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Current Problems Facing the Executor Taking the Section 2053 Estate Tax Deduction

Jay D. Christiansen

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Current Problems Facing the Executor Taking the Section 2053 Estate Tax Deduction

TABLE OF CONTENTS

		Page
I.	INTRODUCTION	795
II.	THE DEDUCTIBILITY OF EXPENSES INCURRED AS A RESULT OF SELLING THE DECEDENT'S PROPERTY	796
	A. *Introduction*	796
	B. *The Conflict in the Circuits*	797
	(1) Estate of Park v. Commissioner	797
	(2) Estate of Smith v. Commissioner	800
	C. *A Critical Analysis of Park and Smith*	802
	D. *The Reaction of the Courts*	807
	E. *Implications of the Tax Reform Act of 1976*	810
	F. *Conclusion*	811
III.	THE DEDUCTIBILITY OF INTEREST PAYMENTS INCURRED TO OBTAIN A DEFERRAL OF THE ESTATE TAX	812
	A. *Introduction*	812
	B. *The Statutory Framework*	813
	(1) The Statute Before 1976	813
	(2) Changes Produced by the Tax Reform Act of 1976	816
	C. *The Deductibility of Interest Paid on Commercial Loans or Under the Statutory Deferral Sections*	818
	D. *Criticism and Comment*	821
IV.	THE DEDUCTIBILITY UNDER SECTION 2053 OF VALID CLAIMS AGAINST THE ESTATE NOT FILED IN THE PROBATE COURT	825
	A. *Introduction*	825
	B. *The Revenue Rulings and their Ramifications*	826
	C. *The Case Law*	828
	D. *The Effect of the Revenue Rulings in Tennessee and in Jurisdictions Where the Uniform Probate Code Has Been Adopted*	834

I. INTRODUCTION

Section 2053 of the Internal Revenue Code allows the executor to deduct from the gross estate amounts attributable to expenses, indebtedness, and taxes. This Note will examine problems currently

confronting an executor who is attempting to utilize the 2053 deduction.

The first problem examined in this Note is the conflict in the federal courts of appeals regarding the deductibility of expenses incurred as a result of a sale of decedent's property. The statute, cases, and regulations in this area will be examined, and a suggested approach for the executor encountering this problem will be provided.

The second problem considered is the deductibility of interest incurred to obtain a deferral of estate taxes. Recent Revenue Rulings and cases will be examined in an attempt to ascertain the deductibility of the interest expense under section 2053. Again, a suggested resolution to the problem will be provided.

The third problem concerns the validity of recent Revenue Rulings requiring the filing of *all* claims against the estate in the probate court in order to deduct the claims under section 2053. The ramifications of these rulings in Tennessee and under the Uniform Probate Code will be considered, and recommendations will be provided for the executor.

II. The Deductibility of Expenses Incurred as a Result of Selling the Decedent's Property

A. *Introduction*

The transfer of property at death results in the imposition of the federal estate tax. All property deemed to have been transferred at death constitutes the gross estate.[1] One of the several items[2] that may be deducted from the gross estate in arriving at the taxable estate is provided in section 2053. That section allows the deduction of administrative expenses[3] if the expenses are allowable by local

1. I.R.C. § 2031.
2. I.R.C. §§ 2052-2056.
3. I.R.C. § 2053(a) provides:

(a) General Rule.—For purposes of the tax imposed by § 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts—

(1) for funeral expenses,
(2) for administration expenses,
(3) for claims against the estate, and
(4) for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate,

as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered.

law.[4] The Internal Revenue Service[5] has imposed additional requirements for deductibility in Treasury Regulations sections 20.2053-3(a) and (d).[6] According to the Service, a deduction for expenses connected with the sale of property of the estate will be allowed only if the sale is necessary to pay debts, expenses of administration, or taxes, to preserve the estate, or to effect distribution of the estate. This necessity requirement, coupled with the IRS dictate that the selling expenses be for the benefit of the estate, has created a considerable problem for federal and state courts determining the federal tax effect to be given local probate court decrees allowing particular selling expenses as administration expenses.

B. The Conflict in the Circuits

(1) Estate of Park v. Commissioner[7]

In 1973 the Sixth Circuit considered the validity of the Service's section 2053 regulations in *Estate of Park v. Commissioner.*[8] In *Park,* the decedent died testate leaving a probate estate valued at $123,234.51.[9] Included in the probate estate were the decedent's

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4. Section 2053(a) of the 1954 Code uses the word "allowable" instead of "allowed" as was used in § 812(b) of the 1939 Code. This change implies that the probate court of the local jurisdiction need not actually pass on the merits of every claim in order to ensure deductibility. 4 J. RABKIN & M. JOHNSON, FED. INC., GIFT & EST. TAX. ¶ 53.02; C. LOWNDES, R. KRAMER & J. MCCORD, FEDERAL ESTATE AND GIFT TAXES 376 (3d ed. 1974) [hereinafter cited as LOWNDES].

5. Hereinafter cited as the IRS or the Service.

6. Treas. Reg. § 20.2053-3(a) (1958) provides:

> (a) *In general.* The amounts deductible from a decedent's gross estate as "administration expenses" of the first category (see paragraphs (a) and (c) of § 20.2053-1) 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, payment of debts, and distribution of property to the persons entitled to it. The expenses contemplated in the law are such only as attend the settlement of an estate and the transfer of the property of the estate to individual beneficiaries or to a trustee, whether the trustee is the executor or some other person. Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions. Administration expenses include (1) executor's commissions; (2) attorney's fees; and (3) miscellaneous expenses. Each of these classes is considered separately in paragraphs (b) through (d) of this section.

Treas. Reg. § 20.2053-3(d)(2) (1965) provides in 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 phrase "expenses for selling property" includes brokerage fees and other expenses attending the sale, such as the fees of an auctioneer if it is reasonably necessary to employ one. . . .

7. 475 F.2d 673 (6th Cir. 1973).

8. *Id.*

9. The following items comprised the probate estate:

residence worth $52,000.00 and a summer cottage worth $24,750.00.[10] The decedent's four sons who received the two pieces of real estate under the residuary clause of the will, decided they would rather receive cash than receive property. Accordingly, they directed the executor to sell the property as he was authorized to do under the will.[11] As a result of the sale of the real estate, the executor incurred $4,285.30 in expenses. This amount was included in the amount approved by the Michigan probate court as administration expenses. The sale expenses were included in the executor's section 2053 estate tax deduction. The deduction of $4,285.30 was disallowed by the Commissioner,[12] and that ruling was affirmed by the Tax Court.[13]

The Tax Court opinion was based primarily on the petitioners' failure to satisfy the requirements of the regulations under section 2053.[14] The Tax Court determined that the expense was not *necessary* for the proper administration of the estate, but was instead an expenditure for the individual benefit of the devisees.[15]

In the Court of Appeals, the Commissioner used the same arguments that had brought him success in the Tax Court:

Residence	$52,000.00
Cottage	24,750.00
U.S. Savings Bonds, Series E	24,069.62
350 Shares Contingentla Associates, Inc., common stock	350.00
Cash in bank account	1,807.45
Social Security benefit	97.90
Income on hand and accrued due deceased's estate from Trust Accounts	6,625.55
Household furniture at 253 Lewiston Read	5,841.25
Household furniture and personal effects at 2315 Lake Shore Road	250.00
Jewelry	2,090.75
Refund of overpayment of 1967 Federal income tax	347.61
Proceeds from Connecticut General annuity policy	5,004.38
	$123,234.51

Id. at 674.

10. *See* note 9 *supra.*
11. 475 F.2d at 674.
12. *Id.*
13. 57 T.C. 705 (1972).
14. Treas. Reg. §§ 20.2053-3(a) (1958), 20.2053-3(d)(2) (1965); *see* note 6 *supra.*
15. 57 T.C. at 709. The Tax Court did not specifically pass on the validity of the regulations. It did note, however, that the regulations had been accepted in previous cases including Estate of Smith, 57 T.C. 650 (1972).

> The respondent relies on the majority approach expressed in *Smith*, to the effect that the provisions of § 2053(a) establish only a threshold consideration. When state law fails adequately to coincide with federal estate tax policies, as reflected in the Treasury Regulations, then the deduction should not be allowed. . . . Consequently, the regulations are valid and must be complied with in order for the expenses to be deductible.[16]

The taxpayer contended that the regulations were invalid as an impermissible restriction on the availability of a deduction provided in the Internal Revenue Code. According to the taxpayer, the only requirement for deductibility under section 2053 was that the expenses be allowable under local law.[17] Thus the issue confronting the Sixth Circuit was clear: whether Treasury Regulations sections 20.2053-3(a) and 20.2053-3(d)(2) must be complied with, in addition to showing allowability of the expense under local law, in order for expenses to be deductible under section 2053.

The Court of Appeals reversed. The court first considered the Tax Court decision of *Estate of David Smith*[18] and rejected that court's rationale for requiring adherance to the Service's regulations. In so doing, the court itemized numerous reasons for rejecting the contentions of the IRS. Foremost among these reasons was the court's literal reading of the statute. The court stated that the statute required only that the expense be allowable under local law. It found no statutory requirement that the expense be *necessary* for one of the purposes set forth in the regulations or that the expense only be for the benefit of the estate. The court thought that Congress committed to the discretion of *state* law the question whether the expense was *necessary*.[19] The court also found an untenable distinction in the regulation's requirement that the expense benefit the estate and not the beneficiary.[20]

The court also identified a practical problem presented by the regulations. The court believed that a prudent fiduciary often will be called upon to dispose of nonincome-producing property even though it is not "necessary" under the regulations. The court felt that in such a situation the good faith judgment of the fiduciary, as approved by the probate court, should not be influenced by the unwarranted intrusion of the regulations' "necessary" requirement.[21]

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16. 475 F.2d at 675.
17. There was no question that Michigan law allowed these expenses. *Id.*
18. 57 T.C. 650 (1972); *see* notes 22-41 *infra* and accompanying text.
19. 475 F.2d at 676.
20. *Id.*
21. *Id.* at 676-77.

(2) *Estate of Smith v. Commissioner*[22]

In 1975 the Second Circuit confronted the same issue that had been presented to the Sixth Circuit in *Park* two years earlier. In *Estate of Smith v. Commissioner,*[23] the deceased artist's estate included[24] 425 pieces of abstract metal sculpture.[25] In order to ensure the highest return possible on these assets, the three executors engaged in an orderly process of gradual liquidation over a period of eight years.[26] During this time nearly $1.6 million were paid in commissions to the art gallery disposing of the pieces of sculpture.[27] The New York Surrogate's Court allowed this sum, and the executors contended that this amount was deductible on the federal estate tax return as an administration expense under section 2053(a).[28]

In 1969, nearly three years after the filing of the estate tax return, the Commissioner increased the value of Smith's estate and disallowed as a deduction under section 2053(a)(2) any commissions in excess of $289,662.[29] The Tax Court, in a de novo review, reduced the asserted value of the estate and allowed only $750,447.74 as a section 2053 deduction for sales commissions. This allowance equaled the amount necessary to pay the decedent's debts, taxes, and expenses of administration.[30] The Tax Court stated that the allowability of the expenses under local law represented only a threshold requirement and that the IRS regulations[31] also had to be

22. 510 F.2d 479 (2d Cir.), *cert. denied,* 423 U.S. 827 (1975).

23. *Id.*

24. In addition to the pieces of sculpture, the estate included liquid assets totalling $210,647.08. 510 F.2d at 480.

25. Decedent is recognized as one of the leading American sculptors of nonrepresentational forms. Since the 1930's he produced more than 500 major and often monumental (up to fifteen feet high) works. Unfortunately, most of the public acclaim and financial success of Smith's art was posthumous. Echter, *Equitable Treatment for the Artists's Estate—the Tax Court Takes a First Step,* 114 TRUSTS & EST. 394 (1975).

26. As mentioned in note 25 *supra,* Smith was not a commercially successful artist during his lifetime. Accordingly, the executors believed that a public auction of all the works would have revealed the large number of works in the estate and would have caused a severe decline in their value. Thus the gradual disposition as authorized by Smith's will. 510 F.2d at 480; *see* 57 T.C. 650, 654 (1972); 17 WM. & MARY L. REV. 363, 372 (1975).

27. Pursuant to a 1963 contract that was renewed by the executors in 1968 and 1970, the Marlborough-Gerson Galleries were entitled to a one-third commission on the net proceeds of the sales. In 1970 $1,187,144.67 in commissions were paid, and from 1970 to 1973 $396,400 in commissions were also received by the galleries. 510 F.2d at 480.

28. 57 T.C. at 654; 510 F.2d at 481-82.

