7th Cir. 1959), *cert. denied*, 363 U.S. 811 (1960) (state law applied in a bankruptcy case). *See also* Boner, Erie v. Tompkins: *A Study in Judicial Precedent* (pts. 1-2), 40 TEXAS L. REV. 509, 619 (1962).

[20] 407 F.2d 608 (6th Cir. 1969).

[21] *Id.* at 610-11; *accord*, First Nat'l Bank v. United States, 301 F. Supp. 667 (N.D. Tex.

The controversy generated by *Smith* results from the fact that the Tax Court did not actually conduct a de novo inquiry into the allowability of the sales commissions as administration expenses under New York law, but rather applied the standards embodied in the treasury regulation and determined merely that the commissions did not qualify as deductions under those standards.[22]

To consider this a de novo inquiry into the question of allowability under New York law requires a finding that the requirements of the treasury regulation and the requirements for allowability as an administration expense under New York law are identical. The Second Circuit found this requisite unity of identity by equating the requirement set forth in section 222 of the former New York Surrogate's Court Act[23] that expenses be "necessarily incurred" with the necessity standard contained in the treasury regulation.[24] The treasury regulation, however, establishes a strict necessity standard, limiting deductions to administration expenses necessar-

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1969) (probate court's approval of attorney's fees incurred in will contest not binding). *See also* R. STEPHENS, G. MAXFIELD & S. LIND, FEDERAL ESTATE AND GIFT TAXATION 5-7 (3d ed. 1974). In Pitner v. United States, 388 F.2d 651 (5th Cir. 1967), the allowability of administration expenses was not considered by a state court since state law did not require probate in this case. Noting that the interest of the federal government is "in protecting its revenues," while that of the state is "in protecting its citizens," *id.* at 659, the Fifth Circuit held that administration expenses not approved by a state court may nonetheless be deductible for federal estate tax purposes if a de novo inquiry reveals that such expenses are allowable under state law. *Id.* at 652.

A de novo inquiry is not required in every case. In First Nat'l Bank v. United States, 422 F.2d 1385 (10th Cir. 1970), the Tenth Circuit affirmed a district court ruling approving the deduction from the gross value of an estate of a claim against the estate settled by the parties and approved by a state court. The Tenth Circuit indicated therein that *Bosch* does not *require* a de novo inquiry in every circumstance. *Id.* at 1387. Treas. Reg. § 20.2053-1(b)(2) (1958), for example, states that state decrees are ordinarily acceptable if the state court actually "passes upon the facts upon which deductibility depends." Indeed, there is some indication in *Smith* that had there been an adversarial proceeding in the state court a de novo inquiry might not be proper: "[A]ppellants' claims . . . were not contested in the Surrogate's Court . . . . In such circumstances, the federal courts cannot be precluded from reexamining a lower state court's allowance of administration expenses . . . ." 510 F.2d at 482 (citations omitted).

In Estate of Park v. Commissioner, 475 F.2d 673 (6th Cir. 1973), a de novo inquiry was not required since allowability under state law was admitted by both parties. Some commentators have suggested that *Park* indicates that a state lower court decision allowing an administration expense is binding on a federal court. *See* Chaffin, *Estate Planning and Taxation: Current Estate and Gift Tax Developments*, 10 GA. ST. B.J. 427, 441-42 (1974); 52 N.C.L. REV. 190, 196-97 (1973).

[22] 57 T.C. at 660-62.

[23] At the time of Smith's death, general administration expenses in New York were governed by N.Y. Surr. Ct. Act § 222, ch. 928, § 222, [1920] N.Y. Laws 631 (repealed 1966), which authorized an administrator to pay the "legal and proper expenses of administration necessarily incurred by him . . . ." This statute has since been replaced by N.Y. EST., POWERS & TRUSTS LAW § 11-1.1(b)(22) (McKinney Supp. 1975), which authorizes a fiduciary "to pay all other reasonable and proper expenses of administration . . . ." Although New York's present rule does not explicitly require that the expenses be "necessarily incurred," the legislature has indicated that the present provision incorporates the substance of the old statute. Revisors' Notes, ch. 952, § 11-1.1(5), [1966] N.Y. Laws 2927.

