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## Estate of Smith - Deductibility of Administration Expenses Under the Internal Revenue Code and Under the Treasury Regulations: Resolving the Conflict

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## ESTATE OF SMITH—DEDUCTIBILITY OF ADMINISTRATION EXPENSES UNDER THE INTERNAL REVENUE CODE AND UNDER THE TREASURY REGULATIONS: RESOLVING THE CONFLICT

The federal estate tax, in effect since 1916, is imposed on the transfer of property at death. Although all property deemed to have been transferred at death must be included in computing the gross estate,<sup>1</sup> the Internal Revenue Code specifies several items that are deducted therefrom<sup>2</sup> in order to determine the taxable estate. One of these deductions is for administrative expenses; pursuant to section 2053(a) of the Code<sup>3</sup> these expenses are deductible if allowable<sup>4</sup> under state law. Treasury

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1. INT. REV. CODE OF 1954, § 2031.

2. INT. REV. CODE OF 1954, §§ 2052-56.

3. Section 2053(a) of the Internal Revenue Code of 1954 provides:

(a) *General Rule*—For purposes of the tax imposed by section 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.*

INT. REV. CODE OF 1954, § 2053(a) (emphasis supplied).

The deductions under section 2053 are designed to take into account the realities of the decedent's financial situation when he died and, therefore, assure an application of the tax rates to a *realistic* taxable estate. The other deduction provisions contained in sections 2052, 2054, 2055 and 2056 are more a matter of Congressional largesse. R. STEPHENS & G. MAXFIELD, *THE FEDERAL ESTATE AND GIFT TAXES* 164 (1959).

Similar provisions were contained in section 812(b) of the Internal Revenue Code of 1939, and in prior Revenue Acts.

4. Section 2053(a) of the Internal Revenue Code of 1954 uses the word "allowable" instead of the word "allowed," which appeared in section 812(b) of the Internal Revenue Code of 1939 and prior corresponding sections. The committee reports do not mention specifically this change in statutory language. The Court of Appeals for the Fifth Circuit has interpreted the change as follows: "This change seems to imply that the policy of the Code is not to rely on formal probated actions in determining permissible deductions. The Eighth Circuit has suggested the reason for

Regulations sections 20.2053-3(a) and (d)<sup>5</sup> impose an additional requirement, however, on expenses connected with the sale of property of the estate; a deduction is permitted only if the sale is necessary to pay debts or taxes, to preserve the estate, or to effect distribution.

In *Estate of Smith v. Commissioner*<sup>6</sup> the executors challenged the validity of these regulations. The expenses in question had been allowed by the state probate court, but the Tax Court<sup>7</sup> found this fact insufficient to establish their deductibility under section 2053(a). The court held that the statute establishes only a threshold condition and that "the requirements of [the] regulations must also be satisfied."<sup>8</sup> On appeal by

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this policy: Section 2053(a) is meant to apply anywhere in the world, 'even in countries where administration of estates is had otherwise than through courts, if any such countries exist.' Pitner v. United States, 388 F.2d 651, 655 (5th Cir. 1967), quoting Commissioner v. Bronson, 32 F.2d 112, 114 (8th Cir. 1929) (emphasis supplied by Pitner Court). For another explanation, see 4 J. MERTENS, THE LAW OF FEDERAL AND ESTATE TAXATION § 2602, at 7 n.7 (1959).

5. Treasury Regulation section 20.2053-3(a) 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(a) (1958).

Treasury Regulation section 20.2053-3(d) (2) provides:

"(d) *Miscellaneous administration expenses.* . . .

(2) 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."

Treas. Reg. § 20.2053-3(d) (2), T.D. 6826, 1965-2 CUM. BULL. 367, 368.

6. 510 F.2d 479 (2d Cir. 1975), *aff'g* 57 T.C. 650 (1972), *cert. denied*, *Lowe v. Commissioner*, 44 U.S.L.W. 3201 (U.S. Oct. 7, 1975).

7. *Estate of David Smith*, 57 T.C. 650 (1972). The validity of the regulations was not challenged in the Tax Court; for a discussion of the procedural development of this issue, see note 69 *infra*.

8. *Id.* at 661.

the executors, the Court of Appeals for the Second Circuit affirmed<sup>9</sup> without specific approval of this language; the validity of the regulations was not considered. Instead, the court held that the Tax Court merely had exercised the prerogative of a federal court, when applying a federal taxing statute, to make its own de novo determination of the relevant state law.<sup>10</sup>

The Court of Appeals for the Second Circuit failed to consider a prior decision declaring the regulations invalid. In *Estate of Park v. Commissioner*<sup>11</sup> the Court of Appeals for the Sixth Circuit had rejected the reasoning of the Tax Court in the *Smith* case. *Park* held that the literal language of section 2053(a) provides that the deductibility of administrative expenses be governed exclusively by their allowability under state law.<sup>12</sup> As the expenditures at issue had been allowed by the state probate court, they were necessarily deductible under section 2053(a).<sup>13</sup>

#### CASE LAW PRIOR TO SMITH

Because courts, prior to *Smith* and *Park*, did not consider carefully whether section 2053(a) of the Code conflicts with the regulations issued thereunder, inconsistent case law has developed. In the Tax Court, for instance, some decisions<sup>14</sup> have permitted deductions solely upon a find-

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9. 510 F.2d 479 (2d Cir. 1975).

10. *Id.* at 483. The case is discussed in detail, *infra* notes 65 *et seq.* & accompanying text.

11. 475 F.2d 673 (6th Cir. 1973), *rev'g* 57 T.C. 705 (1972). *See generally* 52 N.C. L. Rev. 190 (1973).

The *Smith* dissent, however, agreed with the *Park* holding "that the plain meaning of the statute controls and that the Congress intended deductibility to be determined by state law." 510 F.2d at 483 (Mulligan, J., dissenting).

12. 475 F.2d at 676.

13. *Id.*

14. *Estate of Marie A. DeFoucaucourt*, 62 T.C. 485 (1974) (taxpayers permitted to deduct two sets of commissions for duties as trustees and executors because "under [state law] 'double' commissions [were] allowable," *id.* at 489); *Estate of Louis Sternberger*, 18 T.C. 836 (1952), *aff'd*, 207 F.2d 600 (2d Cir. 1953), *rev'd on other grounds*, 384 U.S. 187 (1955) (although proceeds from sale of decedent's residence were not needed to pay debts or expenses of estate, controlling facts were that executor had power of sale under will, that he, rather than trustee, actually sold property, and that "the expenses of the sale were properly allowed as administration expenses under New York law," *id.* at 842); *Estate of Bluestein*, 15 T.C. 770 (1950) (decided prior to *Estate of Bosch*, see notes 81-93 *infra* & accompanying text) (deciding factor was allowance of disputed court costs by the state court after a true adversary proceeding "in which the facts and issues were fully and properly presented," *id.* at 783-84); *Estate of Martha Allison*, 15 P-H Tax Ct. Mem. 932 (1946) (realtor's commission allowed when rental property sold to avoid expending estate funds on

ing that the expenditures were either allowed or allowable<sup>15</sup> under state law, while other decisions<sup>16</sup> have made the further inquiry as to whether the expense was necessary to the administration of the estate. Tax Court cases denying deductibility of administration expenses<sup>17</sup> have relied uniformly upon the requirements of the regulations.<sup>18</sup> The circuit courts also have reached conflicting results; a review of this confusion provides an informative background for a more thorough examination of *Smith*.