29. In 1966 the estate tax return was filed and a deficiency was paid in 1968. In 1969 the Commissioner issued a deficiency note for $2,444,629.17, based on a new valuation of the estate at $5,256,918 and a disallowance of a deduction for commissions in excess of $289,661.65. *Id.*

30. 57 T.C. at 662 & n. 15; 510 F.2d at 481.

31. *See* note 6 *supra.*

satisfied in order for the selling expenses to be deductible. Accordingly, only $750,447.74 could be allowed as a section 2053 deduction because only that amount was "necessary" to pay the decedent's debts, taxes, and expenses of administration.[32]

On appeal to the Second Circuit, the taxpayer maintained that the entire sum paid in commissions should be deductible because the taxpayer complied with the regulations. According to the executors, their fiduciary obligations to liquidate the estate and diversify the nature of the assets held by the estate qualified the commissions as necessary expenditures. The executors further argued that the local court's allowance of the expenses established their deductibility, and that, if the regulations served to disallow the deduction, they were invalid.[33] The Commissioner countered by arguing that the expenses were not incurred out of necessity as required by the regulations, but instead were incurred for the benefit of the legatees.[34]

In finding for the Commissioner, the Second Circuit noted that a local probate court often will not give proper consideration to the interests of the federal taxing authority.[35] In such circumstances, under *Commissioner v. Estate of Bosch,*[36] the local court's determination of allowability is not controlling[37] and cannot preclude a federal court from reexamining the probate court's decision that the expenditures were necessary expenses of administration.[38] The court then stated that the Tax Court's opinion should be affirmed because its appropriate de novo review was not clearly erroneous. The court

32. 57 T.C. at 662 & n.15; 510 F.2d at 481.

33. 510 F.2d at 481-82.

34. *Id.* at 482.

35. *Id.; see* Pitner v. United States, 388 F.2d 651, 659 (5th Cir. 1967).

36. 387 U.S. 456 (1967). For an explanation of the *Bosch* decision, see notes 49-54 *infra* and accompanying text.

37. The court's opinion that a local court's decree is not controlling was partially based on Treas. Reg. § 20.2053-1(b)(2) (1958), which provides in part:

> (2) *Effect of court decree.* The decision of a local court as to the amount and allowability under local law of a claim of administration expense will ordinarily be accepted if the court passes upon the facts upon which deductibility depends. If the court does not pass upon those facts, its decree will, of course, not be followed. For example, if the question before the court is whether a claim should be allowed, the decree allowing it will ordinarily be accepted as establishing the validity and amount of the claim. However, the decree will not necessarily he accepted even though it purports to decide the facts upon which deductibility depends. It must appear that the court actually passed upon the merits of the claim. . . .

38. The court stated:

> [T]here is some question as to whether some of these expenses were in fact incurred for the benefit of the estate in accordance with the general purposes of § 2053 rather than for the benefit of the individual beneficiaries.

510 F.2d at 482; *see* Treas. Reg. § 20.2053-3(a) (1958), note 6 *supra.*

stated that it was not required to pass on the validity of the Service's regulations because the state law governing the administration of the estate required all expenses to be "necessary." Accordingly, any requirement of "necessity" was imposed by local law and not by the regulations.[39] Presumably, this rationale explains the court's omission of a discussion of the *Park* case.[40] The dissent found the majority's failure to discuss *Park* disturbing and agreed with the *Park* holding that the regulations were unwarranted extensions of the statute.[41]

C. *A Critical Analysis of Park and Smith*

In determining whether *Park* or *Smith* represents the better view regarding the deductibility of the expenses of selling assets in the probate estate, it should be remembered that an important difference exists between legislative regulations and interpretive regulations. Legislative regulations result from Congress's specific delegation of its rulemaking authority to the Internal Revenue Service. When regulations of this form exist, they must be adhered to in order to achieve compliance with the statutory section under which they were promulgated. On the other hand, interpretive regulations merely represent the views of the Internal Revenue Service regarding the meaning of the statutory section to which they are addressed. The regulations pertaining to administration expenses under section 2053(a) are *interpretive* regulations.[42] Thus compliance with these regulations cannot be required if they do not clearly reflect the meaning of the statute.

It is essentially the position of the Commissioner that the regulations are consistent with the statute. The Commissioner maintains that the language of section 2053(a)(2) imposes two tests. First, the expenditure must constitute an "administration expense;" secondly, the expense must be "allowable" by the state probate court. The Commissioner then reasons that the regulations imposing the requirements of necessity and benefit only to the estate merely reflect a valid interpretation of the requirement that the expenditures be "administration expenses."[43] In effect, the *Smith*

39. 510 F.2d at 483.

40. The court did not even state why it was not necessary to discuss *Park*.

41. 510 F.2d at 483-85.

42. A reading of § 2053(a) clearly indicates that Congress has not delegated its rulemaking powers to the Internal Revenue Service. This is to be contrasted with § 2053(d)(1) where the statute specifically authorizes the Service to promulgate the governing guidelines.

43. Spragens, *Current Appellate Cases Create Conflict in Deductibility of Selling Costs as Administration Expenses Under Sec. 2053(a)(2)*, 54 TAXES 429, 434 (1976).

case validated this position even though that court disclaimed the necessity of passing on the regulation's validity.[44] This disclaimer is unpersuasive in view of the court's affirmance of the Tax Court decision that *did* require adherance to the regulations. Further, subsequent decisions have interpreted *Smith* as requiring compliance with the regulations in order to obtain the deduction.[45] Thus *Smith* clearly conflicts with *Park* because *Park* specifically invalidated the Commissioner's regulations. To determine which opinion is correct, an analysis of the cases on which they are based is required.

The *Smith* court cited *Pitner v. United States*[46] as authority for the proposition that federal courts should be allowed to determine deductibility under the appropriate federal standard because local probate courts do not always adequately consider the interests of the federal taxing authority. While this is probably a valid synthesis of the *Pitner* decision, the context of the *Pitner* case does not support the *Smith* court's extension of this proposition. *Pitner* only allowed a reexamination of the probate court's ruling in two areas. First, it allowed the federal court to reconsider the question whether the expenditures qualified as "administration expenses;" secondly, it authorized the federal court to redetermine whether the expense was "reasonable."[47] Thus, while *Pitner* does acknowledge a possible conflict between the state courts and the IRS, it does not authorize an unlimited reexamination of the probate court's decision. Accordingly, it appears that the Second Circuit erroneously relied on *Pitner* when it approved the Tax Court's reconsideration of the probate court's decision in order to ascertain whether the expense was solely for the benefit of the estate.[48] The "benefit" test is found only in the regulations—not in *Pitner.*

Perhaps the cornerstone of the *Smith* decision was its reliance on *Commissioner v. Estate of Bosch*[49] as authority for a de novo determination whether the expenses were necessary.[50] Again this reliance is misplaced. In *Bosch* the United States Supreme Court stated that a federal court can make its own determination of state *law* and is not bound by a lower state court interpretation.[51] In *Smith,* however, the court used *Bosch* to justify the federal court's

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44. *See* note 39 *supra* and accompanying text.
45. *See* notes 77-87 *infra* and accompanying text.
46. 388 F.2d 651 (5th Cir. 1967).
47. *Id.* at 659.
48. 510 F.2d at 482.
49. 387 U.S. 456 (1967).
50. 510 F.2d at 482-83.
51. 387 U.S. at 463-64.

new findings of *fact* and then found the facts insufficient to allow the deduction under the requirements of the regulations.[52] This was certainly not a simple reexamination of the state law of New York.

Perhaps the clearest example of the *Smith* court's misconstruction of the *Bosch* decision can be seen by examining the following portion of the *Bosch* opinion:

> We find that the report of the Senate Finance Committee recommending enactment of the marital deduction used very guarded language in referring to the very question involved here. It is said that "proper regard," not finality, "should be given to interpretations of the will" by state courts and then only when entered by a court "in a bona fide adversary proceeding." S. Rep. No. 1013, Pt. 2, 80th Cong., 2d Sess., 4. We cannot say that the authors of this directive intended that the decrees of state trial courts were to be conclusive and binding on the computation of the federal estate tax as levied by the Congress. *If the Congress had intended state trial court determinations to have that effect on the federal actions, it certainly would have said so—which it did not do.*[53]

Note that the Court in *Bosch* was considering the marital deduction under section 2056. In contrast, section 2053(a) *does* proclaim that state court determinations are conclusive: "[t]he taxable estate shall be determined by deducting . . . such amounts . . . as are allowable by the laws of the jurisdiction. . . ."[54] Thus the *Bosch* decision does not support the *Smith* opinion.

In addition to the weak foundation provided by prior case law, neither the longstanding nature of the regulations nor the principle of statutory reenactment[55] support *Smith.* Although the regulations have remained substantially unchanged since 1919,[56] the legislative history of section 2053(a) does not indicate congressional approval of the definition of administration expenses set forth in the regulations.[57] Further, the Tax Reform Act of 1976 left section 2053 substantially unchanged even though Congress was certainly aware of the appellate conflict surrounding that portion of the Code. Accordingly, any arguments of congressional approval or longevity do not justify the *Smith* decision.

Having considered the primary authorities relied upon by the *Smith* court, it is also appropriate to examine those authorities allegedly supportive of *Park.* The *Park* opinion primarily consisted

52. 510 F.2d at 482-83; *see* 17 WM. & MARY L. REV. 363, 376-77 (1975).

53. 387 U.S. at 463-64 (emphasis added).

54. *See* note 3 *supra.*

55. *See* Estate of Park v. Commissioner, 475 F.2d 673, 676-77 (6th Cir. 1973); 52 N.C.L. REV. 190, 193-94 (1973); 17 WM. & MARY L. REV. 363, 380-81 (1975).

56. 57 T.C. at 664.

57. H.R. REP. No. 1337, 83d Cong., 2d Sess. 91 (1954).

of a discussion of the Tax Court decision in *Smith* and a literal statutory interpretation of section 2053. The only supportive authorities mentioned by the *Park* court were *Union Commerce Bank v. Commissioner*[58] and *Goodwin's Estate v. Commissioner.*[59] These cases, however, merely hold that state law is controlling in section 2053 cases and do not examine the validity of requirements contained in the regulations.[60] In essence, the *Park* decision rests almost entirely on the Sixth Circuit's view that the requirements of the regulations simply cannot be harmonized with the language in section 2053(a) making state law controlling.

Despite the Sixth Circuit's failure to rely on previous authorities, past decisions support the *Park* analysis. In *Union Commerce Bank v. Commissioner,*[61] the court clearly stated that state law alone controlled section 2053(a) deductions.[62] A similar statement was made by the court in *Commercial National Bank of Charlotte v. United States.*[63] Although these decisions do not exhaustively examine the validity of the regulations, they do show that the *Park* court was not the first tribunal to find that allowability under local law is the only test that must be satisfied for deductibility under section 2053(a).

Having considered the judicial authorities relevant to the positions adopted by the *Park* and *Smith* courts, it is also appropriate to examine the problems presented by the decisions. Foremost among these problems is the potential conflict between the regulations (validated by *Smith*) and the fiduciary's duty to preserve the estate. If an asset is not producing income, but instead is draining the estate through maintenance costs, the prudent fiduciary would be wise (and perhaps required) to dispose of the asset. This action would preserve the estate by generating liquid assets to be invested in income-producing property and by eliminating maintenance expenditures.[64] Nevertheless, it is entirely likely that the Commis-

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58. 339 F.2d 163 (6th Cir. 1964).

59. 201 F.2d 576 (6th Cir. 1953).

60. In *Goodwin's Estate* the court did approve the regulation concerning the effect of a state court decree *(see* Treas. Reg. § 20.2053-1(b)(2), note 37 *supra).* The court did not consider the "necessity" and "benefit" requirements in the Service's regulations and therefore does not directly support *Park's* rejection of these requirements. 201 F.2d at 580.

61. 339 F.2d 163 (6th Cir. 1964).

62. The court simply stated: "This court has previously recognized the express language of this provision as making state law controlling." *Id.* at 168.

63. 196 F.2d 182, 185 (4th Cir. 1952); *cf.* Ballance v. United States, 347 F.2d 419, 422 (7th Cir. 1965). *But see* Estate of Swayne v. Commissioner, 43 T.C. 190 (1964).

64. 52 N.C.L. REV. 190, 196-97 (1973). It also should be noted that in some states realty vests at the moment of death. In those states the maintenance expenditures often will be incurred by the beneficiary and not the executor.

sioner would find the expenses of the sale unnecessary under his regulations. With the deduction disallowed, the executor would have no choice but to absorb the maintenance costs if the expenses of the sale would be nearly equal to the maintenance expenses.

