Estate of John E. Reid, Deceased, Margaret M. Reid, Executrix, Petitioner v. Commissioner of Internal Revenue, Respondent, 90 T. C. 304 (1988)

The marital deduction must be reduced by inheritance taxes on marital property unless clearly shifted to nonmarital assets, but not by the decedent's income taxes unpaid at death unless the surviving spouse is legally liable.

Summary

John E. Reid established a revocable trust and directed that inheritance taxes could be paid from nonmarital trust assets at the trustees' discretion. Upon Reid's death, the trustees elected to pay all inheritance taxes, including those on marital property, from nonmarital assets. The IRS sought to reduce the marital deduction by the inheritance tax on marital property and by Reid's unpaid income taxes. The court held that the marital deduction should be reduced by the inheritance taxes because the trustees' discretionary power did not clearly shift the burden from marital to nonmarital property at the time of death. However, the marital deduction was not reduced by Reid's unpaid income taxes because the surviving spouse was not legally liable for them at the time of death.

Facts

John E. Reid created a revocable trust in 1976, naming his wife, Margaret Reid, as a beneficiary. The trust allowed trustees to pay inheritance taxes out of nonmarital property at their discretion. Reid died in 1982, survived by his wife. The trust assets included Reid Report-Reid Survey, a sole proprietorship. At death, Reid owed Federal and State income taxes for 1981, but his probate estate was insufficient to cover these taxes. The trustees elected to pay all inheritance taxes from nonmarital trust assets. The IRS sought to reduce the estate's marital deduction by the amount of inheritance tax attributable to marital property and by Reid's unpaid income taxes.

Procedural History

The estate filed a tax return claiming a marital deduction. The IRS issued a notice of deficiency, reducing the marital deduction by the inheritance tax on marital property and by Reid's unpaid income taxes. The estate petitioned the U. S. Tax Court for a redetermination of the deficiency.

Issue(s)

1. Whether the marital deduction should be reduced by the Illinois inheritance tax on property passing to the surviving spouse but payable by trustees at their discretion from nonmarital property?
2. Whether the marital deduction should be reduced by Federal and State income taxes owed by the decedent but unpaid at death?

Holding

1. Yes, because the trustees' discretionary power to pay inheritance taxes from nonmarital property did not clearly shift the burden from marital to nonmarital property at the time of death.
2. No, because the surviving spouse was not legally liable for the decedent's unpaid income taxes at the time of death.

Court's Reasoning

The court interpreted the trust instrument and found that the trustees had discretionary power to pay inheritance taxes from nonmarital property. Under Illinois law, the burden of inheritance tax is on the successor to the property unless the decedent clearly shifts it to nonmarital assets. The court determined that the discretionary language in the trust did not constitute a clear direction to shift the burden, so the marital property remained encumbered by the inheritance tax at the time of death. For the income taxes, the court ruled that the surviving spouse was not liable for them at the time of death under Illinois or Federal law, and thus they did not encumber the marital property. The court cited *United States v. Stapf* to affirm that the marital deduction is allowable only to the extent that the property bequeathed to the surviving spouse exceeds the value of property the spouse must relinquish.

Practical Implications

This decision clarifies that a discretionary power to pay inheritance taxes from nonmarital assets does not suffice to shift the tax burden for marital deduction purposes. Estate planners must use clear and mandatory language to shift tax burdens. The ruling also establishes that a decedent's unpaid income taxes do not reduce the marital deduction unless the surviving spouse is legally liable at the time of death. This case has been followed in subsequent cases, reinforcing the need for precise drafting in estate planning to maximize tax benefits. Legal practitioners should ensure that estate planning documents explicitly address tax apportionment to avoid unintended tax consequences.