It appears that the Court of Appeals for the Third Circuit, considering the deductibility of auctioneers' fees, assumed the validity of the regulations. In *Estate of Streeter v. Commissioner*<sup>19</sup> the court denied the deduction of auctioneers' commissions because under decedent's will only the trustees had the power to sell estate property. Therefore, the auctioneer's

repairs because executor's final account was approved by probate court and "decedent's will specifically empowered the executor to sell the real estate," *id.* at 934); James D. Bronson, 7 B.T.A. 127 (1927), *aff'd*, 32 F.2d 112 (8th Cir. 1929) (court stated that "by section 403(a)(1) of the Revenue Act of 1921 [a predecessor of section 2053(a)] Congress intended that the value of the gross estate should be reduced by the amount of such usual and customary expenses incident to the administration and settlement of estates as are permitted and *authorized by the laws of the jurisdiction* under which such estate is administered and settled without specifically naming them," *id.* at 131) (emphasis supplied).

15. The predecessor of section 2053(a) read "the value of the net estate shall be determined . . . by deducting . . . [s]uch amounts . . . as are *allowed* by the laws of the jurisdiction . . ." INT. REV. CODE OF 1939, ch. 3, § 812(b), 53 Stat. 123 (emphasis supplied). See note 4 *supra*.

16. *Estate of James S. Todd*, 57 T.C. 288 (1971) (court held that state law controls scope of administration expenses and, after examination of relevant Texas law found that disputed expenses were allowable, but added, *citing* Treas. Reg. 20.2053-3(a), that "[t]he burden is on the petitioners to prove that the interest expense was 'actually and necessarily incurred,'" *id.* at 296); *Estate of Dudley S. Blossom*, 45 B.T.A. 691, 693 (1941) (brokerage fees incurred in sale of securities to fund cash legacies were in connection with administration of estate and therefore satisfied requirement of Regulation 80 [now § 20.2053-3(d)]); *Estate of Henry E. Huntington*, 36 B.T.A. 698, 726 (1937) (although disputed expenses were incurred pursuant to order of probate court, Board of Tax Appeals specifically found that expenses were "necessary" part of administration of estate).

17. See, e.g., *Estate of Edward N. Opal*, 54 T.C. 154, 166 (1970), *aff'd*, 450 F.2d 1085 (2d Cir. 1971) (this issue not raised on appeal) (petitioner failed to carry her burden of proof to show that accountant's fees were actually and necessarily incurred); *Estate of Christine Swayne*, 43 T.C. 190, 201 (1964) (order of probate court authorizing sale of decedent's residence insufficient to establish necessity of sale); *Marion M. Jackson*, 18 B.T.A. 875, 886 (1930) (portion of claimed deduction for executor's commissions disallowed because executor in fact was functioning as trustee); cf. *Estate of Louvine M. Baldwin*, 59 T.C. 654, 658-59 (1973) (probate court did not authorize expense; expense in question not for benefit of estate and therefore not an expense of administration).

18. For relevant text of Treas. Reg. § 20.2053-3, see note 5 *supra*.

19. 491 F.2d 375 (3d Cir. 1974), *aff'g* 40 P-H Tax Ct. Mem. 1175 (1971).

fees were expenses of the trust, not of the estate, and did not qualify for deduction under section 2053(a).<sup>20</sup> The court, however, citing section 20.2053-3(d)(2) of the regulations, noted that "if the executors had been empowered by the will to sell assets to effect distribution, auctioneer fees, stipulated to be reasonable, would have been deductible."<sup>21</sup> Moreover, two district courts<sup>22</sup> in the Third Circuit, noting the conclusive presumption under Pennsylvania law that a general power of sale in a will is for the payment of decedent's debts,<sup>23</sup> held that expenses connected with the sale of estate property were deductible since "necessarily" incurred during settlement of the decedent's estate.<sup>24</sup>

Most of the litigation concerning the applicability of the regulations under section 2053 has not examined the deductibility of expenses incurred during the sale of estate property, but rather, has examined other types of administration expenses, especially attorney's fees. In this area as well, the regulations impose limitations upon the statutory standard of allowability under state law; the expenses must have been actually and necessarily incurred<sup>25</sup> for the benefit of the estate. The regulations also prohibit a deduction for attorney's fees incurred for the benefit of the individual heirs or legatees.<sup>26</sup>

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20. *Id.* at 378.

21. *Id.* (dicta). In an earlier case, *Sharpe's Estate v. Commissioner*, 148 F.2d 179 (3d Cir. 1945), the Court of Appeals for the Third Circuit distinguished the duties of an executor from those of a trustee: "The work of the executor is part of the settlement of a decedent's estate. It is done for the benefit of all who are interested, his creditors, his next of kin, his legatees. But the carrying on of the trust is a different enterprise, not in settlement of a dead man's affairs, but for the benefit of the beneficiaries of the trust. It operates to continue the affairs of the living, not to close up those of the departed." *Id.* at 181.

*Sharpe's Estate* approved Treas. Reg. 80 (1937 ed.), Art. 33, which provided, *inter alia*: "'Amounts paid as trustees' commissions do not constitute expenses of administration and are not deductible, whether received by the executor acting in the capacity of a trustee or by a separate trustee as such.'" *Id.* The current corresponding provision is Treasury Regulation section 20.2053-3(b)(3), which provides in relevant part: "Except to the extent that a trustee is in fact performing services with respect to property subject to claims which would normally be performed by an executor, amounts paid as trustees' commissions do not constitute expenses of administration under the first category. . . ." Treas. Reg. § 20.2053-3 (b) (3) (1958).

22. *Dauphin Deposit Trust Co. v. McGinnes*, 208 F. Supp. 228 (M.D. Pa. 1962), *aff'd*, 324 F.2d 458 (3d Cir. 1963) (this issue not raised on appeal); *Brown v. Smith*, 153 F. Supp. 674 (E.D. Pa. 1957).

23. See *In re Shaffer's Estate*, 360 Pa. 390, 61 A.2d 872 (1948).

24. 208 F. Supp. at 237-38; 153 F. Supp. at 678.