Another problem would arise if the executor finds that a large portion of the estate consists of one kind of property. Under these circumstances it would be prudent to dispose of some of the assets to achieve diversification. Despite the desirability of this diversification, it is unlikely that the Service would find the activity to be "necessary."

Additionally, the executor may foresee the need for cash and decide to sell some of the estate's assets. Under *Smith,* his deduction for selling expenses will be limited to that amount necessary for debts, expenses, and taxes. How is the executor to know how much this will be? The problem will be magnified when the assets are difficult to value and are of such a nature that they are not easily marketable. In this situation the executor will be forced to guess as to his cash needs and will incur a severe penalty for error.[65]

An obvious problem created by the *Smith* decision is that federal courts now may have to review many approved expenditures. This violation of the principle of judicial economy[66] could be rectified by allowing the local probate court to pass on the expenses. The probate court's intimate relationship with the fiduciary would allow it to determine more accurately the estate's requirements and best interests.[67]

Another problem stems from *Smith*'s continued requirement that the expenditures be for the benefit of the estate and not the beneficiaries. The Service can always use the benefit test to make out a prima facie case because *any* action benefitting the estate also will benefit the heirs, legatees, and beneficiaries.[68] Accordingly, the test is unworkable and should not be made controlling.

Finally, there is the convenience factor. It is certainly much easier for both the executor and the beneficiaries to deal in cash.[69] This creates a need to provide the executors with discretion, which is necessary to enable the executor to fulfill the obligations his oath requires. Allowing the executor this flexibility would *not* defeat the

65. 17 WM. & MARY L. REV. 363, 382 (1975); Spragens, *Current Appellate Cases Create Conflict in Deductibility of Selling Costs as Administration Expenses Under Sec. 2053(a)(2),* 54 TAXES 429, 435 (1976).

66. 17 WM. & MARY L. REV. 363, 380 (1975).

67. *Id.*

68. *Id.*

69. 52 N.C.L. REV. 190, 197 (1973).

interests of the IRS because the state probate court can only approve the expenses allowed by local law. Thus the regulations and the *Smith* case are not supported by the case law or by the practicalities of estate administration. *Park* is the better view and should be followed.

D. *The Reaction of the Courts*

Nine decisions subsequent to *Smith* and *Park* have considered the issue herein discussed. Only two of the cases seem to have followed *Park*. In the first of these, *Estate of Joslyn v. Commissioner,*[70] the executor sold over four million dollars worth of the decedent's stock in a secondary offering, thereby incurring $70,203.69 in selling expenses.[71] After noting that the Commissioner did not contend that the expenses were unnecessary,[72] the Tax Court stated that the expenses were deductible because the California probate court had allowed the expenditures as expenses of administration.[73] Thus, even though the validity of the regulations was not directly in issue, the court placed great weight on the probate court's determination of allowability.

A stronger statement of approval of the *Park* decision can be found in *In re Estate of Larson.*[74] In that case the executor sold some of the decedent's real estate in order to make a proper distribution of the estate assets. The New York Surrogate's Court found the expense to be deductible for state inheritance tax purposes[75] and formally approved *Park*, describing the reasoning as "sound and reasonable."[76]

Like the cases approving the *Park* position, the cases upholding *Smith* generally fail to engage in an in depth analysis of the validity of the regulations. Instead, they merely accept the *Smith* case as controlling precedent. As an example, consider the case of *Estate of Streeter v. Commissioner,*[77] in which the court disallowed a deduction for auctioneers' commissions because the expenses were those of the trust and not the estate. The court indicated that compliance

70. 63 T.C. 478 (1975).

71. 250,000 of the decedent's 264,396 shares were sold resulting in proceeds of $4,523,750.00. The executor then claimed a § 2053 deduction for $70,203.69 in selling expenses and $288,750.00 representing the discount given to the underwriters.

72. 63 T.C. at 482.

73. *Id.* at 483.

74. 87 Misc. 2d 389, 385 N.Y.S.2d 720 (Sur. Ct. 1976).

75. Under New York law the expense was deductible for inheritance tax purposes only if it would be allowable as an expense for federal purposes under § 2053. *Id.*

76. *Id.*

77. 491 F.2d 375 (3d Cir. 1974), *aff'g* 40 T.C.M. (P-H) 1175 (1971).

with the regulations was required and stated that the expenses would have been deductible had they been expenses of the estate because the fees were "reasonable."[78] Similarly, in *Estate of Agnew v. Commissioner,*[79] the court cited *Smith* for the proposition that:

> [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.[80]

In 1975, two federal district court decisions also approved the *Smith* standard. In *Payne v. United States,*[81] the executors sought to deduct $8,286.48 in expenses incurred as a result of the sale of real property worth $100,000. Noting the contrary authority of *Park*, the court stated that a federal court could not be precluded from redetermining whether the expense was an "administration expense" under section 2053.[82] According to the court, this allowed them to consider whether the sale was "necessary to the administration of the estate."[83] A California district court followed a similar approach in *Hibernia Bank v. United States.*[84] There the court considered both the *Park* and *Smith* decisions. Approving the latter, the court "rejected the proposition that the only requirement for deducting an administrative expense is that a state court has determined the expense is allowable under state law."[85]

Perhaps the most recent case approving the *Smith* opinion is *Estate of Webster v. Commissioner.*[86] In *Webster* the Tax Court simply stated that the regulations had to be satisfied as set forth in the *Smith* decision.[87] This clear statement upholding the validity of the regulations is somewhat difficult to reconcile with the Tax Court's memorandum decision in *Estate of Carson v.*

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78. *Id.*

79. 34 T.C.M. (P-H) 758 (1975).

80. *Id.* at 761.

81. 75-1 U.S. Tax Cas. ¶ 13,059 (M.D. Fla. 1975).

82. *See* note 43 *supra* and accompanying text.

83. The *Payne* court found that the expense was not necessary because there was a sufficient sum of cash in the estate to pay taxes, debts, and expenses. The court therefore thought that the sale was for the benefit of the beneficiaries and not the estate. 75-1 U.S. Tax Cas. ¶ 13,059 (M.D. Fla. 1975).

84. 75-2 U.S. Tax Cas. ¶ 13,102 (N.D. Cal. 1975).

85. *Id.* at 88,899. Having adopted the *Smith* standards, the court rejected the executor's claim of a deduction for interest incurred on loans used to pay the estate tax. The court found that the executor could not satisfy the tests of allowability under state law, reasonableness, and no benefit to the beneficiaries. *Id.*

86. 65 T.C. 968 (1976).

87. *Id.* at 979-80.

Commissioner.[88] In *Carson,* the court stated that the regulations were not in issue because local law (Illinois) also required that the expenditures be "necessary."[89] Nonetheless, the court noted the conflict between the circuits, as represented by *Park* and *Smith,* and stated that it did not need to "take a position on this question."[90] This may represent a conflict with the Tax Court's own opinion in *Webster.*

Perhaps the most important decision subsequent to *Smith* and *Park* is the Tax Court case of *Estate of Vatter v. Commissioner,*[91] which was affirmed in a per curiam opinion by the Second Circuit. In *Vatter,* the decedent owned three rental properties requiring maintenance. Pursuant to a provision in the will giving both the executor and the trustee the power to sell the properties, the executor sold the properties and claimed a section 2053 deduction for the expenses incurred from the sale. The IRS claimed that the sale was not necessary as required by the regulations. The taxpayer alternatively claimed that the sale was necessary to effectuate distribution and that the plain meaning of the statute required reliance on the state court's finding of allowability.[92] In sustaining the taxpayer's position, the Tax Court found it necessary to distinguish the *Smith* case. According to the court, the *Smith* court was required to pass on the necessity of the sale because Smith's will contemplated a specific devise or distribution in kind of the property. In contrast, the Vatter will clearly authorized the executor to sell the property; thus the *Smith* case was not controlling.[93] The *Vatter* court also

88. 1976 T.C.M. (P-H) ¶ 76,073.

89. At issue in *Carson* was the deductibility of the selling expenses incurred upon a sale of the decedent's residence. In disallowing the deduction, the court found that the expenses were incurred by the wife and not by the executor because the property had passed to her by operation of law due to her joint tenancy with the decedent. *Id.*

90. *Id.* at 327.

91. 65 T.C. 633 (1975), *aff'd per curiam,* [1976] FED. TAXES (P-H) ¶ 148,129 (2d Cir. Nov. 29, 1976).

92. *Id.*

93. In order to distinguish the *Smith* case, the court had to engage in a four-step analysis. First, the court found the instant factual situation to be similar to Estate of Sternberger, 18 T.C. 836 (1952), *aff'd,* 207 F.2d 600 (2d Cir. 1953), *rev'd on other grounds,* 348 U.S. 187 (1955). In both cases the executor was given the power to sell the real property. Secondly, the court noted tbat the *Smith* court failed to distinguish *Sternberger,* but instead relied on Estate of Swayne, 43 T.C. 190 (1964). Thirdly, the court discussed the differences in *Swayne* and *Sternberger.* In *Sternberger* the only question was whether the expenses were attributable to the estate or the trust. In contrast, the *Swayne* court had to decide whether the expenses were necessary at all since the will did not authorize the executor to sell the property. Finally, the court noted that the *Smith* and *Swayne* cases contemplated a distribution in kind or specific devise of the assets. Since *Sternberger* and the instant case contemplated no similar procedure, the *Smith* and *Swayne* cases were distinguishable. *Id.* at 637-38.

indicated that because the trustee did not wish to receive a distribution of rental real estate, the sale was necessary in order to effect the distribution of the estate.[94] These two factors led the court to believe that the *Vatter* case presented no conflict with the regulations.[95]

The importance of the *Vatter* decision, as affirmed by the Second Circuit, is that it identifies two relatively easy means of avoiding or complying with the regulations. First, a provision in the will authorizing the executor to sell the assets seems to be a vehicle for escaping the necessity requirement so prominent in *Smith* and the regulations. Secondly, if a trust is used in the decedent's estate plan, a simple refusal by the trustee to accept non-liquid assets will mean that the sale was *necessary* in order to effectuate distribution. Thus, by utilizing these two devices, an alert estate planner probably can avoid the tremendous problems inherent in the *Smith* case[96]—and do so with the apparent approval of the two courts most steadfast in requiring compliance with the regulations.

E. Implications of the Tax Reform Act of 1976

As discussed earlier, the Tax Reform Act of 1976 did not significantly alter section 2053 of the Code.[97] This should not, however, be taken to mean that the Tax Reform Act did not affect the deductibility of expenses incurred in the sale of probate assets by the executor. In fact, changes in section 642(g) will have serious implications for the executor taking the 2053 deduction.

Section 642(g) of the 1954 Code, entitled "Disallowance of Double Deductions," prohibited an executor from deducting the same item on both the estate tax return under section 2053 and on the estate's income tax return.[98] This provision, if literally applied,

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94. *Id.* at 639.

95. *Id.* at 637, 639 n.5.

96. *See* notes 64-69 *supra* and accompanying text. *See also* Hibernia Bank v. United States, 75-2 U.S. Tax Cas. ¶ 13,102 (N.D. Cal. 1975).

97. The only changes were those made by Title XIX of the Tax Reform Act of 1976, referred to as the "Deadwood Bill."

98. Section 642(g) of the 1954 Code provided:

> Amounts allowable under section 2053 or 2054 as a deduction in computing the taxable estate of a decedent shall not be allowed as a deduction in computing the taxable income of the estate or any other person, unless there is filed, within the time and in the manner and form prescribed by the Secretary or his delegate, a statement that the amounts have not been allowed as deductions under section 2053 or 2054 and a waiver of the right to have such amounts allowed at any time as deductions under section 2053 or 2054. This subsection shall not apply with respect to deductions allowed under part II (relating to income in respect of decedents).

would prevent the expenses of a sale of the decedent's property from being deducted on both the estate and income tax returns. Nonetheless, in *Estate of Bray,*[99] the Tax Court held that these expenses may be set off against the gross proceeds received upon the sale of assets by the estate (in computing capital gain or loss), in addition to being a valid deduction for federal estate tax purposes. Thus the estate could receive a double tax benefit upon the sale of these assets. Eventually, the Service acceded to this position.[100]

The 1976 Act clearly changes section 642(g) to prohibit the use of double deductions as authorized in *Bray.*[101] This statutory change may make it unwise for an executor to challenge the validity of the 2053 regulations. Since the deduction probably will be available on the income tax return, and since the deduction can be used only once, it may be a waste of time, effort, and money to challenge the Commissioner's regulations in order to obtain the estate tax deduction. This determination, however, is not as simple as its first appears. A decision to take the expenses as an income tax deduction may have the serious collateral consequence of benefitting the income beneficiary at the expense of the remaindermen. This is especially true where the income tax deduction causes an increase in the amount passing to the surviving spouse under a will containing a formula clause.[102] In such a case, the executor must be aware that he may be required to make compensating adjustments to the remainderman's interest. In these situations the "Warm's Adjustment" may be used increasingly to reconcile the problem.[103] In addition, the different tax brackets of the estate, beneficiaries, and any existing trusts may further complicate the executor's decision. In any event, the choice facing the executor clearly is not entirely alleviated, and the 1976 changes will be extremely important in the years to come.