[24] 510 F.2d at 482.

ily incurred in the course of those *activities* strictly necessary to pay all debts, expenses, and taxes, and to effect distribution.[25] New York law, on the other hand, only requires that the *expenses* be necessarily incurred. The New York courts, moreover, have implied that the activities of the executor need only be reasonable and proper rather than strictly necessary.[26] Thus, by simply identifying the treasury regulation's necessity requirement with that of New York, the court failed to give proper recognition to the disparity between the two sets of criteria. Quite possibly, a particular expenditure will fulfill the requirements of New York law without meeting the more stringent necessity standards established in the treasury regulation.[27] It should also be noted that this problem may well arise in other jurisdictions since most states have imposed a necessity requirement similar to that of New York.[28]

Although the Second Circuit apparently approved utilization of the treasury regulation in a de novo inquiry,[29] the court refused

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[25] For example, Treas. Reg. § 20.2053-3(d)(2), T.D. 6826, 1965-2 CUM. BULL. 367, 368, *formerly* Treas. Reg. § 20.2053-3(d), T.D. 6296, 1958-2 CUM. BULL. 432, 544, allows for a deduction of the expenses incurred in selling estate property only "if the *sale* is necessary in order to pay the decedent's debts, expenses of administration, or taxes, to preserve the estate, or to effect distribution . . . ." (emphasis added).

[26] New York courts have repeatedly declared that administration *expenses* must be necessary. However, the courts do not apply a strict necessity standard in determining the propriety of the expenses incurred, but rather determine whether the executor was acting reasonably and in good faith within the limits of the authority granted him either by law or by the will. *See In re* Estate of Hart, 32 App. Div. 2d 961, 303 N.Y.S.2d 82 (2d Dep't 1969) (mem.), *aff'd mem.*, 27 N.Y.2d 560, 261 N.E.2d 268, 313 N.Y.S.2d 128 (1970) (expenses of moving goods of third party from decedent's residence allowed since incurred in good faith); *In re* Estate of Morawetz, 35 Misc. 2d 762, 231 N.Y.S.2d 1000 (Sur. Ct. Albany County 1962) (allowability of various administration expenses discussed in terms of reasonableness); *In re* Cohen's Will, 13 Misc. 2d 694, 177 N.Y.S.2d 344 (Sur. Ct. Westchester County 1958), *modified on other grounds*, 9 App. Div. 2d 916, 195 N.Y.S.2d 446 (2d Dep't 1959) (expenses resulting from executor's decision to continue operating decedent's business prior to sale allowed even though continuation not necessary); *In re* Estate of Saunders, 77 Misc. 54, 67-69, 137 N.Y.S. 438, 447-48 (Sur. Ct. Westchester County 1912), *aff'd mem.*, 156 App. Div. 891, 141 N.Y.S. 1145 (2d Dep't 1913), *aff'd mem.*, 211 N.Y. 541, 105 N.E. 1099 (1914) (brokers fees allowed for sale of land which was authorized by will but not necessary).

[27] In Estate of Sternberger v. Commissioner, 18 T.C. 836 (1952), *aff'd per curiam*, 207 F.2d 600 (2d Cir. 1953), *rev'd on other grounds*, 348 U.S. 187 (1955), the Tax Court had approved the deduction of sales expenses as an administration expense because they were allowable under New York law even though "[t]he proceeds of the sale were *not needed* to pay debts or expenses" within the contemplation of the treasury regulation. 18 T.C. at 842 (emphasis added). Although it is at least arguable that a similar situation existed in *Smith*, the Second Circuit refused to recognize the validity of such an approach. Thus, one effect of *Smith* is to implicitly overrule *Sternberger*.

[28] *See* 31 AM. JUR. 2d *Executors and Administrators* §§ 524, 527 (1967). For example, VT. STAT. ANN. tit. 14, § 1065 (1974) provides:

> An executor or administrator shall be allowed *necessary expenses* in the care, management and settlement of the estate and, for his services, such fees as the law provides, with extra expenses.

(emphasis added).