25. Treas. Reg. § 20.2053-3(a) (1958). See note 5 *supra*.

26. With respect to deductibility of attorney's fees, Treasury Regulations section 20.2053-3(c)(3) provides: "(3) Attorneys' fees incurred by beneficiaries incident to

As to the deductibility of attorney's fees, the Court of Appeals for the Second Circuit held in *Dulles v. Johnson*<sup>27</sup> that such fees, when incurred by legatees and directed by the New York Surrogate's Court to be paid by the executors out of the estate in accordance with New York law, were administration expenses within the meaning of section 2053(a). Subsequently, the District Court for the Eastern District of New York, in *Sussman v. United States*,<sup>28</sup> held that attorney's fees paid pursuant to an order of the surrogate were deductible, but hypothesized in dicta that perhaps not every expense allowed under local law would be deductible under section 2053(a).<sup>29</sup> The court held the regulations to be inapplicable,<sup>30</sup> however, apparently because the expenses were both familiar and reasonable under the circumstances.<sup>31</sup>

The Court of Appeals for the Fourth Circuit confronted a similar issue in *Commercial National Bank v. United States*.<sup>32</sup> There the court held that fees paid to caveators' attorneys pursuant to a settlement agreement but not included in the court decree never became costs within the meaning of the relevant state statute and, therefore, were not deductible for purposes of the federal estate tax.<sup>33</sup> In dicta, however, the court indicated that the sole standard for determining deductibility was state law. In reply to the Government's contention that had the expenses been allowed<sup>34</sup> under state law they still would be nondeductible for purposes of the estate tax because incurred for the benefit of individual heirs, the court stated: "This position is doubtful since it would seem to have been the purpose of Congress to follow the state law in the allowance for administration expenses . . . ." <sup>35</sup> More recently, however, a

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litigation as to their respective interests do not constitute a proper deduction, inasmuch as expenses of this character are incurred on behalf of the beneficiaries personally and are not administration expenses." Treas. Reg. § 20.2053-3(c)(3) (1958).

27. 273 F.2d 362 (2d Cir. 1959).

28. 236 F. Supp. 507 (E.D.N.Y. 1962).

29. *Id.* at 510.

30. "The regulations do not approach the precise point closely enough to be helpful, but they cannot be read as leading to any different result in spite of the too dogmatic tone of 26 C.F.R. § 20.2053-3(c)(3)." *Id.*

31. *Id.*

32. 196 F.2d 182 (4th Cir. 1952).

33. *Id.* at 185.

34. The case arose under section 812(b) of the Internal Revenue Code of 1939, which provided a deduction for such amounts as were "allowed" by state law. See note 4 *supra*.

35. 196 F.2d at 185. The court did state, however, that the regulations were consistent with "the general purpose of the statute to limit the allowable deductions for administrative expenses to those incurred for the benefit of the estate." *Id.* at 184. Nonetheless,

district court<sup>36</sup> in the Fourth Circuit deferred to the regulations by holding that the expense in question was deductible if: (1) the state probate court, examining the facts upon which deductibility depended under state law, allowed the deduction,<sup>37</sup> and (2) the expense did not violate the regulations that required expenditures to be essential to the proper settlement of the estate and not incurred for the individual benefit of the heirs, legatees or devisees.<sup>38</sup>

The Court of Appeals for the Fifth Circuit has considered the issue of deductibility of administration expenses only once, in *Pitner v. United States*.<sup>39</sup> The court there held that attorneys' fees incurred by beneficiaries in determining their share of the estate were deductible as admin-

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the court cautioned the regulations were to be applied "in connection" with section 2053(a). *Id.*

36. *Hipp v. United States*, 72-1 U.S. Tax Cas. 84,678 (D.S.C. 1971). The expense at issue was interest on a loan made by executors to pay federal and state estate taxes when liquidation of stock, the main asset of the estate, would depress the market value of the stock.

37. The *Hipp* Court relied upon Treasury Regulation section 20.2053-1(b)(2) which provides in relevant part:

(2) *Effect of court decree.* The decision of a local court as to the amount and allowability under local law of a claim or 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. . . . However, the decree will not necessarily be 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. This will be presumed in all cases of an active and genuine contest. If the result reached appears to be unreasonable, this is some evidence that there was not such a contest, but it may be rebutted by proof to the contrary. If the decree was rendered by consent, it will be accepted, provided the consent was a bona fide recognition of the validity of the claim (and not a mere cloak for a gift) and was accepted by the court as satisfactory evidence upon the merits. It will be presumed that the consent was of this character, and was so accepted, if given by all parties having an interest adverse to the claimant. The decree will not be accepted if it is at variance with the law of the State. . . . On the other hand, a deduction for the amount of a bona fide indebtedness of the decedent, or of a reasonable expense of administration, will not be denied because no court decree has been entered if the amount would be allowable under local law.

Treas. Reg. § 20.2053-1(b)(2) (1958).

38. 72-1 U.S. Tax Cas. at 84,679-80. The court found that the borrowing of funds and the expenditure of interest were essential to the proper settlement of the estate and were not incurred for the individual benefit of the heirs, legatees or devisees. *Id.* at 84,680.

39. 388 F.2d 651 (5th Cir. 1967), *rev'd and remanding*, *Jacobs v. United States*, 248 F. Supp. 695 (E.D. Tex. 1965) (remand to determine reasonableness of attorneys' fees).



istration expenses, even though decedent's will never was probated and Texas law prohibited formal administration of the estate on the ground of no necessity.<sup>40</sup> The court relied upon *Commissioner v. Bronson*<sup>41</sup> in support of its finding that "[a] formal probate proceeding is not a prerequisite to a deduction for federal estate tax purposes under § 2053 (a)."<sup>42</sup> The correct test, stated the court, should be whether the deduction is "allowable" by the laws of the jurisdiction under which the estate is being administered.<sup>43</sup> But Texas law provided no guidance in this inquiry, since the applicable code provisions<sup>44</sup> and case law<sup>45</sup> would leave distribution of the estate and payment of expenses to the discretion of the beneficiaries.<sup>46</sup> Relying upon authority from other jurisdictions, the court held that the fees in question would be allowed by a Texas court and, therefore, were deductible.<sup>47</sup> The court, however, also stated that in order to be deductible, an administration expense additionally must satisfy the requirements of federal law,<sup>48</sup> as defined by the regulations.<sup>49</sup>

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40. 388 F.2d at 655-56 n.7, quoting TEX. PROB. CODE ANN. § 178 (1956).

41. 32 F.2d 112 (8th Cir. 1929).

42. 388 F.2d at 654, 658.

43. *Id.* at 655, 658.

44. See TEX. PROB. CODE ANN. § 37 (Supp. 1974-75), which is similar in relevant part to the statute before the court in *Pitner*.

45. *Hart v. Hart*, 170 S.W. 1071 (Tex. Civ. App. 1914); *Patterson v. Allen*, 50 Tex. 23 (1878).

46. 388 F.2d at 656.

47. *Id.* at 657-59.

48. The court in *Pitner* viewed the regulations as definitional. *Id.* at 654. The court further stated:

In the determination of deductibility under section 2053(a)(2), it is not enough that the deduction be allowable under state law. It is necessary as well that the deduction be for an "administration expense" within the meaning of that term as it is used in the statute, and that the amount sought to be deducted be reasonable under the circumstances. These are both questions of federal law and establish the outside limits for what may be considered allowable deductions under section 2053(a)(2).

