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Previously Taxed Property And The Federal Estate Tax

BORIS I. BITTKER AND JAMES B. FRANKEL

In 1918 Congress added to the then simple but rapidly proliferating estate tax law a deduction for property previously taxed, the prototype of today's section 812(c).1 In recommending the new provision, the House Committee on Ways and Means said:2

"It has come to the attention of the committee that persons closely related have died within such a short space of time that the same estate passing within a short period of time has been subjected to the estate tax and thereby diminished unreasonably because of the short period within which the two levies have been made. For example, a husband dies leaving a large amount of property to his wife, an elderly woman, who dies within a few weeks after her husband's death. Under existing law the entire estate is taxed on the transfer from husband to wife and on the transfer from wife to other beneficiaries.

To alter this result the Committee recommended and Congress adopted a provision allowing the executor to deduct from the decedent's gross estate any part thereof that was received by the decedent, directly or by exchange, from the taxable estate of any other person who had died within the previous five years. The provision was simple and straightforward.3

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1 I.R.C. §812(c) is reprinted as an appendix to the text, infra p. 285. Although the present provision's antecedents were numbered variously, all are referred to in the text by the present session number, §812(c). I.R.C. §861(a)(2) is the parallel deduction for non-residents who are not citizens.

2 H. R. Rep. No. 767, 65th Cong., 2d Sess. 22-3 (1918), 1939-1 Cum. Bull. (Part 2) 86, 102. In explaining the bill, Representative Claude Kitchin said, "We have another very just provision, that if a person who receives a share of an estate dies within five years from the death of the person from whom he receives the estate, his share shall not pay another transfer tax within the five-year period." 56 Cong. Rec. (Part 12) 692 (1918).

3 "Sec. 403. That for the purpose of the tax the value of the net estate shall be determined—

(a) In the case of a resident, by deducting from the value of the gross estate—...

(2) An amount equal to the value at the time of the decedent's death of any property, real, personal, or mixed, which can be identified as having been received by the decedent..."
The principle commended itself to the states, some thirty of which now have an analogous allowance.\textsuperscript{4}

When Congress enacted the deduction, the estate tax rates were, by present standards, mild—although of course bitterly assailed as confiscatory at the time. The unhappy couple mentioned in the House Report, for example, would have paid a total of about $3 million on a net estate of $10 million. Today’s rates would exact about $6.7 million upon two transfers of an estate of similar size.\textsuperscript{5}

But in the thirty-four intervening years the deduction for previously taxed property has become so circumscribed by a multitude of restrictions that—in all but verbiage—it is only a shadow of its former self. Originally the deduction was allowed whenever a decedent’s estate contained property either received by him as a share in the estate of a prior decedent or “identified as having been acquired . . . in exchange for property so received,” provided that the prior decedent had died within the previous five years and that his estate had been taxed.\textsuperscript{6} To these conditions Congress has over the years added several others. Moreover, the size of the deduction, once an estate qualifies for it, has been drastically reduced in most cases by a series of complicated limitations. Finally, the addition in 1948 of the marital deduction to the federal estate and gift tax laws was accompanied by a blanket denial of the previously taxed property deduction to any property received from the decedent’s spouse.\textsuperscript{7} The only

\textsuperscript{4} Of the jurisdictions having something on the order of a deduction for property previously taxed, twenty-one have death levies based on the inheritance tax principle, often accompanied by a separate estate tax to take advantage of the federal credit for death taxes paid to a state: Cal., Colo., Del., Dist. of Col., Idaho, Hawaii, Iowa, Kan., Ky., Minn., Mont., Neb., N.C., Ore., S.C., Tenn., Tex., Va., Wash., W. Va., and Wis. Two states (N.Y. and Okla.) have two separate estate taxes; two (N.D. and Utah) have a single estate tax; and five (Ala., Ark., Fla., Ga., Miss.) have an estate tax designed simply to absorb the federal credit. Twenty-one jurisdictions have no provision for property previously taxed: Alaska, Ariz., Conn., Ill., Ind. (provisio in 1929 law abandoned in 1931), La., Me., Md., Mass., Mich., Mo., Nev. (no death levies of any sort), N.H., N.J., N.M., Ohio, Pa., R.I., S.D., Vt., and Wyo.

\textsuperscript{5} Of the thirty jurisdictions which have an allowance for property previously taxed, twenty-three provide for a “deduction” or its practical equivalent, an “exemption.” The remaining seven allow a “credit” for prior taxes paid. See further note 16 infra. The federal law seems to be the source of these state statutes. Cf. CCH INH., ESTAT. AND GIFT TAX REP. 80, 288. No state provisions pre-date the federal one.

\textsuperscript{6} Assuming that the marital deduction was available to the first decedent but not to the second.

\textsuperscript{7} Supra note 3.

\textsuperscript{7} Infra p. 282.
extension of the deduction came in 1924 when, with the enactment of
the first federal gift tax, Congress provided that property received by a
taxable gift within five years prior to the decedent's death might be
deducted.\(^8\)

Despite this one enlargement of the scope of section 812(c), one may
safely say that it accomplishes less work per clause than any other in the
federal estate tax law; indeed, in this respect it may be without a peer in
the entire Code.

The authors propose to examine this abject remnant in some detail.
Our aim is both to describe what it is today, an unrewarding task that
seems not to have been undertaken previously, and to evaluate the need
for it or for some substitute.

**THE CONDITIONS**

Section 812(c) has always required that the property in question have
been received by a taxable transfer. Originally this meant that it had to
be received from an estate that was taxed; but since 1924, as stated above,
property received from a donor by a taxable gift will qualify.\(^9\) Since 1932
a gift or estate tax must have been "finally determined and paid by or
on behalf of such donor, or the estate of such prior decedent, as the case
may be." The statute also requires that the property in question have been
part of the taxable estate or taxable gift.\(^10\)

*The Requirement of a Taxable Transfer.* These conditions can cause
an amusing reversal of the usual roles of taxpayer and Treasury, with
the latter vigorously asserting that the prior decedent or donor owes no
tax, while the executor or donor, mindful of the interests of the trans­
ferree, seeks to force a tax payment on the Treasury.\(^11\) In one case an

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\(^8\) Revenue Act of 1924, Sec. 303(a)(2). The 1924 gift tax also included a deduction
for property previously taxed. *Id.* Sec. 321(a)(4). Cf. Estate of Parker, 35 B.T.A. 609
(1937). But when the gift tax was re-enacted in 1932, this deduction was not carried
forward.

\(^9\) The transfer by gift must have occurred within five years of the decedent's death.
In the case of property received by testamentary transfer, however, the five years is cal­
culated not from receipt but from the prior decedent's death. Second National Bank v.
Comm'r, 63 F.2d 815 (6th Cir. 1933) (*H* died Aug. 4, 1918; distribution of estate oc­
curred June 8, 1920; *A* died Apr. 22, 1925. Deduction denied).

