

## Estate Taxation

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this allocation was unjustified, the Commissioner's findings must be affirmed.

As the *Phillipp* decision indicates, section 482 is a principal weapon in attacking taxpayer transactions. Although there is nothing in *Phillipp* to indicate that the burden of proving that the Commissioner's actions, in applying section 482, were unreasonable or arbitrary is appreciably greater than the burden of overcoming the presumptive correctness of the Commissioner's determinations in most civil tax litigation, it would appear that the proof required by section 482 is nearly unattainable. If this becomes a fact the authorization to make allocations under section 482 will provide a sword for revenue producing, not a shield to preclude the loss of revenue through artificial arrangements among controlled entities. The thrust of section 482 must therefore be employed only where the principal purpose of the questioned transaction was to avoid federal income tax.

#### ESTATE TAXATION

Section 2055(a)(3) of the Code provides for a deduction from the decedent's gross estate for the value of property transferred to a trustee if used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals. The deductions will be disallowed if a substantial part of the activities of the transferee is "carrying on propaganda, or otherwise attempting, to influence legislation. . . ."<sup>68</sup> Other provisions of section 2055 allow a deduction for similar transfers: to or for the use of a domestic governmental body for exclusively public purposes;<sup>69</sup> to or for the use of any corporation organized or operated exclusively for religious, charitable, scientific, literary, or educational purposes;<sup>70</sup> and to or for the use of any

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An additional contention that the foreign sales corporations had a right to receive some income from the transactions which were assigned to them by the New York office, because their capital was at risk, was also denied. No sales contracts, insurance policies, or shipping documents were put into evidence to indicate that the foreign corporations did, in fact, risk capital, as it appeared to the court that "after a profitable sale had been completely arranged by the New York corporation, it was thereafter arbitrarily assigned to one of the foreign corporations." 435 F.2d at 58.

<sup>68</sup> INT. REV. CODE OF 1954 § 2055(a)(3). The Tax Reform Act of 1969, 83 Stat. 487, added the requirement that transfers of property made after December 31, 1969 will not be deductible if the transferee in any way participates in any political campaign. 83 Stat. 553.

<sup>69</sup> INT. REV. CODE OF 1954 § 2055(a)(1).

<sup>70</sup> *Id.* § 2055(a)(2). No part of the net earnings of the corporation may enure to the benefit of any private stockholder or individual. *Id.* The prohibition concerning propaganda activities applicable in section 2055(a)(3) also applies here. Treas. Reg. § 20.2055-1(a)(4) (1958) does not strictly enforce the provision that the transferee must be a corporation; any institution meeting the requirements will suffice.

veterans' organization incorporated by Act of Congress.<sup>71</sup> Recent decisions have dealt with the question of whether or not a charitable bequest to a foreign government is deductible. The Internal Revenue Service has consistently contended that, by their very nature, such bequests are non-deductible. The courts, however, have just as consistently allowed the deduction.

In *Kaplun v. United States*<sup>72</sup> the Second Circuit aligned itself with other circuits in holding that a bequest to any qualified trustee for a charitable purpose may be deducted from the decedent's gross estate. The testatrix bequeathing her coin collection to the State of Israel upon condition that it be exhibited in that state, in perpetuity. The Internal Revenue Service disallowed the deduction of the value of the collection from the estate tax return. The executrix paid the deficiency assessment and sued for a refund. In affirming the district court's order granting the executrix' motion for summary judgment, the Court of Appeals rejected the government's contention that the provision of section 2055(a)(1), allowing deductions for all bequests to domestic governmental bodies, necessarily precludes a deduction for bequests to foreign governments, irrespective of the status as a trustee for charitable purposes.<sup>73</sup> The court indicated that each of the subsections of the statute must be considered and applied separately.<sup>74</sup> The scope of section 2055(a)(1) is to exclude foreign political units from outright bequests for public purposes. How-

<sup>71</sup> INT. REV. CODE OF 1954 § 2055(a)(4).

<sup>72</sup> 436 F.2d 799 (2d Cir. 1971).