*Id.* at 659. However, the court continued:

In most instances the interest of the federal government in protecting its revenues will coalesce with the interest of the state in protecting its citizens, and the state law may be relied upon as a guide to what deductions may reasonably be permitted for federal estate tax purposes. In some cases, however, the state law on its face or in its application may not be responsive to the interests traditionally protected by the state. In other cases, such as the one before us, the state might justifiably feel that it had no interests to protect, and consequently fail to create rules to govern the situation one way or the other. When for any of these reasons state law fails in adequately representing the interest of the federal government, a framework still exists grounded in federal law defining the limits to which

As noted earlier, the Court of Appeals for the Sixth Circuit held in *Estate of Park v. Commissioner*<sup>50</sup> "that the deductibility of an expense under section 2053(a) (or its predecessor) is governed by state law alone."<sup>51</sup> In so holding, the court relied upon two earlier Sixth Circuit cases, *Goodwin's Estate v. Commissioner*<sup>52</sup> and *Union Commerce Bank v. Commissioner*.<sup>53</sup> In *Goodwin's Estate*, the court held that the order of an Ohio probate court directing that daughters' claims for loans to their father be paid out of his estate was controlling for purposes of the estate tax deduction<sup>54</sup> on the grounds that section 812(b)(3) of the Code,<sup>55</sup> the predecessor of section 2053(a), "expressly" made its operation dependent upon state law.<sup>56</sup> *Union Commerce Bank* cited *Goodwin's Estate* as authority for the view that the express language of section 2053(a) was controlling.<sup>57</sup> Giving great deference to the decision of the probate

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an expense may go and still be considered deductible for federal estate tax purposes.

*Id.*

This language has been subject to varying interpretations. The dissent in *Smith* argued that *Pitner* dictated reliance upon the regulations only when state law provided no guidance. 510 F.2d at 483 (Mulligan, J., dissenting). The majority in *Smith* stated that *Pitner* rejected the proposition that the sole standard for deductibility under section 2053(a) is allowability under state law. *Id.* at 482 n.4.

49. For text of Treas. Reg. § 20.2053-3(a), see note 5 *supra*. The court rejected the Government's contention that this regulation required that expenses incurred for the individual benefit of the heirs be disallowed. Although recognizing that plaintiffs acted in their own self-interest in instituting litigation to establish their rights to estate assets, the court held that since distribution of the property to the persons entitled to it thus was facilitated, the expenses came within the statute as being necessary to the settlement of the estate. 388 F.2d at 660.

50. 475 F.2d 673 (6th Cir. 1973). See notes 11-13 *supra* & accompanying text.

51. *Id.* at 676.

52. 201 F.2d 576 (6th Cir. 1953).

53. 339 F.2d 163 (6th Cir. 1964).

54. *Goodwin* relied upon Treasury Regulation 105, section 81.30, 7 Fed. Reg. 1449 (1942), the predecessor of Treasury Regulations section 20.2053-1(b)(2), see note 37 *supra*, and *Freuler v. Helvering*, 291 U.S. 35, 45 (1934). *Freuler* held that the decision of a probate court, until reversed or overruled, established the law of the state. This holding was modified by *Commissioner v. Estate of Bosch*, 387 U.S. 455 (1967); see notes 81-93 *infra* & accompanying text.

The Government asserted in *Goodwin* that the regulation was invalid, but the court rejected this argument. "Treasury Regulations are ordinarily valid unless unreasonable or inconsistent with the statute. . . . If not unreasonable or plainly inconsistent with the revenue statutes, they should not be overruled except for weighty reasons." 201 F.2d at 581.

55. INT. REV. CODE OF 1939, § 812(b)(3). See note 4 *supra*.

56. 201 F.2d at 580.

57. 339 F.2d at 168. Since the Ohio probate court had not considered the question

court, two other cases<sup>58</sup> in the Sixth Circuit justified the allowance of attorneys' fees as administration expenses. The inquiry of the reviewing courts in these cases was restricted to whether the probate court was acting within its jurisdiction under applicable state law.<sup>59</sup>

In *Ballance v. United States*,<sup>60</sup> the Court of Appeals for the Seventh Circuit, citing *Union Commerce Bank*,<sup>61</sup> held that the regulations could not delimit the broad scope of section 812 in determining whether post-death interest on a claim against the estate was properly deductible as an expense of administration.<sup>62</sup> Subsequently, in *Maebling v. United States*<sup>63</sup> the District Court for the Southern District of Indiana cited *Ballance* in relying solely upon Indiana law and the determination of the probate court and held that the expenditure in question was reasonably necessary for the benefit of the estate and was therefore allowable as a deduction.<sup>64</sup>

#### ESTATE OF DAVID SMITH V. COMMISSIONER

In the context of the conflicting authority cited above, *Estate of Smith*<sup>65</sup> presented to the Court of Appeals for the Second Circuit the issue of the validity of the apposite regulations. David Smith, a sculptor, died testate, leaving an estate, the major asset of which consisted of 425 pieces of abstract, metal sculpture. Smith's will gave three executor-trustees the power to sell estate assets.<sup>66</sup> To obtain higher prices for de-

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of deductibility of interest or overdue gift taxes, this issue was remanded to the Tax Court for additional testimony. *Id.*

58. *Cadden v. Welch*, 298 F.2d 343 (6th Cir. 1962); *Schmalstig v. Connor*, 46 F. Supp. 531 (S.D. Ohio 1942).

59. 298 F.2d at 344; 46 F. Supp. at 533.

60. 347 F.2d 419 (7th Cir. 1965).

61. *Id.* at 423.

62. "[T]he definition of 'administration expenses' in the treasury regulations as such expenses as are 'necessarily' incurred in the administration of the estate cannot serve to override the statutory provision . . . authorizing the deduction of '[s]uch amounts . . . for administration expenses . . . as are allowed by the laws of the jurisdiction . . . under which the estate is being administered.'" *Id.* Since Illinois law allowed a credit for expenses of administration if it appeared that the expenditures were reasonably necessary for the benefit of the estate, and since payment of claims was postponed in this case in order to avoid the sale of estate assets at a sacrifice, the resulting post-death interest was, under Illinois law, an allowable expense of administration. *Id.*

63. 20 Am. Fed. Tax R.2d 5997, 67-2 U.S. Tax Cas. 85,617 (S.D. Ind 1967).

64. 20 Am. Fed. Tax R.2d at 5999, 67-2 U.S. Tax Cas. at 85,618.

65. 510 F.2d 479 (2d Cir. 1975).

66. *Estate of David Smith*, 57 T.C. 650, 654 (1972).

cedent's art, the executors, rather than immediately offering the pieces to the public en masse,<sup>67</sup> began an orderly process of gradual liquidation through Marlborough-Gerson Galleries, which was entitled to a one-third commission on the net proceeds of any sale.<sup>68</sup> The gallery was paid commissions totalling \$1,583,544.67, which were allowed by the New York Surrogate's Court; the executors contended that this amount was deductible on the federal estate tax return as an administration expense under section 2053(a). The Tax Court allowed a deduction of only \$750,447.74,<sup>69</sup> the exact amount necessary to pay for administration expenses, debts, and taxes as finally adjudicated.<sup>70</sup>

Relying upon section 20.2053-3(d)(2) of the regulations<sup>71</sup> and an earlier tax decision<sup>72</sup> sustaining the restrictive language of the regulations,

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67. Although Smith had begun to gain critical recognition of his work toward the end of his life he had never been a commercially successful artist. A public auction would have revealed the large number of works in Smith's possession at his death and caused a significant decline in their value. *Id.* at 652, 653.