\(^10\) Thus, if inclusion of the property was resisted by the executor or the prior estate,
and the dispute was settled by a partial inclusion, only that part can be deducted. Lough­
ridge's Estate v. Comm'r, 193 F.2d 294 (10th Cir. 1950), *reversing in part* 11 T.C. 963

\(^11\) This is not the only point at which the executor and Commissioner may find them­selves in each other's shoes. If *A* makes an inter vivos gift of previously taxed property,
paying a gift tax, his executor may try to prove that it is includible in the gross estate,
*e.g.*, as a gift in contemplation of death. For its inclusion may be offset by the section
812(c) deduction, thus costing nothing; and, at the same time, it will give rise to a credit
for the gift tax paid on the transfer.
executor, miscalculating the value of the first estate, found a small tax due and paid it. The Government's audit disclosed that the estate was not taxable. Even though the statute of limitations had not run, however, the executor refused to accept a refund check. The Court held that the Government's acceptance of the executor's erroneous payment was a mere administrative act and not a "final determination" of a tax under section 812(c). Hence the property did not qualify for the deduction. 12

In another case the Commissioner had asserted that certain transfers by the prior decedent were taxable under section 811(c) and had assessed and collected a deficiency on that basis. Thereupon the property was deducted under section 812(c) by the estate of a second decedent. The Commissioner then proposed an over-assessment on the first estate, reversing his original contention that the property should be included. He simultaneously denied the section 812(c) deduction to the estate of the second decedent. The latter estate paid the tax in full and sued for a refund. The District Court held (a) that the property was properly includible in the estate of the prior decedent and (b) that the payment by the first estate of a tax assessed by the Treasury satisfied the "finality" requirement of the statute. 18

These cases are far from settling all the possible issues which may arise from such inconsistent positions. May property be deducted under section 812(c) where a tax was erroneously paid on its transfer if the tax has not been refunded and the statute of limitations on a refund has run? If the Treasury erroneously asserts a deficiency against the transferor, is it thereafter disabled from disallowing a deduction under section 812(c) to the transferee? If the deduction is allowed, what is the consequence of a later action for refund by the transferor? If the tax is refunded and if the transferee is the sole beneficiary of the prior estate, do the principles of estoppel or recoupment prevent a section 812(c) deduction by the transferee? Can the transferee claim a section 812(c) deduction while the transferor is disputing or litigating his liability for tax on the transfer?

Of greater import than these teasing problems of construction is the all-or-nothing character of the statute's requirement that the transferor have been taxed on the property in question. If the prior estate was valued at $60,000, so that by reason of the specific exemption no tax was due, no part of the estate will qualify under section 812(c). If,

12 Hermann S. Vath, 41 B.T.A. 487 (1940).
18 Wells Fargo Bank & Union Trust Co. v. United States, 80 F.Supp. 787, 790-1 (N.D. Cal. 1948). Under the statute, the property in question is covered if it is included in computing the tax as "finally determined." Since it is apparently irrelevant that it was improperly included, it is not apparent why the Court felt called upon to decide that inclusion was in fact proper.
however, the prior estate had been valued at $60,001, so that a nominal
tax was paid, the entire estate would qualify under section 812(c). Similarly,
if a donee receives $33,000 and no tax is paid by the donor because
of the specific exemption and exclusion, the property will not qualify;
increase the supposed gift to $33,001, and it becomes qualified. The
availability of the deduction, then, is wholly independent of the rate at
which the property was taxed on the prior transfer. This fact cannot
easily be reconciled with the Congressional aim of preventing the unrea­
sonable depletion of a family fortune when two deaths fall within a short
period. It has seemed so bizarre to two state courts that they interpreted
analogous (though somewhat differently phrased) state statutes to per­
mit the deduction of only a part of the property. Other states have
avoided the result by granting a credit for the tax paid on the prior trans­
er instead of allowing the value of the property itself to be deducted.

Even if the prior estate was taxed, section 812(c) specifically denies
the deduction if a similar deduction was allowed to the prior estate for
the property in question. Thus if A bequeaths property to B, who in turn
leaves it to C, and all three die within five years, B’s estate may deduct
the property under section 812(c), but C’s estate may not. If, on the
other hand, B (after inheriting the property from A’s estate) had trans­
ferred it to C by gift in contemplation of death, C’s estate could claim
the deduction, notwithstanding that B’s estate enjoyed both a gift
tax credit as well as a section 812(c) deduction on the property. In so

14 Estate of Schmidt, 19 T.C. No. 10 (1952). Property received by gift in one year
was held not to qualify under section 812(c) because the donor applied his exclusion and
part of his specific exemption against it and paid no tax. Property received the follow­
ing year (to the extent that it exceeded the exclusion, see note 44 infra) was conceded
to be qualified under section 812(c) because the donor was taxed although he applied
against the gift the exclusion and the balance of the specific exemption. Presumably if
both gifts had been made in a single year, both would have qualified under section 812(c).

15 Estate of Letchworth, 201 Cal. 1, 255 Pac. 195 (1927); In re Nilson, 201 Iowa 1033,
204 N.W. 244 (1925).

16 They are: Co., Ky., Mont., N.D., Tenn., Va., and Wis. For a proposal that this
technique be applied to the federal tax; see p. 285 infra; Oakes, The Re-Jisio of the Federal

17 Apparently B’s estate may not transfer its rights to C’s estate foregoing the deduc­
tion; the statute denies a deduction to C’s estate if the deduction was “allowable” to B’s
estate.

18 Or, presumably, by any other kind of inter vivos transfer bringing the property into
the gross estate.

19 Estate of Marjorie Hart, 2 T.C. 1246 (1943). The statute denies the deduction
where a similar deduction was allowed in determining the “net estate of the prior
decedent.” This restriction was held to be inapplicable where the property was acquired
by gift rather than by inheritance, even though the donor’s estate may have had a section
812(c) deduction in respect of the property.
holding, the Tax Court called the section's draftsmanship "poor" and acknowledged that the result "may seem strange." The Court was correct on both scores. The basic statutory scheme of taxing gifts in contemplation of death and allied transfers in the same way as testamentary transfers is impaired, since C's estate will be better off if he received the property by a gift in contemplation of death (or other inter vivos transfer) from B than if he received it by inheritance.20

The Necessity for "Identifying" the Property. In addition to showing that the property was acquired from a taxable estate or donor (and, if from the former, that no section 812(c) deduction was allowable to the transferor), the claimant estate must establish that the property can be identified as having been received by the decedent from the donor by gift, or from such prior decedent by gift, bequest, devise, or inheritance, or . . . can be identified as having been acquired in exchange for property so received.

This part of section 812(c) creates two conditions: there must have been a receipt of property by gift, bequest, devise, or inheritance;21 and property in the estate must be traced back to the transferee.

The meaning of the first requirement has been substantially clarified by several judicial pronouncements and statutory amendments. Property received by the present decedent in settlement of claims asserted against a prior estate does not come within section 812(c).22 This is only logical, since the prior estate was allowed to deduct the amount of the claims and, as a consequence, the transfer of the property in question was not taxed. On the other hand, the spirit of the statute quite clearly calls for the allowance in several situations where the Treasury formerly resisted it. Thus, at one time the Treasury took the position that the proceeds of life

20 Perfect coordination of the treatment of gifts in contemplation of death and other lifetime substitutes for transfers at death with the treatment of testamentary transfers is already prevented by the fact that the gift tax paid is not added back to the estate. This indefensible concession to inter vivos transfers is counterbalanced, however, by the vagaries of the gift tax credit, which may be less than the amount actually paid, and by the failure to allow interest on the "down payment."