<sup>73</sup> The government relied on the canon of construction, *expressio unius est exclusio alterius*, as applied in *Edwards v. Phillips*, 373 F.2d 616 (10th Cir.), *cert. denied*, 389 U.S. 834 (1967). In *Edwards*, the decedent bequeathed funds to a Danish school district "to be used by said school district in any manner it may wish for the betterment of the schools or aid to the students of said district." 373 F.2d at 617 (quoting from decedent's will).

<sup>74</sup> In support of its denial of the Government's exclusion argument, the court cited *Schoellkopf v. United States*, 124 F.2d 982 (2 Cir. 1942), wherein the predecessor of the current statute, INT. REV. CODE OF 1939 § 23, was in issue

(T)he trustee should pay annually \$50,000 to one German city and \$100,000 to another, both in Wurtemberg, "for charitable, educational and/or benevolent purposes." This the defendant challenges because § 23(n)(1) exempts gifts made to municipalities within the United States, and by implication does not exempt any others. That would indeed preclude unrestricted gifts to foreign cities, and is a good answer so far as concerns § 23(n)(1); but § 23(n)(1) creates an exemption without local limitations when the purposes are charitable as there defined. The canon, *expressio unius*, does not therefore apply, and the gift is exempt unless we must import a general limitation into § 23(n)(2) so that it shall include no charities except those for the benefit of persons within the United States. We do not understand that the defendant so argues, nor is there any warrant for it in the language of the statute; indeed, the contrast between subdivisions one and two strongly suggests the opposite.

124 F.2d at 985. For other rejections of the *expressio unius* canon in regard to section 2055 see *Continental Ill. Nat'l Bank & Trust Co. v. United States*, 403 F.2d 721 (Ct. Cl. 1968), *cert. denied*, 394 U.S. 973 (1969); *Old Colony Trust Co. v. United States*, 313 F. Supp. 980 (D. Mass 1970).

ever, section 2055(a)(3) expressly mandates deductions when property is transferred to a trustee for religious, charitable, scientific, literary or educational purposes.

The government also argued that the deduction must be disallowed because the trustee named by the testatrix might use the funds to engage in propaganda and influence legislation. This, too, was denied by the court, since there was no indication that the State of Israel would deviate from its pledged responsibility in agreeing to accept the trust.<sup>75</sup>

A final argument that the construction of the statute urged by the executrix would possibly extend favors to nations unfriendly to the United States, and as such, must be rejected as against public policy, was also turned down. While it is true that a denial of a tax benefit might discourage a bequest to an unfriendly country, application of the statute in such a manner on the basis of a speculative factual situation is uncalled for. If occasion demands, corrective legislation would be appropriate, not a reshaping of the wording of the statute by the courts. As there is nothing in the present estate tax statute to prohibit a bequest from being transferred to a foreign country as charitable trustee, the claim qualifies for a deduction.

*Kaplun* represents a concise statement of the particular provisions of section 2055 brought in issue, as they were intended to be applied by Congress.<sup>76</sup> As such it is a welcome buttress for the executor in his claim for a deduction for a charitable transfer. Although the *Kaplun* decision cleared up some interpretational issues concerning deductions for charitable transfers under section 2055, other provisions of the section have caused far greater confusion.

Section 2055(c) provides that any estate, inheritance or legacy tax payable out of a charitable transfer reduces the allowable deduction by the amount of such tax.<sup>77</sup> When federal estate tax is payable out of a

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<sup>75</sup> The court noted that the government was placing undue emphasis on the nature of the trustee, as distinguished from the accomplishment of the trust's objections. It must be understood that "the identity of the trustee is not crucial, rather the important and controlling issue relates to the duties imposed upon the trustee and its execution of them." 436 F.2d at 804.

<sup>76</sup> As pointed out in *Continental Ill. Nat'l Bank & Trust Co. v. United States*, 403 F.2d 721, 724 (Ct. Cl. 1968), Congress could quite easily have drawn a line between public purposes [which could be advanced only under section 2055(a)(1)] and the charitable purposes contemplated under section 2055(a)(3).

<sup>77</sup> Section 2055(c) in effect provides that the deduction is based on the amount actually available for charitable uses, that is, the amount of the fund remaining after the payment of all death taxes.