F. Conclusion

In reviewing the material presented thus far it is clear that

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99. 46 T.C. 577 (1966), *aff'd per curiam,* 396 F.2d 452 (6th Cir. 1968).

100. Rev. Rul. 71-173, 1971-1 C.B. 204.

101. The Tax Reform Act of 1976 changed § 642(g) to read:

> Amounts allowable under section 2053 or 2054 as a deduction in computing the taxable estate of a decedent shall not be allowed as a deduction, *(or as an offset against the sales price of property in determining gain or loss)* in computing the taxable income of the estate or of any other person, unless there is filed. . . .

(language added by the 1976 Act emphasized)

102. LOWNDES, *supra* note 4, at 376.

103. *Id.*

there is a distinct conflict in the circuits over this problem despite the courts' refusal to acknowledge it. The *Park* case represents the better of the two major decisions addressing this issue. Both the supporting cases and an accurate reading of the statute support this conclusion. Furthermore, the practical problems created by the *Smith* decision are numerous and severe. Despite this fact, subsequent cases have been more prone to adopt the *Smith* decision than the *Park* decision. Nevertheless, the executor can be saved these problems if the estate planner utilizes the *Vatter* decision to avoid the regulations. By empowering the executor to sell the assets, and by having the trustee refuse to accept property in kind, the estate still should be able to take the section 2053 estate tax deduction. It should be noted, however, that section 642(g) of the Tax Reform Act of 1976 has made it impossible to obtain the benefit of the off-set against sales price in determining gain or loss in computing the income tax. Thus, although the estate deduction probably can be obtained, the executor must consider the collateral consequences of foregoing the income tax deduction. As a result, we can expect to see an increased use of the "Warm's Adjustment" and continued litigation in the courts over the validity of the regulations.

III. The Deductibility of Interest Payments Incurred to Obtain a Deferral of the Estate Tax

A. *Introduction*

An executor often will find that he does not have a sufficient amount of cash to pay the estate tax when it becomes due. This could easily happen when the bulk of the estate consists of a closely held business or when there is no readily identifiable market for the estate's major assets. In this situation the executor has three choices. First, he could dispose of the assets at a loss (and probably against the wishes of the testator and the beneficiaries). Secondly, the executor could obtain a commercial loan and immediately pay the estate tax. This procedure would give the executor a period of years to generate sums to pay back the loan. Thirdly, the executor could attempt to qualify under the deferral sections of the Code and pay the estate tax in installments over a period of years. Clearly the second and third choices are more desirable than the first. Therefore, the problem can be reduced to an inquiry into the financial advisability of obtaining a commercial loan instead of utilizing the deferral procedures provided in the Code. The answer to this question requires a consideration of the deductibility of the interest

charges as an administration expense under section 2053.[104] At the heart of the issue is Revenue Ruling 75-239,[105] which prohibits a section 2053 deduction for interest paid under the deferral sections of the Code. In contrast, the cases seem to indicate that interest paid on a commercial loan will be deductible. Accordingly, the statute, cases, revenue rulings, and regulations bearing on this issue will be examined, and a recommendation will be provided for the executor confronted with this dilemma.

B. The Statutory Framework

(1) The Statute Before 1976

Before the Tax Reform Act of 1976, three Code sections could be utilized to obtain an extension of the date for payment of the estate tax.[106] One of these was section 6166. Under section 6166, an executor could elect[107] to pay the estate tax in up to ten annual installments if the estate's major asset was a closely held business.[108] It was believed that the deferral period would give the business enough time to generate earnings and profits with which to pay the tax and thereby avoid a forced sale of the business.[109] The entire estate tax, however, could not be deferred for ten years. Instead, only the amount of tax attributable to the closely held business could be deferred,[110] and the first installment was due on the regular due date along with the tax not eligible for deferment.[111] In order to qualify for the 6166 deferral, the interests or interest in a closely held business had to exceed thirty-five percent of the gross estate or fifty

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104. *See* note 3 *supra.*

105. 1975-1 C.B. 304.

106. *See* Joseph, *Several Routes Are Available to Obtaining an Extension to File and Pay Federal Estate Tax,* 14 TAX. FOR ACCOUNTANTS 372 (1975).

107. Under § 6166(a) the election must be made before the due date for filing the return.

108. Int. Rev. Code of 1954 § 6166(a); *see* Hocky, *Estate Tax Payments and Liabilities,* in 219 TAX MNGM'T (2d ed. BNA) [hereinafter cited as HOCKY]. The election can be for less than the maximum amount deferrable and for a period shorter than ten years. This is not usually done because an election once made cannot be changed other than by an election to accelerate the payments. Accordingly, an executor normally will elect to defer the maximum amount for 10 years.

109. H.R. REP. No. 2198, 85th Cong., 2d Sess. (1958).

110. In determining the amount eligible for deferment, this simple formula can be used:

$$\frac{\text{value of the closely held business}}{\text{value of the gross estate}} \times \text{estate tax} = \text{amount eligible for deferment.}$$

Int. Rev. Code of 1954 § 6166(b); *see* HOCKY, *supra* note 108, at A-4.

111. Int. Rev. Code of 1954 § 6166(e); *see* HOCKY, *supra* note 108, at A-4. Thus the maximum amount of time for deferral could have been nine years from the date the tax originally was due.

percent of the taxable estate.[112] Further, the Code provided additional limitations by defining "closely held business." To qualify, the decedent's interest in the proprietorship, partnership, or corporation had to constitute a stated percentage of the total interests in the business.[113] The Code also provided for an automatic termination of the installment privilege and an acceleration of the remaining installments if the estate had undistributed net income after the fourth year; money was withdrawn from the business; the business was disposed of; or the installment payments were not made when due.[114]

The second major statutory provision allowing an extension of the time to pay the estate tax was section 6163. Under section 6163, if a reversionary or remainder interest was included in the taxable estate, the tax attributable to that interest could be postponed until six months after the termination of the preceding interest.[115] This provision prevented the hardship imposed by taxing an interest that was not readily salable or readily available as security for a loan.[116] In addition, if "undue hardship" existed, payment with respect to the reversionary or remainder interest could be deferred an additional three years following the six month period after the termination of the preceding estate.[117]

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112. Int. Rev. Code of 1954 § 6166(a). These values shall be values determined for federal estate tax purposes. *Id.* It should be noted that the use of the alternate valuation date may affect the ability of the estate to qualify for this statutory deferral. Similarly, the availability of the deferral may be affected by a decision to deduct expenses on the income tax return instead of on the estate tax return. HOCKY, *supra* note 108, at A-2. Finally, it is possible that an election to receive § 2032A treatment for a farming operation might result in a reduction of the adjusted gross estate to an extent that would eliminate the availability of § 6166.

113. If the business is a sole proprietorship, only the assets actually used in the business are to be considered in making the determination. If the business is a partnership, the decedent must have owned at least 20% of the capital interest in a partnership with ten or fewer partners. If the business is a corporation, the decedent must have owned 20% of tbe voting stock in a corporation with ten or fewer shareholders. Int. Rev. Code of 1954 § 6166(c).

114. Int. Rev. Code of 1954 § 6166(h).

115. Int. Rev. Code of 1954 § 6163(a); *see* HOCKY, *supra* note 108, at A-11. The amount eligible for postponement can be found by using this simple formula:

$$\frac{\text{values of remainder or reversionary interest (minus adjustments)}}{\text{value of gross estate (minus adjustments)}} \times \text{estate tax} = \text{amount eligible for postponement.}$$

Under this formula the value of the remainder interest, the reversionary interest, and the gross estate must be reduced by the amount of claims and losses attributable to the interest, and by any amount deductible with respect to such interest for a charitable transfer or a marital deduction. HOCKY, *supra* note 108, at A-12.

116. *S. Rept. to § 811 of Rev. Act of 1932,* 1939-1 C.B. pt. 2, 535.

117. Int. Rev. Code of 1954 § 6163(b).

The third major statutory section providing for an extension of the time for paying the estate tax was found in section 6161. Under 6161(a)(1), the District Director, upon a finding of reasonable cause, could extend the time for payment of the estate tax for a period not to exceed twelve months following the original due date.[118] Further, under section 6161(a)(2), the District Director could extend the time for paying the estate tax or one of the section 6166 installments for a period of ten years.[119] In order to be eligible for the ten year deferment, the estate had to show that "undue hardship" would result if the deferment was not available.[120]

Under the regulations, "undue hardship" was a more stringent test than "reasonable cause." Under the "reasonable cause" test a delay in marshalling the estate's assets would be sufficient. Similarly, if assets were tied up in litigation or were merely rights to receive money in the future, the reasonable cause test would be satisfied.[121] On the other hand, a mere showing of inconvenience to the estate would not satisfy the undue hardship requirement.[122] The precise line of demarcation between the two tests was not entirely clear. Nonetheless, the regulations indicated that a sale of estate assets at a sacrifice price would be an undue hardship.[123] Likewise, the sale of a closely held business, not qualifying under section 6166, to an unrelated person at its fair market value might cause undue hardship.[124] Thus, even though the estate could not receive a deferment under sections 6163 or 6166, the executor could still obtain an extension if he satisfied one of the two tests in section 6161.[125]

In each of the three statutory deferral sections previously described, the executor was required to pay interest on the unpaid balance of the estate tax. Prior to July 1, 1975, the interest rate in these situations was four percent instead of the six percent rate generally imposed by the Code.[126] Then, on July 1, 1975, section 6621

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118. Since the estate tax return is not due until nine months after death, § 6161(a)(1) effectively allows the payment of the estate tax 21 months after the date of death. Int. Rev. Code of 1954 § 6161(a)(1).

119. Int. Rev. Code of 1954 § 6161(a)(2).

120. *Id.*

121. Treas. Reg. § 20.6161-1(a) (1958).

122. Treas. Reg. § 20.6161-1(a)(2)(ii) (1958).

123. Treas. Reg. § 20.6161-1(a)(2)(ii), Ex. (2) (1958).

124. Treas. Reg. § 20.6161-1(a)(2)(ii), Ex. (1) (1958).

125. Hocky, *supra* note 108, at A-13.

126. Int. Rev. Code of 1954 § 6601(b) provides:

> If the time for payment of an amount of tax imposed by chapter 11 is extended as provided in section 6161(a)(2) or 6166, or if the time for payment of an amount of such tax is postponed or extended as provided hy section 6163, interest shall he paid at the rate of 4 percent, in lieu of 6 percent as provided in subsection (a).

became effective. That section increased the general interest rate to nine percent and eliminated the special rates for the deferral sections.[127] Thus an executor receiving an extension under sections 6166, 6163, or 6161 was required to pay interest at the rate of nine percent on the unpaid balance of the estate tax.

The nine percent rate did not last long, however, because of the provision in section 6621(b) providing for an adjustment of the interest rate. According to that provision, the Secretary was required to adjust the Code's interest rate every October 15 to an amount equal to ninety percent of the adjusted prime rate charged by commercial banks.[128] As authorized by Congress, Revenue Ruling 75-487[129] set the interest rate, effective as of February 1, 1976, at seven percent per annum.[130] This, of course, meant that the interest rate under the three deferral sections also was seven percent.

(2) Changes Produced by the Tax Reform Act of 1976

The Tax Reform Act of 1976 made significant changes in the statutory framework under which an executor could defer the payment of the estate tax. One of the most important changes removed the "undue hardship" standard and substituted a "reasonable cause" standard for the ten year extension provided in section 6161(a)(2).[131] This change applies to both the estate tax itself and

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127. The Committee Reports to § 6621 indicate that the 6% rate was higher than the prevailing commercial rate when the 6% rate was originally estahlished. This differential was supposed to be an incentive to encourage the prompt payment of taxes. When the commercial rates became higher than the Code rate, taxpayers began to "borrow" tax funds at the low 6% rate. To remedy this situation, and to restore the original purpose of the 6% rate the Committee approved an increase of the 6% rate to 9%. S. Rep. No. 1357, 93d Cong., 2d Sess. 18-21 (1974). In approving the demise of the special rate for the deferral section, the Committee stated:

> [T]he Committee sees no sound reason to permit some taxpayers to pay interest at a lower rate than other taxpayers are required to pay on underpayments of tax. Relief from the hardship of paying taxes in a lump sum should not also mean that the interest rate should be reduced if payments are made in installments. This is particularly so if a closely held business owned by an estate, or a business which has recovered an expropriation loss, is or can be earning a significantly higher return on the tax money which it presently can, in effect, borrow from the Government at 4 percent.