68. 57 T.C. at 653; 510 F.2d at 480.

69. Five judges dissented on the issue of administration expenses; the dissenting opinion raised the invalidity of the regulations for the first time: "It is apparent that the regulations impose a limitation upon the deductibility of selling expenses not prescribed by the Code, to wit, the sale giving rise to the expense must be necessary in order to pay the decedent's debts, expenses of administration, or taxes, to preserve the estate or to effect distribution." 57 T.C. at 663-64 (Goffe, J., dissenting). "I submit that Congress considered only the limitation of State law in enacting section 2053(a)(2). . . ." *Id.* at 664. This issue was not presented to the Tax Court, for the executors argued that the commissions had been incurred necessarily to preserve the estate or to effect distribution of the estate. *Id.* at 660.

70. The case was before the Tax Court on a petition by the executors for a redetermination of the notice of deficiency by the Commissioner on Aug. 7, 1969. (This was three years after the estate tax return had been filed, on Aug. 24, 1966, and over one year after a deficiency of \$46,449.67 had been agreed upon and paid, on July 10, 1968.) The 1969 deficiency of \$2,444,629.17 was based upon a valuation of Smith's estate at \$5,256,918 and a disallowance of any sales commissions in excess of \$289,661.65. The Tax Court reduced the value of the estate to \$2,700,000.00; no appeal was taken from this appraisal. For a discussion of the valuation issue in this case, see Echter, *Equitable Treatment for the Artist's Estate*, 114 TRUSTS & ESTATES 394 (1975).

71. For text of Treas. Reg. § 20.2053-3(d)(2), see note 5 *supra*.

72. 57 T.C. at 660, citing *Estate of Christine Swayne*, 43 T.C. 190 (1964). The majority in *Smith* read *Swayne* as holding that expenses must be necessary to the administration of decedent's estate, as required by the regulations, in order to be deductible for purposes of the federal estate tax. *Id.* The *Smith* dissent, however, argued that the validity of the regulations was neither challenged nor considered in *Swayne*. *Id.* at 663, 665 (Goffe, J., dissenting).

The *Smith* executors distinguished *Swayne* from their case, Brief for Appellants at 21, 22, *Estate of Smith v. Commissioner*, 510 F.2d 479 (2d Cir. 1975), by pointing out that in *Swayne*, decedent's executor was also her son and beneficiary. As executor

the Tax Court held that allowance of the commissions by the New York Surrogate's Court was not sufficient to establish their deductibility under section 2053(a). As noted earlier, satisfaction of the regulations, as well as of the statutory standard, was deemed a condition precedent to a finding of deductibility.<sup>73</sup> The court found that only a portion of the sculpture was sold to satisfy expenses and claims against the estate; the remainder of the works were sold to fund the trusts. Consequently, the commissions paid on these later sales were deemed not deductible as proper administration expenses.<sup>74</sup>

*Estate of Park*<sup>75</sup> specifically rejected the reasoning of the Tax Court

he instituted a special proceeding in the probate court seeking the court's approval of the sale of decedent's home, which had been devised to him. The application was not opposed, and the probate court allowed the sale upon the ground that the specific devisee has consented. Expenses of the sale later were allowed by the probate court as administration expenses. The same expenses, however, then were *disallowed* by the state tax commissioner as administration expenses in his computation of the state succession tax, and this action was approved by the probate court. *Estate of Christine Swayne*, 43 T.C. 190, 201 (1964). Since the Tax Court was presented with three conflicting state court decrees, it was justified, stated the Smith executors, in looking behind the state court proceedings pursuant to the terms of Treasury Regulations section 20.2053-1(b)(2) (for text see note 37 *supra*) and in finding that the taxpayer had not demonstrated the necessity of the sale under either federal or state law.

The *Swayne* court apparently held that applicable Connecticut law and necessity for the sale had not been documented by taxpayers, who had the burden of showing that state law supported their contentions. *Bonney v. Commissioner*, 247 F.2d 237, 239 (2d Cir. 1957). In *Swayne* the deductibility of expenses incurred in the sale of decedent's home was a subsidiary problem, involving only \$2,847.44. The primary issue in the case was deductibility of counsel fees totalling \$25,000.00. It is reasonable that petitioners' brief would have concentrated on this point, and in fact the Tax Court did reverse the Commissioner and held that the attorneys' fees were deductible. Understandably, there was no appeal in this case. It is arguable, however, that had a well-documented brief demonstrated specific reasons for the sale in question and examined Connecticut law on this issue (no statutory rule as to allowance of administration expenses, but see *Ballard v. Ballard*, 13 Conn. Supp. 400 (1945), requiring "necessity"), a reversal might have resulted.

73. 57 T.C. at 660-61. The Tax Court excused *Dauphin Deposit Trust Co. v. McGinnes*, 208 F. Supp. 288 (M.D. Pa. 1962), *aff'd*, 324 F.2d 458 (3d Cir. 1963) and *Brown v. Smith*, 153 F. Supp. 674 (E.D. Pa. 1957) because of the presumption of "necessity" under Pennsylvania law. *Id.* at 661; see notes 22-23 *supra* & accompanying text. This would appear, however, to support the argument of the executors in *Smith* that the only relevant standard under section 2053(a) is state law. If this were only a threshold requirement, as held by the Tax Court, then the *Dauphin* and *Brown* courts would have been free to consider whether the expenses at issue were also "necessary" under the treasury regulation.

74. 57 T.C. at 661-62.

75. 475 F.2d 673 (6th Cir. 1973). Mabel F. Colton Park's estate contained two residences that were to pass to her four sons under the residuary clause of her will.

in *Smith*,<sup>76</sup> and held that the exclusive criteria for deductibility under section 2053(a) should be the standard provided for in the statute itself, allowability as defined by the laws of the jurisdiction under which the estate is being administered.<sup>77</sup> The court reasoned that if the executor, in the exercise of sound judgment approved by the probate court, believed that the estate would benefit by the sale of the property in question, a deduction under section 2053(a) should not be denied because the Government deemed the sale to have been unnecessary.<sup>78</sup>

Subsequent to *Park*, the executors of the Smith estate appealed the decision of the Tax Court. In affirming, the Court of Appeals for the Second Circuit ignored *Park*,<sup>79</sup> finding unnecessary any consideration of the validity of the regulations.<sup>80</sup> By relying on *Commissioner v. Estate of Bosch*,<sup>81</sup> the court avoided discussing a possible conflict between the statute and the regulations.<sup>82</sup> In *Bosch* the Supreme Court held that

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The sons decided they did not want the properties and requested the administrator to sell them under the power given him in the will. The brokerage fees and other expenses incurred in the sales were disallowed as administration expenses by the Commissioner, and the disallowance was upheld by the Tax Court, 57 T.C. 705, 710 (1972), on the basis that the sale of the real estate was for the sole benefit of the beneficiaries and the expenses incurred in the sale were not necessary to pay decedent's debts, expenses of administration, or taxes and not necessary to preserve the estate or effect distribution, as required by the regulations.