Section 2055(c) was a legislative response to *Edwards v. Slocum*, 264 U.S. 61 (1924), which construed the statute then in force in a manner which held that deduction for a residuary bequest to a charity was not to be reduced by taxes payable out of the residue.

bequest to a charitable organization so that the amount of the transfer otherwise passing to the charity is reduced by the amount of tax, the resultant decrease in the amount passing to the charitable organization will further reduce the allowable deduction.<sup>78</sup> Complications arise when a transfer of a remainder interest in property to charity<sup>79</sup> is reduced on account of state taxes. In such a case, three interdependent variables — the amounts of the state and federal taxes and the valuation of a future remainder interest which will constitute a deduction presently claimable for the transfer to charity — come into play.<sup>80</sup> Valuation of the property transferred to charity must be determined as of the date of the testator's death.<sup>81</sup>

In *Connecticut Bank and Trust Co. v. United States*<sup>82</sup> the court of appeals denied a claim for a federal estate tax refund which was based upon a recomputation of the charitable deduction despite the fact that the amount of the charitable transfer had been increased due to a state estate tax refund. The testator's will established two trusts. The first, designated the "A Trust," gave the widow a life estate in the income of

S. REP. No. 398, 68th Cong., 1st Sess. (1924), appearing in 1939-1 CUM. BULL. 266, 290, issued two months after this decision said that:

A sentence has been inserted . . . to make it clear that the amount deductible under these paragraphs on account of bequests, legacies, or devises for the specified benevolent purposes shall be the net amount distributable for such purposes after estate, legacy, or inheritance taxes imposed in respect thereof have been deducted therefrom. It is evident that if a testator of \$1,000,000 to a charity, but the estate taxes payable out of the residue reduce the amount actually distributed to the charity to \$950,000, only the latter amount should be deductible, in computing the amount of the net estate, as a bequest to charity. This sentence so provides.

See also *Harrison v. Northern Trust Co.*, 317 U.S. 476, 479-81 (1943).

<sup>78</sup> Treas. Reg. § 20.2055-3(b) (1958) explains that in such a case the amount of the charitable deduction must be obtained by a series of trial-and-error computations, or by formula. Examples of the computational methods are contained in supplemental instruction to the estate tax return. See note 80 *infra*.

<sup>79</sup> When a life estate is bequeathed to an individual and the remainder is to be donated to charity, many state inheritance tax laws provide that the tax should be paid out of the corpus. The effect of these state laws is to reduce the amount of the fund to be transferred to charity by the amount of the tax. In such a case, the deduction is limited to the present value, as of the date of the testator's death, of the remainder of the fund so reduced. Treas. Reg. § 20.2055-3(a) (1958).

<sup>80</sup> The methods of calculating the ultimate tax liability are complex in this case, as Justice Holmes suggested in *Edwards v. Slocum*, 264 U.S. 61, 63 (1924), wherein he referred to "the problems raised by two mutually dependent indeterminates." The Internal Revenue Service offers a variety of methods involving successive approximations for determining federal tax liability in its Supplemental Instructions for Form 706 for Computation of Interrelated Death Taxes and Marital or Charitable Deduction. See also 4 J. MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION § 30.15 (1959).

<sup>81</sup> *Edwards v. Slocum*, 264 U.S. 61 (1924). Justice Holmes characterized the estate tax as a tax on the transfer of the net estate which "comes into existence before and is independent of the receipt of the property by the legatee" and "manifestly assumes that the net estate will be ascertained before the tax is computed." *Id.* at 62-63.

<sup>82</sup> 439 F.2d 931 (2d Cir. 1971).

the A Trust, with testamentary power over the corpus. In the event the widow defaulted on her exercise of this power, the remainder would go into a second trust, designated as the "B Trust." The terms of the B Trust provided that the widow was to receive the income for life, with the remainder going to charity. All taxes assessed against the estate were to be paid out of the B Trust. The federal estate tax return claimed a charitable deduction for the remainder interest of the B Trust.<sup>83</sup> The state succession taxes paid out of the B Trust were calculated pursuant to Connecticut law.<sup>84</sup> Four years subsequent to filing of the estate tax return, the widow executed a release of her power of appointment over the remainder of the A Trust. The state succession tax was then recomputed and a refund of the excess paid was added to the remainder of the B Trust. The district court granted the refund demanded by the executor on the basis of the contention that the charitable deduction on the federal estate tax return should be recomputed since less taxes had been paid out of the property transferred to charity.<sup>85</sup>

The court of appeals reversed the judgment and dismissed the complaint. The amount of the charitable deduction is to be determined by the market value of the remainder interest at the testator's death.<sup>86</sup> If,

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<sup>83</sup> In computing the charitable deduction on the estate tax return the executor started with the value of the gross estate and subtracted therefrom all monies and properties which were or would be otherwise distributed. 439 F.2d at 933.