Id. at 19-20.

128. Int. Rev. Code of 1954 §§ 6621(b), 6621(c).

129. 1975-2 C.B. 488.

130. *Id.*

131. I.R.C. § 6161(a)(2), as amended by the Tax Reform Act of 1976, now provides:

> The Secretary may, for *reasonable cause,* extend the time for payment if—
>
> (A) any part of the amount determined by the executor as the tax imposed by chapter 11, or
>
> (B) any part of any installment under section 6166 or 6166A (including any part of a deficiency prorated to any installment under such section), for a reasonable period

to any installments under section 6166.[132] This change will have the effect of making the estate tax deferments much easier to obtain.[133]

A second and similar change in section 6163 allows a three year extension beyond the termination of the preceding estate for "reasonable cause" instead of "undue hardship."[134] Again, this should increase the availability of the extension.

Perhaps the most important change made by the 1976 Act deals with section 6166 and the closely held business. The Tax Reform Act of 1976 redesignated section "6166" as "6166A" and left the entire provision intact. In addition, a new deferral section was added as section "6166." Under the new section, an executor can elect to pay no tax for the first five years, followed by ten yearly installments.[135] To qualify, the value of the closely held business (or farm) must exceed sixty-five percent of the adjusted gross estate.[136] The definition of a closely held business has been expanded to include a family farm, and the number of partners or shareholders connected with the business can be as high as fifteen.[137] The new section also makes it easier for multiple business interests to qualify,[138] while restricting the amount of the business that can be disposed of before the acceleration rules are brought into play.[139]

As with "old" section 6166, an annual interest payment must be made on the unpaid balance of the estate tax. Under the new law,

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> not in excess of 10 years from the date prescribed by section 6151(a) for payment of the tax (or in the case of an amount referred to in subparagraph (B), if later, not beyond the date which is 12 months after the due date for the last installment).

(emphasis added).

132. *Id.*

133. I.R.C. § 6161(b)(2) also substituted the "reasonable cause" standard for the "undue hardship" standard when an executor obtains a four year extension for the payment of an estate tax deficiency.

134. I.R.C. § 6163(b).

135. I.R.C. § 6166(a)(1). As with "old" section 6166, only the amount of the tax attributable to the closely held business is eligible for the extension. I.R.C. § 6166(a)(2); *see* note 110 *supra*. There is also a new lien procedure available to the executor deferring estate tax payments under §§ 6166 and 6166A. Under § 6324A an executor can be discharged from personal liability for the extended tax payments if the appropriate agreements are signed.

136. This threshold requirement is more stringent than that which applies to § 6166A. The Committee Report explained this change by stating: "On the other hand, your committee believes tbat the relatively low percentage thresholds for qualification for the 10-year extension are, for the most part, unnecessary." H.R. REP. No. 1380, 94th Cong., 2d Sess. 30 (1976).

137. I.R.C. §§ 6166(b)(1), 6166(b)(3). It should also be noted that if the special use valuation is elected for the estate's farm under § 2032A, this asset will constitute a smaller percentage of the gross estate. This, in turn, may make the deferral sections unavailable, or at least reduce the amount of tax eligible for deferral.

138. I.R.C. § 6166(c).

139. I.R.C. § 6166(g)(1) provides that a disposition of one-third of the business will invoke the acceleration rules instead of one-half as is used in § 6166A.

however, there is a special interest rate of four percent on the estate tax that is attributable to the first one million dollars of farm or other closely held business property.[140] The seven percent rate will continue to apply to amounts in excess of that attributable to the first million dollars. The committee reports indicate that Congress reinstated the low interest rate because of its belief that many businesses are not profitable enough to pay both the estate tax and a high rate of interest.[141]

The changes made by the Tax Reform Act of 1976 make it much easier for an estate to qualify under the statutory sections providing extensions for the payment of the estate tax. In addition, "new" section 6166 is an especially attractive alternative because of its low interest rate and long deferral period. If the executor can qualify under its more rigid requirements, the estate can benefit greatly from the increased extension of the time for paying the tax while continuing to operate the closely held business.

C. *The Deductibility of Interest Paid on Commercial Loans or Under the Statutory Deferral Sections*

In Revenue Ruling 75-239,[142] one thousand shares of stock in a closely held business were included in the decedent's gross estate. One-half of the estate tax liability was attributable to the stock. The executor filed an election to pay this one-half of the tax in ten installments under section 6166. Following the election, the executor attempted to deduct the amounts paid in interest on the unpaid balance as an administration expense under section 2053.[143] Thus the issue presented in Revenue Ruling 75-239 was whether interest payments by an executor electing to pay the estate tax in installments under section 6166(a) of the Code are deductibile as an administration expense under section 2053(a)(2).

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140. I.R.C. § 6601(j).

141. The Committee reported:

> Allowing the reduced interest rate at a 4 percent level for a limited amount of tax is intended to reflect the problems that smaller businesses have in generating enough income and cash flow to pay interest at a normal rate and amortize the principal amount of the estate tax liability. It is felt that the 5-year deferral period plus the reduced interest rate on the tax attributable to the first $1 million in value of a closely held business should, in most cases, give the business time to generate sufficient funds to pay the estate tax and interest thereon without the business having to be sold to satisfy the estate tax liability (including a period for adjustment after the loss of one of the principal owners).

H.R. REP. No. 1380, 94th Cong., 2d Sess. 32 (1976).

142. 1975-1 C.B. 304.

143. *Id.*

The Internal Revenue Service held in Revenue Ruling 75-239 that the interest expense was *not* deductible as an administration expense under section 2053. In order to justify this position, the Service cited section 6601(f)(1)[144] for the rule that interest paid under 6161(a)(2), 6163, or 6166[145] is to be treated as "assessed, collected, and paid in the same manner as taxes."[146] Having found the "interest" to be treated as part of the "tax," the Service went on to say that there is no provision for the deduction of federal estate or state inheritance taxes[147] and, accordingly, disallowed the executor's claimed deduction.

In support of its holding, the Service relied primarily on two authorities. First, it cited Treasury Regulation section 20.2053-3 for the proposition that unpaid income and gift taxes of the decedent *could* be deducted, but federal estate taxes could *not*. That regulation does not really express a position regarding the deductibility of estate taxes. Treasury Regulation section 20.2053-6(c) does, however, state that "no estate, succession, legacy, or inheritance tax payable by reason of the decedent's death is deductible. . .";[148] thus the Service's position as to the nondeductibility of federal estate taxes is supported by the regulations.

The second authority relied upon by the Service was the Seventh Circuit case of *Ballance v. United States.*[149] In *Ballance* the executor elected to pay the estate tax in installments as allowed under the provisions of the Internal Revenue Code of 1939.[150] The executor paid the Service $24,897 in interest because of the installment election[151] and attempted to deduct this amount as an admin-

144. I.R.C. § 6601(f)(1) (unchanged by the Tax Reform Act of 1976) provides:

> Interest prescribed under this section on any tax shall be paid upon notice and demand, and shall be assessed, collected, and paid in the same manner as taxes. Any reference in this title (except subchapter B or chapter 63, relating to deficiency procedures) to any tax imposed by this title shall be deemed also to refer to interest imposed by this section on such tax.

145. I.R.C. § 6601(b) states that § 6601 is the governing section of the Code for interest imposed under §§ 6161(a)(2), 6163, and 6166. This is unchanged by the Tax Reform Act of 1976, and, in addition, "new" § 6166(f)(2) apparently intends to treat the 15 year deferral provision in the same manner.

146. I.R.C. § 6601(f)(1).

147. Rev. Rul. 75-239, 1975-1 C.B. 304.

148. Treas. Reg. § 20.2053-6(c) (1958).

149. 347 F.2d 419 (7th Cir. 1965).

150. *See* Int. Rev. Code of 1939, §§ 890, 891.

151. Interest of $24,897 was paid as a result of the installment payments of the estate tax. The installment method was available because the sale of the leasehold and partnership interest in oil properties (comprising the bulk of the estate's assets) could not be accomplished except at a sacrifice. 347 F.2d at 420.

istration expense.[152] The Seventh Circuit disallowed the deduction. The court found local law allowing the deduction of federal estate taxes for state inheritance tax purposes irrelevant, deeming the "local law" provision of the 1939 counterpart to section 2053 subservient to the more specific deferral sections that treated the interest as part of the tax.[153] The court then found "no basis for imputing to Congress a concomitant intent that the general provision relating to administration expenses was to afford an avenue through which the *amount of the tax itself* was to be reduced because of the interest exacted for the delay in its payment (emphasis added)."[154] As can be seen, this is precisely the reasoning of Revenue Ruling 75-239, and, accordingly, the ruling is solidly supported by the *Ballance* case.

It is important to note that the Service's Revenue Ruling distinguished the cases of *James S. Todd,*[155] and *Hipp v. United States.*[156] In both of these cases the executor found that the estate did not contain sufficient liquid assets to pay the estate tax. To meet this problem, the executors obtained loans from private lenders, paid the estate tax,[157] and attempted to deduct the interest expenses as administration expenses under section 2053(a)(2). In both cases the deduction was *allowed.* The *Hipp* court (and the Service in Revenue Ruling 75-239)[158] distinguished these factual situations from the *Ballance* case because the private loans did not extend the time for payment of the estate taxes under the statutory provisions. This meant that the government was not deprived of its money for any period of time, and the interest was not really part of the "tax."[159] Thus the executor could deduct the interest.

152. *See* Int. Rev. Code of 1939, § 812(b)(2).

153. 347 F.2d at 421.

154. *Id.*

155. 57 T.C. 288 (1971), *acq.* 1973-2 C.B. 4.

156. 72-1 U.S. Tax Cas. ¶ 12,824 (D.S.C. 1971).

157. In *Todd* the executor borrowed $300,000 from the decedent's cattle company at 6.25% per annum. The loan was required to pay the estate tax because the estate did not possess any liquid assets, and the sale of the nonliquid assets would have been at "forced sale" prices. When the loan was repaid, $31,927 in interest had accrued and was paid to the cattle company. Some of this amount was deducted on the fiduciary's income tax return, and the remainder ($23,013.80) was sought as a deduction on the estate tax return under § 2053. 57 T.C. at 292.

In *Hipp* the decedent's estate was valued at $723,693 of which $617,975 consisted of stock in a life insurance company. Because the stock was a "thin-market" stock, the executor believed a sale of the stock would drive the market price down. To avoid this, a loan was obtained to pay the estate tax, and $24,211 in interest was paid on the loan. This is the amount the executor sought to deduct under § 2053. 72-1 U.S. Tax Cas. at 84,678.

158. 1975-1 C.B. at 306.

159. 72-1 U.S. Tax. Cas. at 84,680.

The Revenue Ruling, *Ballance, Todd,* and *Hipp* teach that interest paid to a private lender on a loan to pay the estate tax *is* deductible but interest paid to the government under the statutory deferral sections is *not* deductible. Obtaining a deduction for the interest paid on a private loan, however, is not quite that simple. In both *Todd* and *Hipp* the court required the estate to comply with the regulations under section 2053 in order to obtain the deduction. This meant that the expense had to be "allowable" under local law and the expense had to be "necessary." In each case the court found that the illiquidity of the estate, coupled with the probability of a sacrifice sale, justified a finding that the expense was necessary.[160] In contrast, the court in *Hibernia Bank v. United States*[161] found that the interest payments were not "necessary," because the executor could have sold some of the estate's assets at their fair market value in order to pay the tax. Consequently, the deduction was disallowed.[162] Therefore, even if the interest is paid to a private lender instead of the Service, an executor should be careful to comply with the regulations under section 2053 (to the extent they are valid),[163] as well as making sure that the deduction is allowable under local law.[164]

D. *Criticism and Comment*

An analysis of the authorities relied upon in Revenue Ruling 75-239 reveals that the Internal Revenue Service is probably correct in denying a deduction for the interest payments incurred under the statutory deferral sections. Both the Service's statutory interpretations and the case law compel a disallowance of the deduction.[165] Nevertheless, the *Todd* and *Hipp* cases were correctly decided. Re-

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160. In *Todd* the court found that the Texas Probate Code allowed the executor to borrow funds to pay for the estate tax. 57 T.C. at 295-96. The fact that a sale of the estate's assets would have resulted in "reduced prices" made the sale "necessary." *Id.* at 296.