21 The statute speaks of property "received by the decedent from the donor by gift, or from [the] prior decedent by gift, bequest, devise, or inheritance." Confusion has been generated by the repetition of the word "gift." The reason for the repetition is that receipt from a prior decedent "by gift, bequest," etc. was intended to include gifts in contemplation of death and other inter vivos substitutes for testamentary transfers. See Moses E. Greenebaum, 12 B.T.A. 823 (1928); Estate of Marjorie Hart, supra note 19. The other reference to receipt by gift was added when in 1924 the statute was extended to include property received by a transfer taxed under the new gift tax.

22 Hull v. Continental Illinois Bank, 177 F.2d 217 (7th Cir. 1949). A portion of the property received by the second decedent from the estate of the first was in settlement of a claim of heirship; this part the Treasury allowed under section 812(c). Cf. Guaranty Trust Co., 3 B.T.A. 459 (1926) (property received from prior estate "in settlement of certain lawsuits").
insurance were not received by "gift, bequest, devise or inheritance." 23 It sought similarly to disqualify property held in joint tenancy with the prior decedent, arguing that acquisition by the right of survivorship was not "by gift, bequest, devise or inheritance." 24 Both arguments were unsuccessful, and the Treasury regulations now acknowledge that the statute embraces property received by the decedent as a joint tenant or tenant by the entirety and as a beneficiary of life insurance, as well as community property and property received as dower or curtesy. 25 Since 1942 section 812(c) has embraced property which was taxed to the prior decedent or donor because he possessed a power of appointment. 26 Moreover, the regulations take the position that if the present decedent is the possessor of a power of appointment, the property came to him by "gift" or by "gift, bequest, devise or inheritance." 27

While it is thus comparatively simple to determine whether or not property was received by gift, bequest, devise, or inheritance, it is frequently difficult to establish that the transferee's estate includes property which "can be identified" as the property so received or as having been acquired in exchange therefor. But this second condition of the proviso quoted above must be complied with to get the deduction. If the property in question is Blackacre, identification is easy enough: A owned it, B inherited it, B owned it at the time of his death. Similarly, if A owned and bequeathed to B 100 shares of Consolidated Boondoggles, Inc., and B died owning 1,000 shares of Amalgamated Widgets, Inc., acquired for the Boondoggle stock when that company was merged into Widgets, the Widget shares "can be identified . . . as having been acquired in exchange for property" received by gift, bequest, devise, or inheritance. But what if B inherited money or inherited Blackacre and sold it? Can the property included in B's gross estate—whether cash, securities, real estate, life insurance, jewelry, or what not—be "identified as having been acquired in exchange" for the inherited property? The issue most frequently litigated under section 812(c) has been this question of identification.

The first round—in which was decided the leading case, Rodenbaugh v. United States 28—ended ominously for the taxpayer. Elizabeth Roden-

23 Louise A. Gardner, 22 B.T.A. 1076 (1931). Here the Board of Tax Appeals allowed a deduction for property traceable to life insurance proceeds. But it reduced the allowable deduction to account for the $40,000 of life insurance which was exempted (under pre-1942 law) from taxation in the prior estate.
24 Comm'r v. Fletcher Savings & Trust Co., 59 F.2d 505 (7th Cir. 1932).
25 Reg. 105, Sec. 81.41(a)(1).
26 Revenue Act of 1942, Sec. 407(a)(1).
27 Supra note 25.
28 25 F.2d 13 (3d Cir. 1928).
bough was one of three residuary legatees under the will of her father, who died in 1918. From his estate she received securities worth nearly four million dollars. She sold some of these securities and deposited the proceeds in her personal bank account. About the same time she purchased other securities, paying for them with checks drawn on the same bank account. Upon her death in 1921, her executor claimed a deduction for property previously taxed, *viz.*, the securities purchased in the manner just related. The Commissioner took the position that the decedent's estate could deduct only the very property inherited or other property "exchanged" for it in the most literal sense, *i.e.*, acquired by barter. Moreover, he asserted that there could be only one such "exchange." A sale of inherited property followed by a reinvestment of the proceeds would not qualify. In fact, the Commissioner took the extreme view that even the proceeds of sale would not qualify unless received and held in the form of cash. If the property was paid for by check, and the check was deposited in a bank, the Commissioner argued that there were two exchanges: an exchange of the inherited property for the check; and an exchange of the check for the bank's unsecured promise to pay! 20 This preliminary skirmish was won by the taxpayer. The Court of Appeals for the Third Circuit held that there could be any number of exchanges, so long as the property for which the deduction was claimed could be traced back to the inherited property. This view has been accepted by the regulations, 80 and no more has since been heard of the Commissioner's restricted view of the meaning of "exchange."

But a second, more troublesome point was raised by the Treasury in the *Rodenbough* case—the question of commingling. The parties had stipulated "that Mrs. Rodenbough deposited all moneys that came to her from all sources in one general bank account and that she thus commingled moneys originally her own and moneys which arose from the sale or other disposition of securities she had received from her father's estate." 81 How could the securities owned at the time of her death "be identified as having been acquired in exchange" for the inherited securities? The Commissioner insisted that the executor must produce evidence linking the purchased securities to the inherited property. The executor asserted that it should be presumed that the decedent had used

20 1 B.T.A. 477, 482 (1925).
80 Reg. 105, Sec. 81.43. *See also* Cary v. United States, 22 F.2d 298 (W.D.N.Y. 1927); Estate of Isabella C. Hoffman, 3 B.T.A. 1361 (1926). State courts, construing similar provisions, have arrived at the same result. *In re Cooper's Estate*, 65 N.Y.S.2d 263 (Surr.Ct.N.Y.Co.1946); *In re Raynolds' Estate*, 219 Minn. 449, 18 N.W.2d 238 (1945).
81 *Supra* note 28, at 17.
the proceeds of inherited property for her investments and her "own" funds for her personal expenditures.

The Court, however, refused to presume that this lady, differing from our observation of others of her sex, reached into a common fund and carefully selected for reinvestment those moneys which had come to her from the sale and liquidation of particular securities that she had received from a particular source. Rather than setting up such a presumption, common experience, we think, indicates that she drew funds for reinvestment without thought of their source.

In remanding, the Court stated that if no other evidence was available, it would be necessary to rely upon an analysis of the bank deposits and withdrawals. The purchased securities could then be traced back to the inherited property only to the extent the amounts withdrawn for investment were too large to have been supplied from non-inherited sources. The outcome of the Rodenbaugh case, then, was not very promising for the taxpayer. Although the Commissioner's absurdly circumscribed

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32 Id.
33 The opinion on remand, not officially reported, may be found in 15 A.F.T.R. 551 (E.D. Pa. 1929). The Court found part of the property identifiable.