76. 475 F.2d at 676.

77. "By the literal language of § 2053(a), Congress has left the deductibility of administration expenses to be governed by their chargeability against the assets of the estate *under state law*." *Id.* (emphasis supplied).

78. *Id.* at 676-77.

79. The dissent felt that *Park* was precisely on point and that the five dissenting Tax Court judges were correct in finding that the determination of the New York Surrogate as to deductibility was binding. *Id.* at 483, 485 (Mulligan, J., dissenting).

80. For text of Treas. Reg. section 20.2053-3(d)(2) see note 5 *supra*. The majority also failed to mention *Estate of Christine Swayne*, 43 T.C. 190 (1964), the case that the Tax Court had found to be controlling. For discussion of *Swayne*, see note 72 *supra*.

81. 387 U.S. 456 (1967).

82. The court noted that the New York Surrogate's Court Act, see note 86 *infra*, like most state laws concerning executors and administrators, required an administration expense to be "necessary" in order to be allowable and acknowledged that a surrogate's decree approving an expenditure as a proper administration expense under New York law normally would be controlling and would not "raise questions concerning possible discrepancies between § 2053 of the . . . Code . . . and Treas. Reg. § 20.2053-3(d)(2)". 510 F. 2d at 482 (emphasis supplied). Since the interest of the federal government in taxing the transfer of wealth at death, however, will not always completely or accurately be reflected in a state's interests in supervising the fiduciary responsibilities of executors", *id.*, "the federal courts cannot be precluded from re-examining a lower state court's allowance of administration expenses to determine whether they were in fact necessary to carry out the administration of the

"where federal estate tax liability turns upon the character of a property interest held and transferred by the decedent under state law, federal authorities are not bound by the determination made of such property interest by a state trial court,"<sup>83</sup> but "must apply what they find to be the state law after giving 'proper regard' to relevant rulings of other courts of the State."<sup>84</sup> The appellate court in *Smith* thus reasoned that the Tax Court's finding that the additional sales of sculpture were not "necessary," did not involve a refusal to follow New York law.<sup>85</sup> Rather, because section 222 of the New York Surrogate's Court Act<sup>86</sup> required that allowable administration expenses be "necessary," the Tax Court merely was exercising its duty under *Bosch* to make a de novo determination of the factual necessity for these expenditures.<sup>87</sup>

The holding of the *Smith* court was surprising, as considerable prior case law supported the position of the estate.<sup>88</sup> Moreover, the cases cited in *Smith* to justify affirmance of the Tax Court's holding are not persuasive. Reliance on *Estate of Bosch*, for instance, appears erroneous for three reasons. First, as noted by the dissent in *Smith*, the Court in *Bosch*, examining application of the marital deduction, relied upon a report of the Senate Finance Committee,<sup>89</sup> which recommended "that

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estate or merely prudent or advisable in preserving the interests of the beneficiaries." *Id.* at 482-83.

83. *Id.* at 457.

84. *Id.* at 465.

85. 510 F.2d at 483.

86. Section 222 of the New York Surrogate's Court Act, in effect at the time of *Smith's* death, provided:

§ 222. Payment of expenses incurred by representative.

An executor, administrator, guardian or testamentary trustee may pay from the funds or estate in his hands, from time to time, as shall be necessary, his legal and proper expenses of administration necessarily incurred by him, including the reasonable expense of obtaining and continuing his bond and the reasonable counsel fees necessarily incurred in the administration of the estate. Such expenses and disbursements shall be set forth in his account when filed, and settled by the surrogate.

N.Y. SUR. CR. ACT § 222 (McKinney 1920).

87. 510 F.2d at 483.

88. See, e.g., *Estate of Park*, 475 F.2d 673, 676 (6th Cir. 1973); *Ballance v. United States*, 347 F.2d 419, 423 (7th Cir. 1965); *Dulles v. Johnson*, 273 F.2d 362, 369-79 (2d Cir. 1959); *Estate of Louis Sternberger*, 18 T.C. 836, 843, *aff'd*, 207 F.2d 600 (2d Cir. 1953); *Estate of Martha Allison*, 15 P-H Tax Ct. Mem. 932,934 (1946). Further, the only case precisely in agreement with the position of the Government and the Tax Court on the additional requirement of "necessity" under the regulation was *Estate of Christine Swayne*, 43 T.C. 190 (1964), see note 72 *supra*, a case that was not cited by the appellate court in *Smith*.

89. S. REP. NO. 1013, 80th Cong., 2d Sess. 4 (1948). See *Estate of Smith v. Commissioner*, 510 F.2d 479, 481 n.1 (2d Cir. 1975) (Mulligan, J., dissenting).

'proper regard,' not finality, should be given to the interpretation of a will by a state court."<sup>90</sup> When administration expenses are deducted, however, the statute itself specifically makes its operation dependent upon state law.<sup>91</sup> Second, the Tax Court in *Smith* clearly did not make its own interpretation of New York law; rather, it held that there were additional criteria under federal law that the estate had not satisfied.<sup>92</sup> Third, *Bosch* stated that a federal court must make its own determination of relevant state law and was not bound by the interpretation of a lower state court, whereas *Smith* involved no question concerning the applicable New York law. What the *Smith* court implied, however, was that a federal court could reconsider the state court decision and make new findings of fact.<sup>93</sup>

Despite its assertion that consideration of the validity of the regulation was unnecessary, the Court of Appeals for the Second Circuit ap-

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90. 510 F.2d at 481 n.1 (Mulligan, J., dissenting), citing 387 U.S. at 464. The Supreme Court reasoned: "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." *Id.* (emphasis supplied). But see H.R. No. 1337, 83d Cong., 2d Sess. 91 (1954) on the reenactment of section 2053, note 117 *infra*, which mentioned only allowability under state law as a limitation on the deduction. See also INT. REV. CODE OF 1939, § 812(b) (amended in 1950 to repeal this feature), which allowed the gross estate to be reduced by amounts "reasonably required and actually expended" for the support of the decedent's dependents during the settlement of the estate to the extent that such expenses were allowed by state law. This repealed statute lends support to the argument that if Congress had intended an additional requirement of necessity it would have stated so in the statute.

91. 510 F.2d at 484 n.1 (Mulligan, J., dissenting). It should be noted, however, that the *Bosch* rule has been applied with respect to section 2053(a) deductions in the following cases: *Kasishke v. United States*, 426 F.2d 429 (10th Cir. 1970) (claim against the estate held properly disallowed by district court under Oklahoma law even though approved by probate court); *Underwood v. United States*, 407 F.2d 608 (6th Cir. 1969), *rev'g and remanding on this issue but aff'g on another issue*, 270 F. Supp. 389 (E.D. Tenn. 1967) (court supported probate's allowance of an 8% executor commission even though will limited commissions to 5%, because state law did not forbid a court from allowing compensation in excess of amount fixed in will); *Hipp v. United States*, 72-1 U.S. Tax Cas. 84,678 (D.S.C. 1971) (interest paid on loan obtained to pay federal and state taxes held to be properly authorized by probate court under local law); *Estate of Anna Lewis*, 49 T.C. 684 (1968) (disallowance of claim barred by Michigan statute of limitations as interpreted by state's highest court even though allowed by probate court).