In *Hipp* the court found that the expense was allowable under South Carolina law, and was in fact allowed by the probate court. 72-1 U.S. Tax Cas. at 84,678. The court also found "that it was necessary to acquire funds to pay the estate tax liabilities without sacrificing the assets of the estate." *Id.* at 84,680.

161. 75-2 U.S. Tax Cas. ¶ 13,102 (N.D. Cal. 1975).

162. In *Hibernia* the California probate court had approved interest payments totaling $196,210. The district court found the interest payments to be unnecessary because the executor could have sold bank stock to raise the cash, or he could have distributed the unprofitable real estate in kind. 75-2 U.S. Tax Cas. at 88,901.

163. *See* section II of this Note for a discussion of the validity of the Treasury Regulations applicable to § 2053.

164. *See* Maehling v. United States, 67-2 U.S. Tax Cas. ¶ 12,486 (S.D. Ind. 1967); *cf.* Estate of Webster, 65 T.C. 968 (1976).

165. *See* notes 148-54 *supra* and accompanying text.

call that in those cases the courts allowed the deduction because the Treasury was not being deprived of money that "rightly belonged" to the Treasury.[166] Viewing all of these cases together, a curious fact becomes immediately apparent: whether the estate obtains a private loan or utilizes the statutory deferral sections, it is required to pay interest for the privilege of paying its tax obligation in yearly installments. Yet under the private loan situation, the executor can receive a large section 2053 deduction for the interest payment and thereby reduce the amount of the tax he is required to pay.[167] Therefore, even if the estate can qualify for a deferral under the Code, it may be cheaper for the executor to forego a utilization of the statutory provisions and obtain a commercial loan instead.

The economic advantages of obtaining a private loan can be illustrated by the following example.[168] Assume a gross estate in 1981

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166. *See* notes 155-59 *supra* and accompanying text.

167. *Id.*

168. The calculations for the example are as follows:

	Calculations under the deferral sections with interest at 7%		Calculations using a private loan with interest at 8%	
	2,000,000	Gross estate	2,000,000	
(without int.	200,000	§§ 2053, 2054 Deductions	246,760	(with interest
deduction)	1,800,000	Adjusted gross estate	1,753,240	deduction)
	900,000	Marital deduction	876,620	
	900,000	Taxable estate	876,620	
	306,800	Tentative Tax	297,681	
	47,000	Unified Credit	47,000	
	259,800	TAX DUE	250,681	

$$\frac{1{,}000{,}000 \text{ (value of closely held business)}}{2{,}000{,}000 \text{ (gross estate)}} \times 259{,}800 \text{ (tax)} = 129{,}900 \text{ (amount eligible for deferment)}$$

(Payments)

[deferral sections]				[private loan]		
(non-deferrable portion of tax)	(install-ment)	(interest)		(non-deferrable portion of tax)	(install-ment)	(interest)
129,900	+ 12,990	+ 8,183	—Year 1—	129,900	+ 12,990	+ 9,352
	12,990	+ 7,274	—2—		12,990	+ 8,313
	12,990	+ 6,365	—3—		12,990	+ 7,274
	12,990	+ 5,455	—4—		12,990	+ 6,235
	12,990	+ 4,546	—5—		12,990	+ 5,196
	12,990	+ 3,637	—5—		12,990	+ 4,156
	12,990	+ 2,727	—7—		12,990	+ 3,117
	12,990	+ 1,818	—3—		12,990	+ 2,078
	12,990	+ 909	—9—		12,990	+ 1,039
	12,990	+ 0	—10—		12,990	+ 0
		40,914	. . . . . . Total Interest Payments			46,760

259,800	Tax Paid	250,681
40,914	Interest Paid	46,760
300,714	Total Expenditures	297,441

300,714	Expenditures under code provisions
297,441	Expenditures using private loan
3,273	Savings

of $2,000,000 with section 2053 and section 2054 deductions of $200,000 (not including a deduction for the interest expense). In this situation the adjusted gross estate is $1,800,000. Assuming the maximum marital deduction, the taxable estate is $900,000.

Further assume that the gross estate includes a qualifying closely held business or unmarketable assets worth $1,000,000. The estate therefore probably would qualify for the statutory deferral under either section 6161 or section 6166A, but not section 6166.[169]

If no gifts were made by the decedent, the tax payable, after the subtraction of the unified credit,[170] would be $259,800. Of this amount, $129,900 could be deferred in ten yearly installments of $12,990. At the current seven percent rate applicable to sections 6166A and 6161, the executor would pay $40,914 in interest over the ten year deferral period. Adding this figure to the estate tax, the expenditures of the executor would equal $300,714.

Now assume that instead of proceeding under the statutory deferral sections the executor obtained an eight percent commercial loan.[171] If the amount obtained from the loan was the same as the amount deferred under the statutory sections, the executor would pay $46,760 in interest over ten years. In addition, the interest payments would be deductible under section 2053 as an administration expense, and the taxable estate would be $876,620. The estate tax on this amount would be $250,681. Adding the estate tax and the interest, the total expenditures would equal $297,441—$3,273 *less* than the amount expended by taking advantage of the deferral provisions in the Code.

Further comments on the above example are appropriate. First, note that over $3,000 is saved by procuring a private loan. Secondly, this saving occurs regardless of whether the loan can meet the requirements for qualification under the Code. Additionally, the es-

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Value of closely held business	$1,000,000
35% of gross estate	$ 700,000
50% of taxable estate	$ 450,000
65% of adjusted gross estate	$1,170,000

170. *See* I.R.C. § 2010.

171. It must be noted that a bank loan may not be available to many estates whose major asset is stock in a closely held business because such stock may be considered poor collateral. Lewis & Barcal, *Estate Planning for Closely Held Business Interests*, 1976 U.S.C.L. CENTER, TAX INST. 117, 180. Especially in those situations it may be wise for the executor to consider using a § 303 redemption in connection with a deferral of the estate tax under § 6166 or § 6166A. *See* Rosen, *New Tax Savings Opportunities in Post-Mortem Planning Provided by Tax Reform Act of 1976*, 1977 TAX. FOR LAW. 202, 205-06.

tate planner and decedent are not burdened with pre-mortem planning in order to insure that the estate qualifies under the Code.[172] Thirdly, observe that the savings are actually greater than the example indicates. Since the estate tax is reduced, the executor might not need to borrow as much as $129,900. If he does not, the interest payments will be less (as will the deduction). If he does, he will have more cash available for other purposes.

It should be noted that the profitability of the commercial loan depends in large part upon the interest rate charged by the private lender. If the rate is significantly higher than the statutory rate (two points or more in the example), the deferral provisions of the Code probably will be cheaper. The four percent rate charged under "new" section 6166 will probably be more advantageous than any commercial loan likely to be available, but the stringent requirements for qualification under this section may make the provision unavailable.

One final factor also must be considered. It is likely that many executors may attempt to take a deduction for the interest expense on the fiduciary's income tax return. While Revenue Ruling 75-239 is restricted to an estate tax deduction,[173] it remains unlikely that the interest expense would be a valid income tax deduction. In arriving at this conclusion a three step analysis is appropriate. First, the *Ballance* case and the Revenue Ruling dictate that interest under the statutory deferral sections is part of the tax.[174] Secondly, it should be observed that income tax deductions for an estate are generally the same as those deductions available to an individual.[175] Finally, it is clear that individuals are generally prohibited from taking an income tax deduction for estate taxes.[176] Following this analysis, it is unlikely that an interest expense can properly be deducted on the fiduciary's income tax return.[177]

In conclusion, the executor should consider the possibility of securing a private loan instead of opting for the Code provisions providing a deferral of the time for paying the estate tax. The executor and the decedent will not be burdened by pre-death adjustments to the business and the estate in order to insure compliance with the

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172. *See* note 112 *supra.*

173. 1975-1 C.B. at 306.

174. *See* notes 145-47 *supra* and accompanying text.

175. 3 FED. TAXES (P-H) ¶ 28,000.

176. I.R.C. § 275(a)(3); *see* L.B. Foster Co. v. United States, 248 F.2d 389, 392 (3d Cir. 1957); Treas. Reg. § 1.164-2(c) (1960); 2 FED. TAXES (P-H) ¶ 13,202.

177. *Contra* Lewis & Barcal, *Estate Planning for Closely Held Business Interests,* 1976 U.S.C.L. CENTER TAX INST. 117, 183.

statutory requirements. Additionally, there may be a significant tax savings. A possible detrimental aspect of this procedure may be the judicially-imposed requirement that the interest expense be necessary. This will probably not be a major obstacle because the executor will seldom consider deferring the estate tax if the interest expense is not "necessary" as required by the regulations. Finally, if the estate can meet the requirements of "new" section 6166, its four percent interest rate probably will make that statutory provision more attractive than any other procedure. In all other cases the executor would be wise to consider the private loan alternative.

IV. THE DEDUCTIBILITY UNDER SECTION 2053 OF VALID CLAIMS AGAINST THE ESTATE NOT FILED IN THE PROBATE COURT

A. *Introduction*

Section 2053(a) of the Internal Revenue Code allows claims against the estate to be deducted from the decedent's gross estate in determining the taxable estate.[178] This deduction is allowed in order to ensure that only the property actually passing at death will be taxed.[179] Section 2053(a) requires only that the claim be allowable under local law. Treasury Regulation section 20.2053-4 further limits the deduction to claims that are *enforceable* under the laws of the jurisdiction where the estate is being administered.[180] Neither the Code nor the regnlations indicate what effect events after the decedent's death should have on the deductibility of claims against the decedent's death.[181] Specifically, they do not address the question whether a deduction can be obtained when an executor pays a claim informally presented to him, even though local law requires that the creditor file his claim in the probate court. In 1975, the Internal Revenue Service issued two Revenue Rulings holding that

178. I.R.C. § 2053(a) is set forth in note 3 *supra*.

179. Kahn v. United States, 20 F. Supp. 312 (S.D.N.Y. 1937).

180. Treas. Reg. § 20.2053-4 (1958) provides in part:

Only claims enforceable against the decedent's estate may be deducted. Except as otherwise provided in § 20.2053-5 with respect to pledges or subscriptions, section 2053(c)(1)(A) provides that the allowance of a deduction for a claim founded upon a promise or agreement is limited to the extent that the liability was contracted bona fide and for an adequate and full consideration in money or money's worth . . . .

181. For a discussion of the effect of post-mortem occurrences on probate administration, see Note, *Federal Estate Taxation: Recent Developments in the Deductibility of Claims Against the Decedent's Estate and Their Effect in Illinois*, 52 CHI.-KENT L. REV. 664 (1976); Comment, *Estate and Income Tax: Claims Against the Estate and Events Subsequent to Death*, 22 U.C.L.A. L. REV. 654 (1975); Comment, *Effect of Events Subsequent to the Decedent's Death on the Valuation of Claims Against His Estate Under Section 2053 of the Federal Estate Tax*, 1972 U. ILL. L.F. 770; 10 WAKE FOREST L. REV. 328 (1974).

a deduction will be disallowed under these circumstances.[182] This portion of the note will examine these Rulings and the cases pertinent to the issue the Rulings purport to decide. The implications of the Rulings will be considered under the Uniform Probate Code and in a jurisdiction such as Tennessee where creditors are required to file their claims in the probate court. Finally, recommendations will be suggested for the executor confronted with these problems.

B. The Revenue Rulings and Their Ramifications

In Revenue Ruling 75-24, the decedent, a Mississippi resident, died owing an unsecured debt. Three months after the decedent's death, the creditor asserted his claim against the executor. The executor paid the debt with the approval of the beneficiaries and deducted the claim on the estate tax return.[183] Because section 2053(a) provides deductions only for those claims that are allowable under local law,[184] the Internal Revenue Service felt obligated to examine the applicable Mississippi law in order to determine whether the amount expended to satisfy the debt was deductible. Under the Mississippi Code, a fiduciary is prohibited from paying any claim that has not been filed in and allowed by the probate court.[185] Nonetheless, in *Townsend v. Beavers*,[186] the Mississippi Supreme Court held that an executor could not be surcharged for paying a valid but unfiled claim when the distributees of the estate had consented to the payment.[187] According to the Service, this case meant that in Mississippi the payment of the unfiled claim in the Revenue Ruling was "allowable," and therefore deductible despite the statutory filing requirement.[188]

Revenue Ruling 75-177[189] presented a similar factual situation. An unsecured creditor of the decedent informally presented his claim to the executor instead of filing his claim in the Florida probate court. With the consent of the beneficiaries, the claim was paid and a deduction was taken for the amount of the debt on the federal estate tax return. Again the Service considered the local law of probate administration.[190] As in Mississippi, the Florida Code re-

182. Rev. Rul. 75-24, 1975-1 C.B. 306; Rev. Rul. 75-177, 1975-1 C.B. 307.
183. 1975-1 C.B. at 306.
184. *See* note 3 *supra* and accompanying text.
185. MISS. CODE ANN. § 91-7-151 (1972).
186. 185 Miss. 312, 188 So. 1 (1939).
187. 1975-1 C.B. at 306.
188. *Id.* at 307.
189. *Id.*
190. *Id.*

quired creditors to file all claims in the probate court within six months from the date the notice to creditors was first published.[191] Unlike the Mississippi court, however, the Florida Supreme Court had stated clearly that the filing of the claim could not be waived regardless of whether the beneficiaries had approved the payment.[192] Thus, in the case considered in the Revenue Ruling, the claim was not "allowable" and therefore could not be deducted. The Service did concede, however, that an exception would be made if the creditor was also the sole beneficiary of the estate.[193]

If the position of the Revenue Rulings is sustained by the courts, an executor administering an estate in a jurisdiction requiring the filing of claims will face many severe problems. If the executor pays the claim without requiring a filing in the probate court, he may subject himself to personal liability.[194] If the executor pays the claim without obtaining a corresponding estate tax deduction, he has caused a reduction in the amount of property available for distribution to the beneficiaries without decreasing the amount of the estate tax. In addition, if the claim is later determined to be void because of the creditor's failure to file, the service might consider the cancellation of the obligation as a receipt of income, thereby causing an increase in the income taxes as well.[195] Should these results obtain, a beneficiary probably would be successful in a suit to surcharge the executor.