Tracing by the Rodenbaugh method can be even more of an obstacle to the deduction than the facts in the case itself suggest. For even if it can be shown through an analysis of the decedent's bank deposits that property was purchased with inherited funds, that property in turn might have been later sold and the proceeds commingled with non-previously taxed property. Suppose that thereafter property is purchased with a check drawn on the mixed account and that this property is owned at death. Presumably the "Rodenbaugh rule" would have to be applied a second time. Consider this example: A has $100,000 on deposit, of which $50,000 was the proceeds of a sale of inherited property. He spends $25,000 for his living expenses and buys securities for $75,000. (Under the Rodenbaugh rule if these securities were held until death, only $25,000 (in the absence of other evidence) could be attributed to the inheritance.) A then sells the securities for $75,000 and deposits the proceeds of sale. Thereafter he deposits in the same account $50,000 from other sources. He then uses $20,000 for personal expenses and buys securities for $105,000. These securities are held until death. Presumably only $5,000 can be traced back to the inheritance, because when the securities owned at death were purchased, there were sufficient non-inherited funds on hand to cover $100,000 of their cost. Where the decedent has bought and sold with some frequency, there may be repeated nibbling away at the amount of property that can be traced back to inherited property. The contrast between the decedent who kept his inherited property in a special account and the decedent who commingled his funds is especially striking in such instances.

The example just described can also be used to illustrate certain unsettled issues under the Rodenbaugh rule. If the final purchase of securities is of 10,500 shares of XYZ, Inc. at $10 per share, and 500 shares are sold before death to meet living expenses, can any of the 10,000 shares left be traced back to the inherited property? Suppose the final purchase consisted of $5,000 worth of the securities of each of 21 companies. Can the last $5,000 order placed or filled be traced to the inherited property, so that if these are the only securities left, they will qualify under section 812(c)? Suppose the first $75,000 purchase assumed above (of which $25,000 is traceable to inherited property) is for securities that increase in value, so that they bring $100,000 on a sale. When the proceeds of this sale are deposited, how is the inherited property account to be credited in order to apply the Rodenbaugh rule subsequently? Perhaps if all securities had increased by the same percentage, the inherited property account would be treated as rising from
definition of "exchange" was rejected, the necessity for an identification came to the fore as a major problem. Commingling of funds, a natural action, might prove fatal to the deduction.

It will be noted, however, that the implacable analysis of the Rodenbough case was to be applied only because "[t]he only evidence available is . . . the decedent's deposits, withdrawals and balances shown in her bank account." In several later cases this has been the chink in the Commissioner's armor. Thus, where the decedent indicated that she wished "to purchase securities from the funds bequeathed her from her mother's estate," the securities so purchased were held to be traceable.\(^{34}\) It was found in effect (in the words of the Rodenbough rule) that the decedent had "reached into a common fund and carefully selected for reinvestment those moneys which had come to her" by inheritance. In another case, where no testimony of the decedent's desires was presented, the Court virtually established a presumption that the decedent "intended to purchase the new securities from the proceeds of the sale of the old."\(^{35}\) The Court went on to say:

To apply the Rodenbough rule would not be realistic. It would not be in accord with human experience.\(^ {36}\)

The Court emphasized that the decedent in question was "an experienced investor." On the same day, however, the same Court applied the Rodenbough rule where there was "an entire failure" to establish the decedent's intent.\(^ {37}\)

$25,000 to $33,333. But what if some securities tripled in value while others declined? Can particular securities be allocated to the inherited property account, on the assumption that the last $25,000 bought were, by the Rodenbough rule, acquired with traceable funds? If so, can this assumption be applied where the entire $75,000 were bought on the same day, by reference to the order in which the broker was told to buy the various securities or by an analysis of the hour and minute when each order was executed?

\(^{34}\) Wiggin v. Hassett, 56 F.Supp. 263 (Mass. 1944). See also Estate of Miller, 3 T.C. 1180 (1944).


\(^{36}\) Supra note 35, at 174. The Court went on to indicate that it thought "the Rodenbough rule" was to assume that the second decedent always intended to draw on his inheritance for his living expenses and on his other funds for his investments. Of course, the Rodenbough rule meant simply that if the executor, who must establish the source of the property he seeks to deduct, can offer no other evidence than the bank records, he has not traced any investments to the inherited property if there are other funds with which the investments could have been made.

\(^{37}\) Van Dyke v. Kuhl, 78 F.Supp. 698 (E.D. Wis. 1945). The Court distinguished the Horlick case, supra note 35, as one "where all the facts and circumstances clearly indicated an intent by the second decedent to purchase the new securities from the proceeds of the old." The Horlick opinion, however, sets out no "facts and circumstances," except that the decedent there was "an experienced investor" whose bank balance, before the proceeds of the inheritance were deposited, was "quite low." The Court then asked: "How can there be any doubt that he intended to purchase the new securities from the
Apparently only "an experienced investor" could be presumed to have the requisite thought of the source of his investment. It remained for Judge Learned Hand, in deciding another commingling issue under section 812(c), to administer what could be the coup de grâce to the Rodenbaugh rule. He held that, in the absence of evidence, he would assume that the action most favorable to the taxpayer was taken, apparently because if the consequences had been understood that was the action that would unquestionably have been taken. He was then speaking of an executor, who of course has a fiduciary obligation to act thus, but the decedent himself also has a motive, though not a duty, to pursue his self-interest. This rationale would serve to bury the Rodenbaugh rule even as to giddy females and shiftless males.

In examining the Rodenbaugh rule and its competitors, one is struck by the fact that persons in precisely the same economic circumstances will be treated differently, depending upon whether someone can be found to testify that the decedent's fondest desire was to reinvest his inheritance or upon whether a court will assume that that was what he probably wanted. The deduction can be insured by depositing the funds in a separate account and drawing on it for investments. It is sticking in the bark to deny the deduction for want of a formality having utterly no non-tax consequences.

proceeds of the sale of the old? In the Horlick case, the Court seems to reject the Rodenbaugh rule and to adopt its exact opposite, yet in the Van Dyke case the Court seems to embrace the Rodenbaugh approach.

38 Blair v. Dustin's Estate, 30 F.2d 774 (2d Cir. 1929). The issue here arose under a proviso added to section 812(c) in 1921 (since repealed, see pp. 277-8), providing that previously taxed property could be deducted only if it was not deducted as (i.e., used to pay) administration expenses or charitable bequests. The executors of the estate in question had sold previously taxed property and deposited the proceeds in an account that also included other funds and then drew checks on the commingled funds to pay charitable bequests and administration expenses. In holding that the remaining funds not so used could be regarded as the previously taxed property, Judge L. Hand said: "We think that the situation at bar is such as to justify raising a . . . presumption . . . that the executors did act with a view to the estate's best interest, which, as we have said, is equivalent to assuming that they knew the law. Like any other presumption, it would cease, once proof were introduced on the other side. Here there was none. So, while as mere matter of reasoning we agree that we should have no right to conclude that they did so intend, we hold the transaction one where justice requires us to act as though they had. If we did not, we should have to presume that the earliest withdrawals were from the earliest deposits, an equally gratuitous assumption, and adopted only in default of any other. It is true that we might hold that, in the absence of all proof, the taxpayer should fail; but, in so doing, we should abandon doctrines generally applicable to such situations, which are dealt with by recourse of one sort or another to such devices." 30 F.2d 774, 776.

Query: Would proof that the executors acted in ignorance of the law dissipate the presumption?