92. 57 T.C. at 661.

93. "[T]he Tax Court's determination . . . did not involve a refusal to follow New York law, but rather was the result of a *de novo* inquiry into the factual necessity for these expenditures." 510 F.2d at 483 (emphasis supplied).



peared to support the Tax Court's view that the regulations establish additional criteria under federal law and cited *Pitner v. United States*<sup>94</sup> as establishing the Fifth Circuit's agreement with this position.<sup>95</sup> But the situation confronting the *Pitner* court was totally unlike that presented in *Estate of Smith*. *Pitner* examined the deductibility of an administration expense for which Texas law did not provide.<sup>96</sup> The Court of Appeals for the Fifth Circuit indicated that state law ordinarily could be relied upon as a guide to what deductions may be permitted for federal estate tax purposes, but the *Pitner* court recognized that in some instances state law might fail to represent adequately the interests of the federal government. In such situations, noted the court, the expenditure should be measured against the federal definition of administration expenses as found in the regulations.<sup>97</sup> This position seems inapplicable to *Smith*, as New York law, both statutory<sup>98</sup> and decisional,<sup>99</sup> specifically allowed the type of expense in issue.

The *Smith* court also relied upon *Commercial National Bank*,<sup>100</sup> a case that would appear to support the position of the estate more than that of the Government. In *Commercial National Bank* the Court of Appeals for the Fourth Circuit clearly indicated that its decision was controlled by North Carolina law.<sup>101</sup> As noted earlier, the expenses reviewed by the court in *Commercial National Bank* were not deductible for purposes of the federal estate tax because they were not allowed by the laws of the jurisdiction under which the estate was being administered.<sup>102</sup> The court rejected the Government's contention that even if the fees had been assessed as costs by the state court they would not be deductible for purposes of the estate tax<sup>103</sup> because they were not administrative expenses within the meaning of the federal statute but were incurred for the individual benefit of the heirs and widow.<sup>104</sup> The court indicated that

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94. 388 F.2d 651 (5th Cir. 1967). See notes 39-49 *supra* & accompanying text. At issue in *Pitner* was the deductibility of attorneys' fees and other expenses of litigation incurred by the beneficiaries in two separate suits.

95. 510 F.2d at 482-83 n.4.

96. See note 40 *supra* & accompanying text.

97. 388 F.2d at 659; see note 48 *supra* & accompanying text.

98. N.Y. Surr. Ct. Act § 222 (McKinney 1920); for text see note 86 *supra*.

99. *In re Rosenberg's Estate*, 6 N.Y.S.2d 1009, 1012-13 (Surr. Ct. 1938).

100. 196 F.2d 182 (4th Cir. 1952). See notes 32-35 *supra* & accompanying text.

101. *Id.* at 184-85.

102. See notes 32-35 *supra*.

103. *Id.* at 185 (dictum).

104. *Id.* at 183-84.

Congress had intended state law to be controlling in determining the deductibility of an administration expense.<sup>105</sup>

In further support of its holding, the court in *Smith*, relying on *United States v. Stapf*,<sup>106</sup> stated that administration expenses must be of "the 'type intended to be deductible' . . . , ultimately a question of federal law."<sup>107</sup> In *Stapf* the Supreme Court considered whether a deduction could be taken for the entire amount of the community's debts and expenses, when the decedent's will directed that his executors pay all community expenses and debts entirely out of his half of the community property.<sup>108</sup> The Court concluded that these "claims against the estate" and "administration expenses" were not of the type intended to be deductible under the provisions of section 812(b) because the effect would be to authorize tax free gifts, contrary to the general policy of the federal estate tax.<sup>109</sup> *Stapf* is distinguishable from *Smith* for the simple reason that the payments therein examined were characterized by the Supreme Court as marital gifts rather than as claims or expenses.<sup>110</sup>

In yet another instance of inappropriate reliance, the Court of Appeals for the Second Circuit held that the decision of the Tax Court would be affirmed because it was not "clearly erroneous," as required by *Commissioner v. Duberstein*.<sup>111</sup> Reliance on *Duberstein* is inapposite since it merely recognizes that the clearly erroneous test is applied when an appellate court is reviewing questions of fact;<sup>112</sup> the court in *Smith* examined a question of law. The statute in *Smith* provided a standard for determining what was an allowable administration expense under state law. The issue was whether the Code should be interpreted according

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105. *Id.* at 185 (dictum).

106. 375 U.S. 118 (1964).

107. 510 F.2d at 482 n.4, quoting *United States v. Stapf*, 375 U.S. 118, 130 (1964).

108. Absent this provision in the will, Texas law would provide that "only one-half of the community debts would be charged to the decedent's half of the community." 375 U.S. at 130.

109. *Id.* at 131.

110. *Id.* at 134.

111. 363 U.S. 278 (1960). In *Duberstein* the Court considered what standard to apply in determining what constituted a gift within the meaning of section 102(a) of the Internal Revenue Code of 1954, which provided no statutory guidelines for this determination. The Supreme Court held that this question must be decided on a case by case basis by the trial court, which could weigh the totality of the facts in each situation. 363 U.S. at 290. Consequently, appellate review of Tax Court determinations in this area would be quite restricted. See Griswold, *Of Time and Attitudes—Professor Hart and Judge Arnold*, 74 HARV. L. REV. 81, 86-91 (1960) (*Duberstein* criticized as typical of "excessive deference to triers of fact").

112. FED. R. CIV. P. 52(a).

to its literal language or as clarified by the regulations. Since statutory interpretation always is reviewable, the appellate court was free to substitute its own judgment on this question for that of the Tax Court.<sup>113</sup>

The test proposed by the Court of Appeals for the Second Circuit in *Smith* would require a federal court, in every case involving application of section 2053(a), to review the decision of the state probate court and determine if an allowed expense was in fact necessary to carry out the administration of the estate and was, therefore, the type of expense intended to be deductible under the statute. In some cases this test might lead to an absolute rejection of the statutory standard of allowability under state law. This situation was avoided in *Smith* because the applicable New York law also required the expenditures to be "necessary"; in some states, however, this determination is left to the discretion of the probate court.<sup>114</sup> Although Treasury Regulations ordinarily are accorded great weight, they must be interpreted, if possible, consistently with the statutory mandate; a regulation in derogation of the Code is invalid.<sup>115</sup>

The *Smith* court approved, at least implicitly,<sup>116</sup> the standard set forth in the regulations. The legislative history of section 2053(a) does not indicate, however, that Congress approved the definition of administrative expenses set forth in the regulations as the type of expense intended to be deductible under section 2053(a). The House Reports recommending adoption of this section of the Internal Revenue Code of 1954 noted the state law limitation, but did not mention the corresponding regulation.<sup>117</sup> The Tax Court in *Smith* relied upon the principle of statutory

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113. See 510 F.2d at 485 (Mulligan, J., dissenting). As a result of legislation in 1948 Congress negated the favored position enjoyed by Tax Court decisions under the Supreme Court's ruling in *Dobson v. Commissioner*, 320 U.S. 489 (1943). *Commissioner v. Duberstein*, 363 U.S. at 291 n.13. Section 7482(a) of the Internal Revenue Code of 1954 now provides in pertinent part: "The United States Courts of Appeals shall have exclusive jurisdiction to review the decisions of the Tax Court . . . in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury. . . ." INT. REV. CODE OF 1954, § 7482(a).