Other problems created by an application of the position set forth in the Revenue Rulings are simply those of time and expense. If obviously valid claims are required to be filed in order to obtain the estate tax deduction, the executor will have to force all creditors to go to the time, expense, and trouble to file their claims. This, in

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191. At the time letters testamentary were issued, the Florida Code absolutely required a filing of all claims. FLA. STAT. ANN. § 733.16 (West 1965). Less than four months later the Florida statute was amended to allow the executor to pay unfiled claims with the consent of all the beneficiaries so long as the claim was presented informally to the executor within the regular statutory time period for filing. The Service stated that if this law had been in effect at the time the letters were issued, the deduction would have been allowed as in Rev. Rul. 75-24. 1975-1 C.B. at 307.

192. Twomey v. Clausohm, 234 So. 2d 338 (Fla. 1970).

193. This concession was given in both the Revenue Rulings. *See, e.g.*, Howells v. Fox, 251 F.2d 94 (10th Cir. 1957).

194. *See, e.g.*, the personal liability provisions of Florida and Mississippi as discussed in the Revenue Rulings considered at note 182 *supra*.

195. The recent cases of Estate of Hagmann, 60 T.C. 465 (1973), *aff'd per curiam*, 492 F.2d 796 (5th Cir. 1974), and Estate of Bankhead, 60 T.C. 535 (1973), may compel this result. For a discussion of this specific effect of a creditor's failure to file his claim, see Comment, *Estate and Income Tax: Claims Against the Estate and Events Subsequent to Date of Death*, 22 U.C.L.A. L. REV. 654, 657 (1975); 10 WAKE FOREST L. REV. 328, 333 (1974).

turn, will place an increased burden on the state probate courts. The filing requirement also will create an unnecessary delay in the payment of the decedent's debts. Creditors will be forced to await approval by the probate court, and this may be a considerable length of time, depending on the extent of the congestion caused in the courts by the filing requirement.[196] Further, the executor will be left with no discretion. Instead, he will be forced to insure that every valid and bona fide obligation is brought to the probate court's attention where it probably will receive only perfunctory attention. Because of the severe consequences of the Revenue Rulings, the following subsection considers their validity.

C. *The Case Law*

Under section 2053, an executor can obtain a deduction for claims against the decedent's estate if they are "allowable" under local law. In addition, the regulations require that the claims be "enforceable" against the estate.[197] The unanswered question is when must the allowability or the enforceability of the claim be determined. If determined as of the decedent's death, valid obligations of the decedent are clearly allowable and enforceable regardless of whether they are later filed in the probate court. From this perspective, all valid claims paid by the executor existing at the decedent's death should be deductible. On the other hand, if the actual events occurring after the decedent's death are considered, the deduction should not be permitted. This would happen when a creditor failed to file his claim in the probate court as required by statute. In that event the claim would become void, and therefore not allowable or enforceable by the probate court. Hence the deduction would not be available.[198]

Both of the theories discussed above have considerable support in the case law. The leading case prohibiting a consideration of events occurring after the decedent's death is *Ithaca Trust Co. v. United States.*[199] In *Ithaca Trust* the decedent left the residue of his estate to his wife for life with the remainder in trust to charity. The decedent's wife died six months after the decedent and before the

196. At least one writer has stated that the delay caused by a filing requirement should not be too burdensome in view of the delay generally encountered in the processing of the estate tax return. 2 FLA. ST. U.L. REV. 625, 639 (1974).

197. *See* note 180 *supra* and accompanying text.

198. *See* Note, *supra* note 181, at 665; Comment, 22 U.C.L.A. L. REV., *supra* note 181, at 672; Comment, 1972 U. ILL. L.F., *supra* note 181, at 776-77.

199. 279 U.S. 151 (1929).

filing of the estate tax return. In determining the amount of the charitable contribution deduction, the executor sought to deduct an amount equal to the value of the property less the value of the six months interest of the wife. The government, on the other hand, attempted to decrease the amount of the charitable deduction by arguing that the deduction must be determined by subtracting (from the value of the property) an amount equal to the value of the wife's life interest as determined by her life *expectancy* at the decedent's death.[200] Since her life expectancy was more than the six months she actually lived, the value of the charitable deduction would be less if the statistical probability method advocated by the government was used instead of the actual time of her survivorship. The United States Supreme Court held for the government. According to Justice Holmes, the estate should be settled as of the date of the decedent's death.[201] Thus, under *Ithaca Trust,* post mortem events probably should not be considered in determining deductions provided by the Code.

Only six months after *Ithaca Trust,* the Eighth Circuit held that events subsequent to death *could* be considered in determining the deductibility of a claim against the estate. In *Jacobs v. Commissioner,*[202] the decedent had entered into an antenuptial contract with his wife providing that she would be paid $75,000 out of his estate if she would surrender her dower and other marital rights. Under the will, however, the widow was given the option of receiving a life income interest in $250,000 instead of the $75,000 bequest. The widow elected to receive the income interest, but the executors still attempted to deduct $75,000 on the theory that the wife had a valid claim for this amount at the date of the decedent's death. In resolving this question, the court distinguished *Ithaca Trust* on the grounds that it involved a charitable bequest rather than a deduction for a claim against the decedent's estate.[203] The court disal-

200. *Id.*

201. Justice Holmes stated:

> The question is whether the amount of the diminution, that is, the length of the postponement, is to be determined by the event as it turned out, of the widow's death within six months, or by the mortality tables showing the prohabilities as they stood on the day when the testator died. The first impression is that it is absurd to resort to statistical probabilities when you know the fact. But this is due to inaccurate thinking. The estate so far as may be is settled as of the date of the testator's death. . . . The tax is on the act of the testator not on the receipt of property by the legatees. . . . Therefore, the value of the thing to be taxed must be estimated as of the time when the act is done.

Id. at 155.

202. 34 F.2d 233 (8th Cir.), *cert. denied,* 280 U.S. 603 (1929).

203. 34 F.2d at 236.

lowed the deduction by noting that the deduction for claims against the estate was grouped with the deductions for funeral and administration expenses.[204] Since the amount of these deductions could be ascertained only *after* the decedent's death, the court thought that post death events could also be considered in determining the deductibility of claims against the estate. The court also stated that Congress did not intend to provide a deduction for claims that were never paid. Accordingly, the deduction was disallowed.[205]

In the cases subsequent to *Ithaca Trust* and *Jacobs*, the courts have been unable to agree whether post mortem events *(e.g.,* a creditor's failure to file his claim in the probate court) can be considered in passing on the deductibility of a claim against the decedent's estate under section 2053. Until 1957, the courts were usually persuaded by the *Jacobs* rationale.[206] Then, in *Winer v. United States,*[207] the court resurrected the *Ithaca Trust* decision when a claim became unenforceable due to an inadvertant failure to file the claim in the probate court. Citing *Ithaca Trust,* the court sustained the deduction because the claim was allowable and enforceable[208] at the time of the decedent's death.[209] In 1958, the Tax Court also followed *Ithaca Trust,* but was reversed by the Second Circuit in *Estate of Shively.*[210]

Because of the *Winer* decision, the Internal Revenue Service issued Revenue Ruling 60-247.[211] In that Ruling, the Service rejected *Winer* by asserting the validity of the *Jacobs* opinion. In holding that a creditor's failure to file his claim will bar the deduction,[212] the

204. Rev. Act of 1921, ch. 136, § 403(2)(1), 42 Stat. 279 (now I.R.C. § 2053).

205. 34 F.2d at 236.

206. *See, e.g.,* Commissioner v. State Street Trust Co., 128 F.2d 618 (1st Cir. 1942); Buck v. Helvering, 73 F.2d 760 (9th Cir. 1934); Estate of Metcalf, 7 T.C. 153 (1946). *See also* Note, *supra* note 181, at 669; Comment, 22 U.C.L.A. L. REV., *supra* note 181, at 674; Comment, 1972 U. ILL. L.F., *supra* note 181, at 778. *But see* Estate of Wittman, 1952 T.C.M. (P-H) ¶ 52,202.

207. 153 F. Supp. 941 (S.D.N.Y. 1957).

208. *See* note 180 *supra* and accompanying text.

209. 153 F. Supp. at 943-44.

210. 17 T.C.M. (CCH) 965 (1958), *rev'd,* 276 F.2d 372 (2d Cir. 1960). In *Shively* a deduction was claimed for periodic alimony payments. Although the payments were terminated upon the widow's remarriage, the Tax Court still applied *Ithaca Trust* because the possibility of remarriage had been considered in the actuarial valuation of the claim. 17 T.C.M. at 967-68. The Second Circuit disagreed, stating that the estate could obtain "no greater deduction than the established sum, irrespective of whether this amount is established through events occurring before or after the decedent's death." 276 F.2d at 375.

211. 1960-2 C.B. 272.

212. In its holding the Service stated:

> [N]o deduction will be allowed for claims against the estate which have not been paid or will not be paid because the creditor waives payment, fails to file his claim within

Service entirely omitted a discussion of *Ithaca Trust.*

Shortly after the Service's 1960 Revenue Ruling, the Tax Court decided to follow *Jacobs* in *Estate of Shedd.*[213] In 1966, however, a district court in Illinois again rejected *Jacobs* and the holding of Revenue Ruling 60-247. In *Russell v. United States,*[214] the decedent's husband left his children a great deal of stock in a trust to be administered by his wife. During her life, the decedent/trustee sold the assets and commingled the proceeds with her own funds. The children did not learn of the trust until twenty-three months after issuance of letters testamentary to the executor of their mother's estate. At this time they brought an action in the probate court to recover the funds belonging to them under the terms of the trust.[215] Despite the requirement in Illinois that all claims against the estate be filed within nine months of notice to creditors,[216] the probate court approved the beneficiaries' claim. Thereafter, the executor took an estate tax deduction for the amount paid to the children. In approving the deduction, the district court specifically rejected Revenue Ruling 60-247 and found that the word "allowable," as used in section 2053, referred to that instant immediately following the decedent's death. The subsequent event of the creditors' failure to file their claim was irrelevant.[217]

In 1972 and 1973 the Tax Court continued the two conflicting lines of authority when it decided the cases of *Estate of Lester*[218] and *Estate of Hagmann.*[219] In *Lester,* the executor wanted a deduction for the full amount of the purchase price of the annuity he bought to satisfy the decedent's alimony obligation.[220] In a strange reversal of roles, the government contended that the amount of the deduction should be determined according to the value of the debt at the decedent's death.[221] In upholding the Commissioner, the court

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the time limit and under the conditions prescribed by the applicable local law, or otherwise fails to enforce payments.

Id. at 274.

213. 37 T.C. 394 (1961). In returning to the *Jacobs* approach, the court stated that Congress intended to allow a deduction only for those claims actually paid or to be paid. *Id.* at 397.

214. 260 F. Supp. 493 (N.D. Ill. 1966).

215. *Id.* at 496.

216. ILL. ANN. STAT., ch. 3, § 204 (Smith-Hurd 1961).

217. 260 F. Supp. at 499.

218. 57 T.C. 503 (1972).

219. 60 T.C. 465 (1973), *aff'd per curiam,* 492 F.2d 796 (5th Cir. 1974).

220. 57 T.C. at 506.