39 The Tax Court has gone the whole way, holding that identification is sufficient, notwithstanding a commingling of funds, if the cost of the new securities is less than the proceeds of the old. Estate of Schroeder, 13 T.C. 259 (1949).
It should be noted, however, that even the most lenient cases on commingled funds will not help the poor (or rich) devil who draws on inherited funds for riotous living and later goes to work and saves his earnings.\(^{40}\) His economic position may be precisely the same as his neighbor's, but the deduction will be denied because the property owned at death cannot be traced to the inheritance. Similarly, if he has separate accounts for previously taxed property and for other assets but draws on the latter account for his investments, they will not qualify under section 812(c). So long as identification is required, formalism will take precedence over equity among taxpayers.

Certain other questions of identification may also be briefly noted. It is now established that securities acquired as a stock dividend or through the exercise of subscription rights on previously taxed securities may qualify for the deduction.\(^{41}\) Where property owned at death by the second decedent was purchased by him from the prior decedent on credit, and the debt was discharged with funds or property inherited from the prior decedent, the property qualifies under section 812(c).\(^{42}\) Similarly, where the beneficiary of a prior estate, during its period of administration, borrowed money to purchase property, the property was held to qualify under section 812(c) because the loan was paid off upon receipt of the legacy.\(^{43}\)

**The Limitations**

Compliance with the foregoing conditions serves to qualify the property under section 812(c). The deduction, however, is not necessarily the full value of the property so qualified; a variety of limitations now comes into play to determine the amount of the deduction. These limitations include provisions that limit the basic valuation assigned to a given item of prop-

\(^{40}\) See Estate of Schroeder, *supra* note 39, at 264: "Of course, if the previously taxed cash had been deposited in this account and then withdrawn before additional non-previous taxed cash was deposited, it could not be said that the credit balance on the date of decedent's death was traceable to previously taxed cash."

\(^{41}\) Blair v. Dustin's Estate, 30 F.2d 774 (2d Cir. 1929). It was conceded that any new money contributed upon exercise of the stock rights must be deducted from the final valuation. If the rights are not exercised but are sold instead, the proceeds (if properly identified) will qualify for the deduction. Estate of Susan K. Thorn, 16 B.T.A. 181 (1929).


\(^{43}\) Estate of Devereux Milburn, 6 T.C. 1119 (1946). One Court has declined to follow similar logic when it operated to the taxpayer's disadvantage. In Levi v. United States, 14 F.Supp. 513 (Ct. Cl. 1936), the decedent had been left certain corporate stock under his wife's will. Before distribution of the wife's estate the decedent had made a gift to his nephew of an equal amount of the same stock because he felt that his wife should have left the stock to the nephew. The Court of Claims nevertheless allowed the decedent's estate to deduct the stock received from his wife's estate.
Property and others that reduce the amount so assigned to compensate for certain attendant circumstances.

**Valuing the Previously Taxed Property.** In the first place, in computing the deduction the executor must use either the value of the property as reported by him or its value as “finally determined” in reporting the previous transfer, whichever is lower. If the property has declined in value, the deduction cannot exceed its present value; if the value has increased, the deduction cannot exceed the value previously taxed. Otherwise, of course, the deduction would do more than simply prevent the unduly rapid diminution of a family fortune; either appreciation would go untaxed or (in the event of depreciation) the deduction would serve to immunize the second decedent's non-inherited property from tax. Where more than one item of property is involved, however, the aggregate value may be used. Thus, if one or more items have decreased in value between the two deaths while others have increased, the subsequent estate is not limited to the lower value of each specific piece of property. Depreciation in some items may be offset by appreciation in others.

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44 This valuation technique was added by the Revenue Act of 1929, Sec. 403(a)(2). Under the 1918 Act the deduction was set at the value of the property in the second decedent's estate. Supra note 3. But it was soon discovered that this gave the second decedent a “windfall” if the property appreciated during the period he held it, and the statute was amended. For cases discussing what is a “final determination” of the value of inherited property where the executor of the prior estate and the Treasury were in dispute, see note 10 supra. See also on the valuation issue, Estate of Hauch, 19 T.C. No. 12 (1952).

Where the property was received by gift, the regulations take the position that only the part that exceeds the exclusion is “the value of such property in determining the value of the gift.” Reg. 105, Sec. 81.41(b)(3), second paragraph. Thus, if property worth $24,000 is received by gift, and an exclusion of $4,000 is applied against it, only the balance of $20,000 will qualify under section 812(c). The regulations go on to carry its logical extreme this view that only the excess over the exclusion was taxed to the transferor. If the property in question is worth $18,000 when the transferee dies, only 5/6 (i.e., 20,000/24,000) of its value, or $15,000, may be deducted. This limitation is based on the statutory language: “This deduction shall be allowed . . . only to the extent that the value of such property is included in the decedent's gross estate.” The phrase “such property” is apparently construed by the Treasury to mean the percentage of the property that was reported as a “gift” by the donor. An attempt to apply somewhat similar reasoning to the specific exemption was rejected by the Tax Court. Supra note 14.

At the opposite extreme is Virginia V. Gary, 30 B.T.A. 1143 (1934). Here the second estate included a remainder interest, worth $285,000, in certain shares. The shares themselves had been included in the prior estate at the value of $375,000; at that time, the remainderman's interest was worth $273,000. The Court held that “the property” had been included in the prior estate at the value of $375,000. Pressed to its extreme, this view would frustrate the Congressional purpose. There could be several remainders, all claiming under section 812(c); if the property had appreciated, each might have an interest worth $375,000. The aggregate section 812(c) deductions could then exceed the value actually taxed, thus allowing the appreciation to escape a transfer tax. (In the Gary case the stock had not in fact increased in value.)

45 This provision was added by the Revenue Act of 1932, Sec. 806.
**Claims Against the Transferor.** In 1932 Congress enacted a corollary to the rule that the deduction may not exceed the value of the property as reported by and taxed to the prior estate or donor. If a mortgage or other lien against the property was deducted in computing the tax on the prior transfer, the section 812(c) deduction must be reduced to the extent that the mortgage or lien has been paid off. The proviso's effect is best illustrated by an example. Assume that property worth $100,000, subject to a mortgage of $25,000, was inherited, that the mortgage was paid off by the second decedent, and that the property's present value is still $100,000. The proviso has the effect of reducing the deduction to $75,000. The theory is that only the equity of redemption, not the full value, was taxed on the prior transfer.

Where a claim was a lien against the entire prior estate, however, and the present decedent is the sole beneficiary or residuary legatee of that estate, the law is not so clearly defined. If the prior estate has not yet been administered, it has been held that the decedent's estate may report as property previously taxed only the net value of what is due him from such prior estate. And if the decedent, acting as executor of the previous estate, distributed to himself property subject to general liens and then paid off those liens from his own funds, his estate may deduct only the net value (property less liens) as property previously taxed. To the extent he paid off the liens from his own funds, the decedent is a purchaser, not a legatee. On the other hand, it has been held that the estate of a decedent who receives property subject to a debt to himself may deduct the full value of the property as previously taxed. Here the decision was based on a finding that the decedent "waived his right" to collect the debt.

