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Marital Deduction Not Reduced by Federal Estate Taxes Resulting from Assets Included in Estate under I.R.C. § 2036

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In general, for purposes of the marital deduction, the value of property passing to the surviving spouse, and therefore the amount of the deduction, is reduced by federal estate taxes and other administrative costs attributable to the marital share unless state law or the will provides otherwise.[1] However, if there are insufficient estate assets not included in the marital bequest to pay federal estate taxes, the marital assets used to pay those taxes reduce the marital deduction whether or not so directed by state law or the will.[2]

A recent case[3] explores the effect on the marital deduction by federal estate taxes due because of property not in the estate but brought into the taxable estate by imposition of I.R.C. § 2036 on pre-death gifts.

The Prior Case

In April 2002, the decedent and spouse had formed a family limited partnership (FLP) and both contributed a total of $8,667,342 in assets to the FLP in exchange for each receiving a 49.5 percent limited partnership interest and a 0.5 percent general partnership interest. By January 2003, the decedent had transferred 27.7 percent of the interests in the FLP as gifts to family members. The decedent died in February 2004.

The decedent's will provided for the passing of estate assets to the surviving spouse "undiminished by any estate, inheritance, succession, death, or similar taxes and having a value equal to the maximum marital deduction."[4] Under Georgia law, federal estate and state inheritance taxes are to be paid from the residue of an estate unless otherwise directed in the will.[5] Thus, the decedent's will had no provision as to the allocation of any estate taxes, a reasonable omission given that the decedent expected the marital deduction to reduce the estate taxes to zero. However, if the estate still owed estate taxes, the decedent's will provided for a credit bypass trust for the decedent's children up to the extent of the applicable credit amount. This case would have ended there, except the will had no applicable provision if the additional estate taxes exceeded the applicable credit amount, as they did as of the conclusion of the first hearing of this case.

In this prior case,[6] the court held that the value of the pre-death gifts of the FLP interests had to be included in the taxable estate under I.R.C. § 2036 because the transfer of property to the FLP was not considered a *bona fide* sale for adequate and full consideration, the estate failed to show that the FLP was formed for any legitimate and significant non-tax reason, and there existed an implied agreement among the family members that the

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decedent and spouse would retain control over the FLP and its assets during their lifetime.

In addition, the court held that the marital deduction could not be increased by the value of the property brought into the taxable estate under I.R.C. § 2036 because the pre-death gifts were not made to the surviving spouse and would not be included in the surviving spouse's estate.

The inclusion of the pre-death gifted FLP interests used up the applicable credit amount, before any consideration of the credit bypass trust, and resulted in an assessment of estate taxes.

The Current Case

After the prior holding that the value of the pre-death gifted FLP interests were included in the decedent's estate, the estate and IRS disagreed on the issue of whether the payment of the additional taxes resulting from the gifts was chargeable to the marital bequest and consequently reduced the marital deduction.

The IRS argued that, under I.R.C. § 2056(a) and Treas. Reg. § 20.2056(a)-1(a), (b)(1)(ii) the marital deduction is available only with respect to assets actually passing from the decedent to the surviving spouse; therefore, the marital deduction must be reduced to account for the assets used to pay federal estate, state death taxes, and related interest.

The estate argued that I.R.C. § 2207B(a) gives the estate the right to recover estate taxes, if resulting from inclusion under I.R.C. § 2036 of pre-death gifts, from the recipients of the pre-death gifts.[7]

The court pointed out that the decedent's will[8] indicated the decedent's intention that the marital bequest was not to be charged with payment of estate taxes; therefore, I.R.C. § 2207B(a) applies to allow the decedent's estate to pay the additional taxes without reducing the marital bequest or deduction.

The IRS also argued that Treas. Reg. § 20.2056(b)-4(c)(1) requires that

> "In the determination of the value of any property interest which passed from the decedent to his surviving spouse, there must be taken into account the effect which the Federal estate tax, or any estate, succession, legacy, or inheritance tax, has upon the net value to the surviving spouse of the property interest."

The court ruled that the regulation did not apply in this case because the marital bequest would not be affected by the additional taxes which were to be paid by the donees of the pre-death gifts.

Thus, the Tax Court held that the additional taxes resulting from inclusion under I.R.C. § 2036 of the value of pre-death gifts were not chargeable to the marital bequest and did not reduce the marital deduction.

Effect of Post-Death Estate Income on Marital Deduction

A second issue litigated in this case concerned whether the estate could increase the marital deduction by the amount of post-death income produced by the estate and passed to the surviving spouse.

I.R.C. § 2056(a) provides the marital deduction such that the value of the taxable estate shall be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property that passes or has passed from the decedent to a surviving spouse. The marital deduction is permitted "only to the extent that such interest is included in determining the value of the gross estate."[9]

Post-death income earned by an estate is reported as ordinary income of the estate[10] and is not included in the taxable estate for estate tax purposes.[11] Thus, the court held that the post-death income could not increase the marital deduction because the income was not included in the taxable estate.

ENDNOTES

[1] See Harl and Achenbach, *Agricultural Law* § 44.02[3][ix] (2018). *See, e.g.*, Estate of Swallen v. Comm'r, 98 F.3d 919 (6th Cir. 1996), *aff'g*, T.C. Memo. 1993-149 (marital deduction reduced by share of estate taxes where will directed payment of taxes from estate); Ltr. Rul. 8240014, June 29, 1982 (marital bequest required to share in federal estate tax liability on equal basis with other bequests absent clear direction in will to pay federal estate tax from non-marital amounts).

[2] See Murray v. United States, 687 F.2d 386 (Ct. Cl. 1982) (marital deduction reduced by decedent's liability for unpaid federal gift taxes because property involved was only source of payment of gift tax liability); Ltr. Rul. 8344008, July 25, 1983 (value of property passing to spouse reduced by proportionate share of federal and state taxes attributable to probate property after apportionment of taxes between probate and nonprobate property).

[3] Estate of Turner v. Comm'r, 151 T.C. No. 10 (2018). See also Estate of Turner v. Comm'r, 151 T.C. Memo. 2011-209 (2011), *supplemented by*, 138 T.C. 306 (2012).

[4] Estate of Turner v. Comm'r, 151 T.C. No. 10 (2018).

[5] Ga. Code § 53-4-63(a).

[6] Estate of Turner v. Comm'r, 151 T.C. Memo. 2011-209 (2011), *supplemented by*, 138 T.C. 306 (2012).

[7] I.R.C. § 2207B(a):
"Estate Tax.—
(1) In general.—If any part of the gross estate on which tax has been paid consists of the value of property included in the gross estate by reason of section 2036 (relating to transfers with retained life estate), the decedent's estate shall be entitled to recover from the person receiving the property the amount which bears the same ratio to the total tax under this chapter which has been paid as
(A) the value of such property, bears to
(B) the taxable estate.
(2) Decedent may otherwise direct.—Paragraph (1) shall not apply with respect to any property to the extent that the decedent in his will (or a revocable trust) specifically indicates an intent to waive any right of recovery under this subchapter with respect to such property."

[8] See N. 4 and accompanying text above.

[9] I.R.C. § 2056(a).

[10] See I.R.C. §§ 1(e), 641, 6012.

[11] See Estate of Horne v. Comm'r, 91 T.C. 100 (1988).