[29] Although the Second Circuit did not direct that the regulation be applied in determining deductibility, it did affirm the Tax Court decision applying the regulation. Moreover,

to explicitly consider the regulation's validity.[30] Section 20.2053-3 of the Treasury Regulations has been in effect without substantial change since 1919,[31] and yet its validity has only recently been put directly in issue. The Tax Court in *Smith* expressly upheld the validity of the regulation, finding it to be a reasonable attempt to safeguard "the integrity of the estate tax"[32] by limiting deductible expenses to those normally anticipated and required.[33] The *Smith* Tax Court was also apparently influenced by the age of the regulation and the fact that Congress has reenacted the estate tax provisions of the Code without indicating any disapproval of the regulation.[34]

In *Estate of Park v. Commissioner*,[35] the Tax Court similarly upheld the regulation's validity in disallowing the deduction of ad-

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the language and the rationale employed by the Second Circuit do seem to indicate an acceptance of the standards embodied in the regulation. For example, the *Smith* court embraced the dichotomy between an expenditure for the benefit of the estate and an expenditure for the benefit of the beneficiaries, 510 F.2d at 482, a distinction also found in the treasury regulation. *See* note 2 *supra*. The court's discussion of the varying interests of the federal and state courts in evaluating administration expenses also seems to indicate that allowability under state law is not in itself sufficient to warrant federal estate tax deductibility and that the application of federal criteria is required. Indeed, in United States v. Stapf, 375 U.S. 118 (1963), the Supreme Court intimated that the varying state and federal interests in evaluating administration expenses might give rise to uniquely federal criteria in federal estate tax litigation. Considering the application of Int. Rev. Code of 1939, ch. 1, § 812(b)(2), 53 Stat. 123, the predecessor of INT. REV. CODE OF 1954, § 2053(a), the *Stapf* Court stated that the section "must be read in light of the general policies of taxing the transmission of wealth at death . . . ." *Id.* at 134. In light of these varying interests, it is arguable that the term "administration expenses" as used in the Code should be considered a term of art in federal tax law and that it does not necessarily include every expenditure authorized by a state. *Cf.* Morgan v. Commissioner, 309 U.S. 78, 80-81 (1940) ("general power of appointment" defined as used in federal tax law); Lyeth v. Hoey. 305 U.S. 188, 191-94 (1938) ("acquired by inheritance" defined as used in federal tax law).

[30] 510 F.2d at 483.

[31] *See* T.D. 2910, 21 TREAS. DEC. INT. REV. 752, 778-79 (1919).

[32] 57 T.C. at 661-62.

[33] Other Tax Court panels have similarly applied the regulation's standards in determining which administration expenses are properly deductible. In Estate of Opal v. Commissioner, 54 T.C. 154, 166 (1970), *aff'd on other grounds*, 450 F.2d 1085 (2d Cir. 1971), the Tax Court disallowed the deduction of accountant's fees as an administration expense because they did not fulfill the requirements of the treasury regulation. Similarly, in Estate of Swayne v. Commissioner, 43 T.C. 190, 200 (1964), the Tax Court held that expenses incurred in the sale of estate property were not deductible because they did not meet the regulation's requirements. In *Swayne*, however, there was apparently some question as to whether the expenses were allowable under state law. Although it originally approved of the expenditures, the probate court subsequently affirmed the state estate tax commissioner's refusal to allow the expenses as a deduction from the state estate tax. In neither of these cases, however, was the validity of the regulation challenged.

[34] 57 T.C. at 660. The dissenters of the *Smith* tax court stated that due to the lack of evidence that Congress had ever considered the regulation, *see* H.R. REP. No. 1337, 83d Cong., 2d Sess. 91 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 124 (1954), reenactment of the estate tax provisions in the 1954 Code does not indicate congressional approval of the regulation. 57 T.C. at 663-64 (Goffe, J., dissenting).