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46 Revenue Act of 1932, Sec. 806. Although the statute itself does not require that the mortgage or lien have been applicable to the inherited property, this was its obvious intention, as the regulations acknowledge. Reg. 105, Sec. 81.41(b)(2). See H. R. REP. No. 708, 72d Cong., 1st Sess., 1939-1 CUM. BULL. (Part 2) 457, 492. It has been held immaterial that the debt was paid off with other funds of the estate rather than with funds of the heir. Ransbottom's Estate v. C.I.R., 148 F.2d 280 (6th Cir. 1945). This result was proper in the case itself, where the second decedent was the sole beneficiary of the first estate, but would not comport with the statutory purpose if he were not.

47 If the value of the property had declined to $60,000, the deduction would be only $35,000. Reg. 105, Sec. 81.41(b)(2).

48 Bahr v. Comm'r, 119 F.2d 371 (5th Cir. 1941); Thomas v. Earnest, 161 F.2d 845 (5th Cir. 1947). The latter decision qualifies the former by holding that estate taxes should not be deducted from the value of the prior estate in determining its net value. This limitation is proper; the value of the estate before the estate tax is deducted is what has been "previously taxed" so as to be entitled to immunity from a second tax.

49 Central Hanover Bank & Trust Co. v. Comm'r, 159 F.2d 167 (2d Cir. 1947). The Court asserted that "[i]t is of no consequence whether the debts were liens in a formal sense upon the [prior decedent's] assets; it is enough that, if the [present decedent] did not pay them, the creditors could follow them and sell them on execution." Id. at 168.
Where the income of the prior estate during administration was used to pay off general debts of the prior estate, the courts have gone both ways. Some allow the full value of the property in the prior estate as a deduction. Another court has limited the deduction to the net value of the prior estate at the time of the prior decedent's death. The latter result seems more in keeping with the purpose of the statute.

Claims Against the Transferee's Estate. Once the value of the property has been adjusted to take account of claims against the prior estate or donor, it becomes necessary to make other (similarly downward) adjustments because of the claims to which the property is subject in the present estate. The general problem may be illustrated by assuming that the property previously taxed is bequeathed by the second decedent to a charity or used to pay administrative expenses. May the estate deduct both the expense or charitable bequest and also the property previously taxed? Under the provision as first enacted it could.

In 1921 Congress made its first move to deny such a double deduction. The statute was amended to provide that the previously taxed property could be deducted under section 812(c) only to the extent that it was not deducted as a charitable contribution or as an expense. Form was thus placed above substance, for the deduction now apparently depended upon whether expenses or charitable legacies were paid with previously taxed property or with some other item in the estate. In point of fact, the courts neatly emasculated the restriction. Some did this by presuming that if the executor commingled previously taxed funds with other funds, he used the latter to pay expenses and charitable bequests. Others held even more boldly that if the estate had enough other property to cover the expenses and charitable bequests, there was no forbidden double

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50 Estate of George Rice, 7 T.C. 223 (1946). Four judges dissented. The decision is well criticized in a case note at 59 HARV. L. REV. 1315 (1946).
51 Comm'r v. Garland, 136 F.2d 82 (1st Cir. 1943); Constance C. Churchill, P-H T.C. MEM. DEC. 443. These cases relied on a literal interpretation of the statute.
52 McCarthy v. Delaney, 76 F.Supp. 471 (D. Mass. 1948). Here the Court specifically repudiated the Garland rationale, supra note 51, even though that case had been decided by its own Court of Appeals. It asserted that "[w]here A owing X money, leaves to B all his estate, B's right to the property is junior to X's right to reach the property. Regardless of whether A's debts to X are paid out of the sale of some of the assets in A's estate... or out of the income which A's estate earns after A's death [and which is therefore not a part of A's bequest to B], or out of B's pocket, the value of the bequest from A to B is the value of A's gross estate less the amount of A's debt to X." Id. at 473. It makes no difference, said the Court, whether what was paid off was a mortgage or an "inchoate floating charge." Ibid.
53 Supra note 3.
54 Revenue Act of 1921, Sec. 403(a) (2).
55 Blair v. Dustin's Estate, supra note 38.
deduction and consequently no occasion to limit the section 812(c) deduction. 56

Recognizing that the purpose of the 1921 restriction had “not been entirely accomplished,” Congress in 1932 extensively revised the statute. 57 Its new approach was to charge the previously taxed property with a portion of all the deductions (including the exemption) allowed to the second estate. Thus, if the gross estate was $300,000, of which $100,000 was previously taxed property, and the specific exemption and deductions (other than for previously taxed property) came to $150,000, the previously taxed property would be reduced by its share (50 per cent) of the exemption and other deductions. The deduction under section 812(c) would then be $50,000.

In 1942 Congress refined (to speak charitably) the formula for charging previously taxed property with its “fair” share of the exemption and other deductions, and the statute has not been changed in this respect since. 58 In giving the statute its present form, Congress was concerned with the fact that some of the estate’s deductible claims might be enforceable only against specific items of property. To the extent that the previously taxed property is not subject to a particular claim against the estate, it seemed unfair to reduce the section 812(c) deduction by any part of that claim. On the other hand, some of the non-previously taxed property might be immune to levy on a particular debt; in this event, it seemed

56 Seaboard National Bank, 11 B.T.A. 1386 (1928); Parrott v. United States, 42 F.2d 522 (N.D. Cal. 1929); Estate of Thorn, 16 B.T.A. 181 (1929); Emma C. Boetticher, 19 B.T.A. 616 (1930); Calvert Crary, 19 B.T.A. 634 (1930). In the Seaboard case the Board pointed out that under the strict construction urged by the Commissioner “the allowance of the deduction for prior-taxed property would be made to depend upon accident, mistake, or the method of bookkeeping employed by the executor, and we are not persuaded that such was the intention of Congress in providing for the deduction in question.” (1396-7)

Where part of the property previously taxed was the subject of a specific charitable bequest, however, the deduction under section 812(c) was limited to the balance. Estate of Laura N. Kirkwood, 23 B.T.A. 955 (1931). This result also followed where the executor failed to show that there were available sufficient funds from other sources to satisfy charitable bequests. Fidelity Union Trust Co., 6 B.T.A. 125 (1927).


58 Revenue Act of 1942, Sec. 405(b). The change in section 812(c) was inspired by the same principle that occasioned an amendment then being made to I.R.C. §812(b), relating to deductions for claims against the estate. Id. Sec. 405(a). This change limited the deduction for such claims to the value of the property in the estate which could be subjected to payment of the claims in the final settlement of the estate. See H. R. Rep. No. 2333, 77th Cong., 2d Sess. 164 (1942), 1942-2 Cum. Bull. 372, 418. Cf. Estate of Samuel Hirsch, 14 T.C. 509 (1950). Prior to this change, some estates had obtained deductions in an amount which exceeded the value of property against which claimants could proceed for satisfaction. E.g., Union Guardian Trust Co., 32 B.T.A. 996 (1935).
that such a claim should be fully allocated against the property (including any previously taxed property) that was subject to it. The report of the House Committee on Ways and Means gives this example of the effect of the new provision:

This general rule may be illustrated by the case of a gross estate consisting of Blackacre valued at $100,000, Whiteacre valued at $120,000, and insurance proceeds, exempt from creditors’ claims, in the amount of $100,000, and deductions allowed under section 812(a), (b), and (d) totaling $170,000, including a $20,000 mortgage enforceable only against Blackacre. If the estate is entitled to a deduction under section 812(c) by reason of the inclusion of Whiteacre in the estate of the prior decedent at a value of $120,000, under section 812(c), as amended, the amount allowable as the deduction is $30,000, computed by reducing $120,000 by $150,000 of $200,000.