114. See, e.g., N.C. GEN. STAT. § 6-21 (1969); 52 N.C.L. REV. 190, 199-200 & nn.48-51 (1973).

115. The Supreme Court has stated that "[c]ourts need not defer to an administrative construction of a statute where there are 'compelling indications that it is wrong.'" *Espinoza v. Farah Mfg. Co.*, 414 U.S. 86, 94-95 (1973), citing *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 381 (1969). See *United States v. Calamaro*, 354 U.S. 351, 359 (1957); *Estate of Smith v. Commissioner*, 510 F.2d at 484 (Mulligan, J., dissenting); *Dorfman v. Commissioner*, 394 F.2d 651, 655 (2d Cir. 1968).

116. See note 82 *supra*.

117. This argument was raised by the dissent in *Estate of David Smith v. Commissioner*, 57 T.C. 650, 664 (1972) (Mulligan, J., dissenting).

The House Report provides:

reenactment to support the validity of the regulation. This principle of statutory construction has been criticized by the Supreme Court, particularly when the legislative history has not considered or indicated Congressional approval of prior administrative or judicial construction.<sup>118</sup>

*Smith* also creates practical problems for executors in the fulfillment of their duties and for courts that must review their actions. The test proposed in *Smith* continues the confusing distinction, inherent in the regulations, between expenses incurred for the benefit of the estate and those incurred for the benefit of individual beneficiaries. Courts have differed on this determination in the past;<sup>119</sup> under *Smith* both taxpayers and the Commissioner of Internal Revenue will continue to have grounds for appeal on this issue.

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*G. Expenses, indebtedness, and taxes (sec. 2053)*

Funeral expenses, administration expenses, claims against the estate and unpaid mortgages are deductible in computing the taxable estate under present law. However, *this deduction is limited to those expenses allowable by the laws of the jurisdiction under which the estate is being administered* and cannot exceed the value of the property included in the gross estate subject to claims, that is, the probate estate. Thus, if the decedent has placed most of his assets in a trust (not includible in his probate estate) funeral and other expenses actually paid . . . out of the trust assets are not allowed as a deduction to the extent they exceed the value of the property in the probate estate.

These arbitrary distinctions have been removed under your committee's bill. Expenses incurred in connection with property subjected to the estate tax, although not in the probate estate, are to be allowed as deductions, if the expenses are of the type which would be allowed as deductions if the property were in the probate estate and they are actually paid within 1 year of the decedent's death.

In addition, expenses in connection with property subject to claims are to be allowed without regard to the total value of the probate estate if they are paid within the period provided for the assessment of the estate tax.

H.R. REP. NO. 1337, 83d Cong., 2d Sess. 91 (1954) (emphasis supplied).

118. See *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (questions significance of re-enactment without express approval of prior interpretation); *Estate of David Smith*, 57 T.C. 650, 664 (1972) (Goffe, J., dissenting). But see *Morgan v. Commissioner*, 309 U.S. 78, 80 (1940), in which the Court stated: "With these regulations outstanding Congress has several times re-enacted § 302(f), and has thus adopted the administrative construction."

119. Compare *Pitner v. United States*, 388 F.2d 651, 660 (5th Cir. 1967); *Dulles v. Johnson*, 273 F.2d 362, 369-70 (2d Cir. 1959); *Commercial Nat'l Bank v. United States*, 196 F.2d 182, 185 (4th Cir. 1952); *Schmalstig v. Connor*, 46 F. Supp. 531, 533 (S.D. Ohio 1942); *Estate of Harry Porter*, 49 T.C. 207, 225 (1967), with *Jacobs v. United States*, 248 F. Supp. 695, 699-700 (E.D. Tex. 1965) (reversed by *Pitner*); *Estate of Louvine M. Baldwin*, 59 T.C. 654, 659 (1973); *Estate of Edward N. Opal*, 54 T.C. 154, 166 (1970); *Estate of Christine Swayne*, 43 T.C. 190, 201 (1964).

The decision also places an unrealistic burden on executors of large estates with few liquid assets, who now must anticipate exactly how much will be required for payment of debts, expenses, and taxes, and then liquidate only so much of the estate's property as will produce this amount of ready cash. This determination is difficult when as in this case, valuation of the gross estate also is contested,<sup>120</sup> and may actually conflict with a fiduciary's duty to protect the assets of the estate.<sup>121</sup>

Although the Court of Appeals for the Second Circuit did not decide specifically the validity of section 20.2053-3(d)(2) of the Treasury Regulations, it affirmed the decision of the Tax Court upholding the regulation. The *Smith* court also reiterated the Tax Court's position that an expense incurred for the benefit of individual beneficiaries was not deductible, a requirement that had been rejected by several prior cases.<sup>122</sup> *Smith* acknowledged a potential conflict between section 2053(a) and the regulation but refused to consider this issue and failed to provide any viable test for the future. The decision of the Court of Appeals for the Sixth Circuit in *Park* provides a more practical solution, one that recognizes the realities of estate administration. *Park's* rejection of the regulation is also more consonant with the statutory mandate. Section 2053(a), by its express terms, makes its operation dependent upon state law; any additional limitations should come from Congress.<sup>123</sup>

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120. Cf. *First Nat'l Bank v. United States*, 233 F. Supp. 19, 29 (D. Kan. 1964) (As a practical matter the original federal estate tax return in larger estates is preliminary and exploratory, since the taxpayer cannot know if the Government will approve valuation of assets, marital deduction, or deductions under section 2053).

121. See 52 N.C. L. Rev., *supra* note 114, at 196-97.

122. See, e.g., *Hipp v. United States*, 72-1 U.S. Tax Cas. at 84,680 ("[I]t is almost axiomatic . . . that what benefits an estate . . . will also benefit the takers thereof."); *Estate of Harry Porter*, 49 T.C. at 255 (fact that some benefit results to beneficiaries is not a reason to disallow expense).

123. "If additional safeguards are needed they should come from Congress, not from the Secretary or his delegate in the form of unauthorized regulations. In my opinion the integrity of the estate tax must be safeguarded from unauthorized and unwarranted limitations imposed by regulations as well as abuses which may occur elsewhere." 57 T.C. at 665 (Goffe, J., dissenting).