<sup>84</sup> The Connecticut succession taxes paid and deducted amounted to \$151,519.75. The state tax law, CONN. GEN. STAT. § 12-355(a), (West 1967), provided that if it is impossible to compute the present value of any property to be transferred, the executor and the state tax commissioner may enter into an agreement as to what the tax liability of the estate will be and such an agreement will be binding on the parties. If an agreement cannot be reached then, under section 12-355(b), the estate is to pay a tax based "upon the assumption that the contingencies will so resolve themselves as to lead to the highest tax possible under the provisions of this chapter." This latter procedure was followed in the present case.

<sup>85</sup> See note 77 *supra*. The executor did not claim a refund under section 2055(a) (see notes 68-70 *supra* and accompanying text) based on the larger sums that will enure to charity as a direct result of the widow's relinquishment of her power of appointment over the corpus of the A Trust. This attack was not open to him since the entire amount had already been deducted under the marital deduction. See section 2056. Furthermore, the widow's disclaimer was not made before the date prescribed for filing of the estate tax return, as is required by section 2055(a):

[T]he value of the taxable estate shall be determined by deducting from the value of the gross estate the amount of all bequests, legacies, devises, or transfers (including the interest which falls into any such bequest, legacy, devise or transfer as a result of an irrevocable disclaimer of a bequest, legacy, devise, transfer, or power, if the disclaimer is made before the date prescribed for the filing of the estate tax return). . . .

INT. REV. CODE OF 1954 § 2055a (emphasis added).

<sup>86</sup> *Ithaca Trust Co. v. United States*, 279 U.S. 151 (1929). In *Ithaca Trust*, a testator had bequeathed his estate in trust for his wife for life, with the remainder to charities. Although the wife had died within the year granted by the statute for filing the estate tax return, the Court held that the deduction for the charitable bequest must be reduced by the value of the wife's life estate as determined by "mortality tables showing the probabili-

as of that date, a charitable transfer is dependent upon the occurrence of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible.<sup>87</sup> As the widow did not release her general testamentary power until some time after the estate tax return was filed, the increase resulting from the state tax refund will not alter the amount of the charitable deduction.

The decision in *Connecticut Bank and Trust* appears to be a harsh application of the federal estate tax law. Although the rationale employed by the court cannot be attacked it seems to be a case wherein insistence upon strict interpretation of the statute renders an unjust result. The court stated that "[t]o permit the taxpayer to prevail in the instant case would ignore the very palpable possibility that the B Trust would remain" as the testator had left it.<sup>88</sup> Yet, such was not the case. The B Trust was, in fact, increased by the remainder of the A Trust disclaimed by the widow. It is difficult to see what value is attained by the court closing its eyes to facts brought to light by subsequent events. The uncertainty concerning the widow's actions, admittedly in existence as of the date of filing the estate tax return, was removed at a future date. As such, her actions should be allowed to take their just effect.<sup>89</sup>

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ties as they stood on the day when the testator died." 279 U.S. at 155. The amount of the charitable deduction was to be determined by the market value of the remainder interest at the testator's death.

<sup>87</sup> The court indicated that there was no assurance, at the time of filing of the estate tax return, that the widow would release her power of appointment over the A Trust, thereby effecting the refund of the Connecticut taxes previously paid out of the B Trust. See also *Estate of Brooks v. Commissioner*, 250 F.2d 937 (3d Cir. 1958).

<sup>88</sup> 439 F.2d at 935.

<sup>89</sup> Indeed, the government did not dispute that, had the widow made an irrevocable disclaimer of her power of appointment before the date prescribed to filing the estate tax return, the amount of Connecticut taxes deductible from the charitable bequest would have been correspondingly reduced, with an appropriate reduction in the deduction therefrom for federal estate tax, and the resulting decrease in federal estate tax for which the executor [contended].

439 F.2d at 935.