It may be noted that the statute goes much further than simply to allocate against Blackacre and Whiteacre the full amount of the general claims to which the insurance proceeds are not subject. For the deductions charged exclusively against the two parcels of real property include the specific exemption. The insurance proceeds are taken out of the equation (because they are not subject to general claims) no matter how small in amount the general claims may be.

On the other hand, the statute, in keeping with this favorable treatment of property not subject to general claims, grants a boon to the estate where the previously taxed property itself is immune to general claims. To the extent that it is so immune, it is not charged with any of the estate’s deductions. To revert to the example above, if Whiteacre were immune to “general claims,” its value would not be reduced at all.

The computation can also be stated in the following manner, which follows more closely the language of the statute. Let:

\[
X = \text{the amount by which the deduction is to be reduced;}
\]

\[
A = \text{“the amounts allowed as deductions under subsections (a), (d), and (e) and the amounts of general claims [as defined in the penultimate sentence of section 812(c)] allowed as deductions under subsection (b)”};
\]

\[
B = \text{“the amount otherwise deductible under this subsection [as defined by section 812(c)(2)]”};\]

\[
C = \text{“property subject to general claims [as defined in the penultimate sentence of section 812(c)].”}
\]

Then: \(X : A :: B : C.\)

Or, using the figures of the illustration:

\[
\frac{X}{150,000} = \frac{120,000}{200,000}
\]

\[X = 90,000.\]

60 This is because “the amount otherwise deductible under this subsection” (B in the
Commentators have pointed out that the elaborately fashioned reduction can be avoided in some states by the absurdly simple device of placing previously taxed property in a revocable trust. Where such trust property is not subject to the claims of creditors, it will not have to be reduced by any of the estate’s deductions. This will be so despite the decedent’s retention for his life of the same control he would have had if the property had not been placed in trust. Where local law provides that property in a revocable trust remains subject to the claims of creditors, other trust provisions to immunize the previously taxed property from general claims can be adopted, though they entail the loss of some control over the property.

Congress has thus struggled from 1921 to now to little avail. In point of fact, however, its 1932 and 1942 theory that the previously taxed property should be charged with part of the estate’s deductions is about as hard to defend as its equally unsuccessful 1921 effort to deny the section 812(c) deduction altogether when the previously taxed property was used to pay charitable bequests or expenses. Unless the estate’s deductions are greater because of the previously taxed property, the rationale of the section 812(c) deduction seems to dictate that the property, having “paid its way” on the previous transfer, should go scot-free now. It would make more sense to charge against it a share of the deductions of the prior estate, a practice now followed (as has been seen) only with respect to mortgages and liens chargeable against the property itself.

Having decided that previously taxed property should be charged with a share of the second estate’s deductions, however, how did Congress happen to open such a broad route to avoidance of its purpose? The formula supra note 59) includes only that part of the previously taxed property subject to general claims. See section 812(c)(2). If none of the previously taxed property is subject to general claims, B becomes zero; then:

\[
\frac{X}{\$150,000} = \frac{0}{\$200,000}
\]

\[
X = 0.
\]

See Trachtman, Property Previously Taxed, 89 Trusts & Estates 160 (1950); Montgomery’s Federal Taxes—Estate, Trusts and Gifts 733 (1951). On the other hand, increasing the amount of non-previously taxed property subject to general claims increases the denominator of the fraction and thus is another way to prevent a reduction of the section 812(c) deduction. Realizing this, taxpayers have several times tried to prove that borderline items in an estate were really subject to general claims. E.g., Estate of Susie C. Haggett, 14 T.C. 325 (1950); Estate of Emma H. Emanuel, 9 T.C. 779 (1947). Both cases involved revocable transfers in trust. If the property so transferred had been previously taxed, the same question (whether the corpus was subject to general claims) would have been present, but the executors and Commissioner would have reversed their arguments. Supra note 60.
Committee Reports show that this occurred in the effort to refine the formula of reduction still further: 62

In some cases, however, the previously taxed property (or the property received in exchange therefor) itself may not be wholly subject to general claims. In such cases it is first necessary to reduce the deduction by the amount of the deductible items under section 812(b) which, under the applicable law, in the final adjustment and settlement of the estate may be enforced only against such property. Then the balance, if any, of the deduction is to be reduced as previously indicated, this time, however, substituting for the full amount of 'the amount otherwise deductible' only that part of such amount which is subject to general claims. Thus, if in the example previously given, Blackacre instead of Whiteacre were the property previously taxed, the deduction would be $20,000, computed by first reducing the $100,000 otherwise deductible by $20,000, the amount of the mortgage enforceable only against Blackacre, and then by reducing the balance, $80,000, by $150,000 of $80,000.

This adjustment is of course entirely consonant with the Congressional aim of allocating a portion of the "floating" deductions against the previously taxed property. It requires all deductions specifically chargeable against that property to be applied against it first, and a fair share of the rest of the deductions to be applied against the balance. The draftsmen apparently overlooked the possibility that previously taxed property might be immune to general claims not because it was encumbered by specific claims but because it was not subject to claims at all!

THE EFFECTS OF THE MARITAL DEDUCTION

The latest, and most drastic, limitation on the deduction for property previously taxed came in 1948. In creating the marital deduction, Congress made three changes in section 812(c). 63

First, in charging the previously taxed property with its share of the present estate's other deductions—the restriction just discussed—Congress included the estate's marital deduction as one of the amounts so to be allocated. This change was consistent with the 1942 modifications.

Second, Congress provided that if the decedent received the property

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62 Supra note 59, at 492-3.
63 Revenue Act of 1948, Sec. 362. The changes do not apply to I.R.C. §§861(a)(2), the provision governing the deduction for property previously taxed that is part of the estate of a non-resident alien, apparently because the marital deduction itself was not made applicable to such estates. But the estate of a non-resident alien may include property inherited from a resident spouse who took advantage of the marital deduction. It is surprising to find that the non-resident alien may deduct it under section 861(a)(2), when a citizen cannot do so under section 811(c). The same anomaly exists as to property received by gift from a couple who took advantage of section 1000(f) to split the gift in computing gift tax.
by gift from a married couple, one-half should be considered as received by the decedent from each spouse if the donors took advantage of the option offered by section 1000(f) to split the gift for tax purposes. Thus, if one spouse was able to apply a specific exemption against one-half of the gift, while the other's specific exemption was exhausted, only one-half will be regarded as property previously taxed. Were it not for this restriction, it might be asserted that "the amount finally determined as the value of such property in determining the value of the gift" was its full value. One problem is left unclarified. If only one-half of the donated property is found in the estate at death, can it be "identified" in whole or in part with the half of the gift that was taxed? Should the far-sighted donee deposit one-half of the gift in an account labelled "father's gift" and the other half in an account labelled "mother's gift," using for personal expenses only the latter account if it was his mother who applied her specific exemption against the gift when the transfer was made?