221. The position taken by the Commissioner was unusual because an event subsequent to death *(e.g.,* failure to file a claim) normally will serve to reduce the amount of the deduction. In *Lester,* however, the purchase of the annuity subsequent to death would increase the deduction.

adopted the position of *Ithaca Trust* and ignored events occurring subsequent to the decedent's death.[222]

In *Hagmann* the executor deducted debts that were valid claims against the decedent's estate. The Commissioner argued that the claims were not allowable or deductible because they were not filed in the probate court as required under Florida law.[223] The executor responded that the claims were allowable at the time of the decedent's death and they were deductible under *Ithaca Trust.* This time the Tax Court rejected the *Ithaca Trust* rationale and held for the government. The court rejected *Russell* and *Winer,* and stated that Congress intended to tax only the net estate passing to the beneficiaries. In order to effectuate that purpose, it was necessary to consider post-death events.[224]

In the five years since *Hagmann* and *Lester,* the Tax Court apparently has settled on a position approving *Jacobs* instead of *Ithaca Trust.* In *Estate of Courtney,*[225] the court stated that "events occurring after the decedent's death must be considered in determining the deductibility of claims under section 2053(a)(3)."[226] This position was reiterated in the memorandum decision of *Estate of Conard.*[227] In that case the court specifically approved the *Jacobs* decision because Congress did not intend to allow a deduction for "theoretical" claims. Another memorandum decision, *Ehret v. Commissioner,*[228] also approved *Jacobs.* The court in *Ehret* clearly stated that the deduction for the payment of the creditor's claim could not be allowed because it was not filed within seven months as required under the law of Illinois.[229]

The most recent Tax Court case in this area and the only one actually to consider the validity of the 1975 Revenue Rulings, is *Estate of Gosch.*[230] The facts in *Gosch* were almost identical to those

222. 57 T.C. at 507.

223. *See* notes 191-92 *supra* and accompanying text.

224. 60 T.C. at 469.

225. 62 T.C. 317 (1974).

226. *Id.* at 322. Under similar facts the same result was reached in Estate of Fawcett, 64 T.C. 889 (1975).

227. 1975 T.C.M. (P-H) ¶ 75,249.

228. 1976 T.C.M. (P-H) ¶ 76,315.

229. The court relied heavily on *Hagmann,* stating:

> We have held under Florida law that where no claims were filed with respect to certain debts of decedent within the statutory period and the claims have not and will not be paid by the estate, such claims are not deductible under section 2053(a)(3). . . . Here under the applicable Illinois law claims not filed in the probate proceeding within seven months of the issuance of letters testamentary are barred as to the estate assets which have been inventoried during that seven month period.

Id.

230. 1976 T.C.M. (P-H) ¶ 76,082.

considered in Revenue Ruling 75-177.[231] The executors paid a claim that was informally presented to them without requiring the creditor to file her claim with the Florida probate court. In disallowing the deduction, the court reluctantly relied on and approved the 1975 Revenue Rulings:

> Although the result may appear to be harsh in this case, we can find no escape from it in view of the Florida statute and the authoritative interpretation of it by the Supreme Court of that state. Our holding is, of course, limited to those estates the administration of which began prior to October 1, 1973. A different and more reasonable result could be reached in cases governed by the later statutory provisions.[232]

Finally, the case of *Estate of Chesterton v. United States*[233] represents the latest Court of Claims decision in this area. In that case the court clearly adopted the *Jacobs* rationale by allowing post-death events to be considered in ascertaining the appropriate amount of an estate tax deduction for alimony expenditures.[234] An examination of the cases indicates that neither *Jacobs* nor *Ithaca Trust* have become controlling on the question whether events subsequent to the decedent's death can be deducted under section 2053. More specifically, it is still unsettled whether an executor can obtain a deduction for a claim against the estate if the creditor has not filed his claim in the local probate court, nor does it appear that the Service's position in the 1975 Revenue Rulings is entirely consistent with the existing case law. It does seem, however, that both the Tax Court and the Court of Claims recently have approved the position of the Commissioner.[235] Accordingly, an executor who intends to litigate the issue should probably pay the tax and sue for a refund in the district court. Of course litigating the issue probably presents a more onerous burden than simply refusing to pay a claim that is not filed in the probate court. As discussed earlier, numerous problems and inconveniences will stem from such a decision, but many of these negative effects will befall the court and creditors instead of the executor.[236] Thus, even though the Revenue Rulings may not be valid, the pragmatics of the situation probably compel compliance with the Rulings by the executor.

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231. *See* notes 189-93 *supra* and accompanying text.
232. 1976 T.C.M. (P-H) at 76-349.
233. 3 FED. EST. & GIFT TAXES (P-H) ¶ 148,145 (Ct. Cl. March 23, 1977).
234. *Id.*
235. *See* notes 224-34 *supra* and accompanying text.
236. *See* notes 194-96 *supra* and accompanying text.

D. The Effect of the Revenue Rulings in Tennessee and in Jurisdictions Where the Uniform Probate Code Has Been Adopted

Like most probate administration statutes, the Uniform Probate Code requires the executor or personal representative to inventory the assets of the estate[237] and publish a notice to creditors in a newspaper of general circulation.[238] Under the scheme of the Uniform Probate Code, all claims against the decedent's estate must be "presented" to the executor within four months of the notice to creditors (or within three years of death if no notice was given) or be forever barred.[239] Although the Uniform Probate Code contains a "non-claim" provision similar to those in many states,[240] it possesses a unique feature in section 3-804. Under that section, "presentment" of the claim is accomplished by either a written notice to the personal representative *or* filing in the probate court.[241] In fact, the comments indicate that the probate court will act merely as a depository with most claims being presented personally to the executor.[242] Although the executor may be personally liable if he pays a claim without requiring presentment,[243] this procedure promotes the prompt and efficient settlement of estates.

In a jurisdiction that has adopted the Uniform Probate Code, it is likely that the 1975 Revenue Rulings will have little effect because the Uniform Probate Code does not require a filing in the probate court. Instead, only presentment is necessary. Under the Revenue Rulings, if the state law does not require a filing of the claims, a deduction can be obtained if the executor simply follows the procedure mandated by the state statute.[244] Thus, in a Uniform

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237. UNIFORM PROBATE CODE § 3-706.

238. UNIFORM PROBATE CODE § 3-801.

239. UNIFORM PROBATE CODE § 3-803(a) provides in part:

> All claims against a decedent's estate which arose before the death of the decedent . . . are barred against the estate, the personal representative, and the heirs and devisees of the decedent, unless presented as follows:
>
> (1) within 4 months after the date of first publication of notice to creditors if notice is given in compliance with Section 3-801 . . . .
>
> (2) within [3] years after the decedent's death, if notice to creditors has not been published.

240. *See, e.g.*, note 247 *infra*.

241. UNIFORM PROBATE CODE § 3-804 provides in part:

> Claims against a decedent's estate may be presented as follows:
>
> (1) the claimant may deliver or mail to the personal representative a written statement of the claim indicating its basis, the name and address of the claimant, and the amount claimed, or may file a written statement of the claim, in the form prescribed by rule, with the clerk of the Court. . . .

242. UNIFORM PROBATE CODE § 3-804, Official Comment.

243. *See* UNIFORM PROBATE CODE, art. III, pt. 8, Official General Comment.

244. Rev. Rul. 75-24, 1975-1 C.B. 306; Rev. Rul. 75-177, 1975-1 C.B. 307, 308.

Probate Code jurisdiction, if the executor paid a valid claim that was not filed, he could still deduct the payment to the creditor on the federal estate tax return.

In Tennessee, Tennessee Code Annotated (T.C.A.) section 30-509 requires the clerk of the court to provide newspaper notice to creditors of the decedent's estate[245] to alert them of the need to file their claims against the estate with the probate court. Under T.C.A. section 30-510, creditors have six months from the date notice was first given to file their claims along with an affidavit asserting the genuineness of the claim.[246] If the creditor fails to file his claim in the county probate court within the specified time period, his claim is forever barred under T.C.A. section 30-513.[247] The only exception to this requirement is T.C.A. section 30-514 which allows the personal representative to waive the filing requirement for claims less than 100 dollars.[248]

Under the statutory framework set forth in the Tennessee Code, it is quite possible that the 1975 Revenue Rulings will have a serious effect on Tennessee executors. Since Tennessee procedure is quite similar to Florida procedure,[249] it is likely that the Internal Revenue Service will eventually impose the rule of Revenue Ruling 75-177 in Tennessee. Recall that this Ruling disallowed a deduction for the payment of an informally presented claim against the estate because the Florida statute absolutely required all claims to be filed in the probate court. Since the Florida and Tennessee statutes are so similar, it is likely that the burdensome filing requirement will

245. TENN. CODE ANN. § 30-509 requires the first of two weekly notices to be published in a county newspaper within 30 days of the issuance of letters testamentary.

246. TENN. CODE ANN. § 30-510 provides in part:

> Within six (6) months from the date of the notice to creditors, required by § 30-509, all persons, resident and nonresident, having claims against the estate of the decedent, . . . shall file them in duplicate with the clerk of the court in which the estate is being administered. . . . [A]nd every claim shall be verified by affidavit of the creditor before an officer authorized to administer oaths, which affidavit shall state that the claim is correct. . . .

247. TENN. CODE ANN. § 30-513 provides:

> All claims and demands not filed with the county or probate court clerk, as required by the provisions of §§ 30-509—30-512 or in which suit shall not have been brought or revised before the end of six (6) months from the date of the notice to creditors, shall be forever barred.

248. TENN. CODE ANN. § 30-514 provides:

> Notwithstanding the provisions of §§ 30-510—30-513, the personal representative, if in his discretion it is deemed proper, may waive the requirement for the filing of and may pay any claim not exceeding one hundred dollars ($100) principal amount. If the act of the personal representative in so doing is brought into question, he will have the burden of showing the validity of the claim so paid.

249. *See* note 191 *supra*.

have to be complied with or the validity of the Revenue Rulings will have to be litigated.

Apparently, under the decisional law of Tennessee there is no exception to the statutory filing requirement. This fact is borne out by the Tennessee Supreme Court case of *Needham v. Moore*,[250] and by an informal attorney general's opinion. T.C.A. section 30-514, which allows the claim to be paid without filing if it is less than 100 dollars, may provide some relief for the executor because many claims will be less than this designated amount. Despite this fact, caution is required because the statute commits the waiver of the filing requirement to the executor's discretion.[252] It is possible that the Commissioner could find an abuse of discretion even though the probate court later approved the payment of the claim. In this situation the deduction again would be lost.

As has been discussed, numerous problems can be expected in the near future in Tennessee because of the recent Revenue Rulings.[253] An amendment to section 2053 by Congress is unlikely. A switch in positions by the Internal Revenue Service would be equally surprising. Accordingly, perhaps the best approach to alleviate these problems would be an amendment to the Tennessee Code. Provisions similar to those in the Uniform Probate Code would be extremely useful.[254] Another possibility would be a code section similar to that recently adopted in Florida.[255] The amendment should authorize the executor to pay *informal* claims presented to him within the six month claims period if the payment has been approved by the heirs, devisees, and beneficiaries of the estate. Such a claim would then be allowable and enforceable under Ten-

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250. 292 S.W.2d 720 (Tenn. 1956).

251. On April 8, 1964, the Tennessee Attorney General considered a question concerning the state inheritance tax. In that opinion, the Attorney General stated that amounts paid to the decedent's creditors for the expenses of his last illness could not be deducted because the claims were not filed in the probate court. In that opinion the Attorney General stated:

> To concur with the position taken by the executor herein would mean that the Department of Revenue would be cast in the role of a probate court in cases such as the one posed, abrogating to itself the right and duty of determining whether or not a deht claimed by a personal representative in his individual capacity was a lawful and proper one, and not excessive. I cannot believe this is the intention of our inheritance tax or probate laws.
>
> You are accordingly advised that in my opinion the expenses claimed cannot be allowed as a deduction.

OP. ASST. ATT'Y GEN., issued to Donald R. King, Commissioner of Revenue (April 8, 1964).

252. *See* note 248 *supra*.

253. *See* notes 194-96 *supra* and accompanying text.

254. *See* notes 237-43 *supra* and accompanying text.

255. *See* Rev. Rul. 75-177, 1975-1 C.B. 307.

nessee law despite the creditor's failure to file. This, in turn, would insure the deductibility of the claim under section 2053.[256] In the meantime, an executor justifiably hesitant to litigate the validity of the 1975 Revenue Rulings should force every creditor to file his claim in the probate court in order to be sure that the claim will be deductible. Although this will cause immense time and expense, the current Internal Revenue Service position leaves the executor no real choice.

JAY D. CHRISTIANSEN

256. *See* Note, *supra* note 181, at 681-82.