[35] 57 T.C. 705 (1972), *rev'd*, 475 F.2d 673 (6th Cir. 1973).

ministrative expenses approved by a state probate court.[36] The Sixth Circuit reversed, holding that the regulation was an invalid extension of the provisions of the Code:

> By the literal language of § 2053(a), Congress has left the deductibility of administrative expenses to be governed by their chargeability against the assets of the estate under state law. . . . In the situation before us, the expenses were admittedly allowable under [state] law. . . . Hence they are deductible under §2053(a).[37]

In his dissent in *Smith*, Judge Mulligan adopted a similar rationale, stating that if the treasury regulation purports to impose a federal "necessity" requirement for deductibility, it is contrary to the clear language of the Internal Revenue Code itself, and is, as such, invalid.[38]

Although the Second Circuit avoided complete variance with the Sixth Circuit by refusing to explicitly uphold the validity of the treasury regulation, the practical effect of its decision in *Smith* will be to engender conflict between the two circuits in determining deductibility of administration expenses. Under the Second Circuit's ruling in *Smith*, administration expenses may be subject to a de novo inquiry employing the stringent necessity standards imposed by the treasury regulation. This stands in sharp contrast to the policy adopted by the Sixth Circuit of limiting any de novo

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[36] The Tax Court applied the regulation and concluded that the sales involved were not necessary to pay debts or taxes, to preserve the estate, or to effect distribution and were, therefore, for the benefit of the heirs rather than the estate. 57 T.C. at 709.

[37] 475 F.2d at 676. Other federal courts have approved administration expenses, if allowable under state law, without considering the treasury regulation. *See, e.g.*, Union Commerce Bank v. Commissioner, 339 F.2d 163 (6th Cir. 1964) (interest paid on overdue gift taxes for period after decedent's death held deductible administration expense since allowable under state law); Cadden v. Welch, 298 F.2d 343 (6th Cir. 1962) (attorneys' fees deductible administration expense since allowable under state law); Dulles v. Johnson, 273 F.2d 362, 369 (2d Cir. 1959), *cert. denied*, 364 U.S. 834 (1960) (attorneys' fees for individual legatees deductible administration expense since allowable under state law); Scott v. Commissioner, 69 F.2d 444, 445 (8th Cir. 1934) (executors' commission for sale of real estate deductible administration expense since allowable under state law); Schmalstig v. Conner, 46 F. Supp. 531 (S.D. Ohio 1942) (attorneys' fees deductible administration expense since allowable under state law); Estate of Todd v. Commissioner, 57 T.C. 288, 295 (1971) (interest on loan to pay death taxes deductible administration expense since allowable under state law); Estate of Sternberger v. Commissioner, 18 T.C. 836 (1952), *aff'd per curiam*, 207 F.2d 600 (2d Cir. 1953), *rev'd on other grounds*, 348 U.S. 187 (1955) (expenses incurred in sale of real estate deductible administration expense since allowable under state law). *See also* Estate of Baldwin v. Commissioner, 59 T.C. 654 (1973) (attorneys' fees not deductible administration expense since not allowable under state law).

[38] If the Regulation by adding the word "necessary" gives the Commissioner of Internal Revenue the authority to review the determination of the New York State Surrogate and interpret what is "necessary" solely from the point of view of the federal taxing power, then the Regulation conflicts with the Code, is contrary to the intent of Congress, and is therefore invalid.

510 F.2d at 484 (Mulligan, J., dissenting).

inquiry to the question of allowability under state law. The unfortunate result will necessarily be an uneven, and therefore inequitable, application of the section 2053(a) deduction.[39]

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[39] Until 1970, the Tax Court had declared that as a court of national jurisdiction it was not bound by and would not follow precedents set by the courts of appeals. *See* Lawrence v. Commissioner, 27 T.C. 713 (1957), *rev'd per curiam on other grounds,* 258 F.2d 562 (9th Cir. 1958). It has since reconsidered this issue and presently follows the precedent of whichever circuit will have jurisdiction of the case on appeal. Golsen v. Commissioner, 54 T.C. 742 (1970), *aff'd,* 445 F.2d 985 (10th Cir.), *cert. denied,* 404 U.S. 940 (1971). Hence, the Tax Court will doubtless apply the regulation in cases appealable to the Second Circuit, but not in cases appealable to the Sixth Circuit.