The third amendment to section 812(c) is far more drastic. Congress felt, properly, that if property had enjoyed the benefit of the marital deduction on the prior transfer, it had not "paid its way" so as to earn the privileges of previously taxed property. Indeed, in some circumstances allowance of the section 812(c) deduction to the widow on her death (or to the widower on his) might have made a shambles of the estate tax. If H left one-half of his property to W and the rest to his children, and W's estate (assuming her death within five years) got a section 812(c) deduction for the very property that gave H's estate the marital deduction, the whole family fortune would go to the children at the price of a tax on only one-half. While the section 812(c) deduction should certainly be denied here, a partial allowance would be quite appropriate if H had left his entire estate to W.

But Congress, perhaps influenced by the present intricacy of section 812(c), apparently did not wish to grope for a formula defining when the deduction should be allowed and when denied. Instead it enacted a blanket disqualification of all property (a) received from the estate of a prior decedent who was the spouse of the present decedent and who died after December 31, 1947, or (b) received by gift after the enactment of the Revenue Act of 1948 from the present decedent's spouse. Since spouses are more likely to die within a few years of each other than per-

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64 Now we can look forward to some questions of identification. Suppose a bank account is made up of funds inherited within five years from a spouse, funds inherited within five years from another testator, and other funds, and that the second decedent draws indiscriminately on it for investments and living expenses. If the Rodenbaugh rule, supra note 39, is rejected, will the courts go so far as to presume that a testator not only meant to invest inherited funds, but that he intended to invest only the funds that would qualify for deduction under section 812(c)?
sons of different generations, the 1948 change prevents section 812(c) from being applied to precisely those situations where it is most needed. This of course adds fuel to the passion, which may have unfortunate personal consequences, of leaving to a spouse the amount of the maximum marital deduction and not a penny more. While a "refined integration" of the marital deduction with the previously taxed property deduction might have been a forbidding task, it would have been possible to provide that if W received any amount in excess of the marital deduction taken on the transfer, that excess would qualify for the section 812(c) deduction.

CONCLUSION

In any comprehensive revision of the federal estate and gift tax structure—already long overdue—section 812(c) will require a thorough overhauling. Several observers, indeed, have proposed reforms so thorough-going that no room would be left for section 812(c). Other proposals, however, would preserve the deduction but alter it extensively. So far as we can judge, the more drastic suggestions have so little prospect of adoption, that at least for the foreseeable future the question of a deduction for previously taxed property will remain with us.

The statutory aim of the deduction—to prevent an "unconscionable dilution of an estate"—is appealing. Yet we know almost nothing of the extent of the problem. In 1945, the last year for which details are available, the average deduction for previously taxed property was about

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65 Of the reported federal cases dealing with the deduction for property previously taxed, almost half involve transfers by one spouse to another.
67 "The estate and gift taxes have been the neglected stepchildren of the federal revenue system. The care and attention lavished on the federal income tax have been noticeably absent in the case of these transfer taxes. The rudimentary beginnings in 1916 of the 'modern' estate tax, to use the adjective in only a chronological sense, have been succeeded by patchwork revisions both as to technical features and revenue features." Surrey, An Introduction to Revision of the Federal Estate and Gift Taxes, 38 CALIF. L. REV. 1 (1950).
68 One such reform is the "bequeathing power succession tax," which would make the tax independent of the number of transfers and dependent upon the age differential between transferor and transferee. VICKREY, AGENDA FOR PROGRESSIVE TAXATION 224-48 (1947). Another is the proposal that estate and gift taxes be abolished and all gratuitous receipts be taxed to the recipient as income. SIMONS, PERSONAL INCOME TAXATION 125-47 (1938).
69 FEDERAL ESTATE AND GIFT TAXES, A PROPOSAL FOR INTEGRATION AND FOR CORRELATION WITH THE INCOME TAX 61 (Joint Study by Advisory Committee to Treasury Department and Office of Tax Legislative Counsel, 1947); Rudick, A Proposal for an Accessions Tax, 1 TAX L. REV. 25, 40-1 (1945).
70 Rudick, supra note 69.
$4,000 per taxable estate and $450 per non-taxable estate. But these bare figures scarcely support any firm conclusions as to the importance of some provision, not necessarily the present one, for property previously taxed. For one thing, they tell nothing of the amount of tax paid on the prior transfer. The Treasury, by inspecting the prior returns, could ascertain in how many cases the second tax, if the property previously taxed had not been deducted, would have worked "an unconscionable dilution" of the estate. This task should certainly be undertaken as a prologue to any revision of the law.

It may be that the supposed problem does not arise frequently enough to justify a statutory safeguard, though of course mere frequency alone should not be the test, since grave unfairness in a few cases may be worthier of statutory attention than slight inequity in more instances. Moreover, the published statistics report the deductions taken rather than the value of the property previously taxed. A Treasury report on the amount of property involved before the statutory downward adjustments are applied would better show the extent of the problem than the amount of the net deduction. No Treasury study, to be sure, will uncover the previously taxed property that is never claimed on the return because identification is thought by the executor to be totally impossible. Perhaps the tax rate pattern for such property would not differ markedly from the pattern for identifiable property. If there is a difference, it would probably be that unidentifiable property is less heavily taxed at either transfer; where a heavy tax has been paid or is in prospect, there is more likely to be a tax advisor who will warn about the importance of a separate account for the previously taxed property.

If there is need for a safeguard against two taxes in rapid succession, it is clear that section 812(c) does not now provide it. The requirement of identification, serving no policy purpose, acts as the first restriction. Where the property can be properly traced, it must be reduced, perhaps drastically, by a portion of the second estate's deductions. Finally, property received from a spouse will ordinarily not qualify at all.

On the other hand, in one way section 812(c) is too lavish. In seeking to prevent "unconscionable dilution," it may facilitate the escape of a generation of taxes, where property is transferred from father to son to grandson, a loophole of some importance if the first transfer was taxed lightly. Of course, if we can swallow the life-estate-remainder sequence, we should perhaps not strain at this relatively minor defect in the estate tax structure. But when reform comes, it will be hard to defend the way

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12 Surrey, supra note 66, at 18-23.
section 812(c) confers blanket immunity upon all previously taxed property without regard to the amount of tax paid on the prior transfer.

These observations lead us to suggest the following changes in section 812(c) if a Treasury study of the kind suggested discloses sufficient reason for the retention of some allowance for previously taxed property:

1. No tracing or identification should be required. No one has ever advanced a shred of reason for distinguishing between the heir who retains his patrimony intact while living on his "own" funds, and his brother who does the reverse.

2. The value of the property as otherwise determined should not be reduced by any part of the second estate's deductions. While it is possible that some of these deductions are greater because of the inherited property, the possibility (except for the marital deduction) is too flimsy to form the basis for a statutory restriction.

3. The 1948 disqualification of all property received from a spouse should be moderated, as suggested earlier, so that any excess over the marital deduction will be entitled to the section 812(c) deduction.

4. The tax actually paid on the prior transfer should be taken into account. This could be done by converting the deduction into a credit in the following way:

   (a) compute a "tentative" tax on the estate as reduced by the value of the previously taxed property;

   (b) compute a tax on the estate including the previously taxed property, and credit against the tax so computed the amount of tax actually levied on the prior transfer (an amount bearing the same relation to the total tax paid as the value of the transferred property bore to the net estate or to the total net gifts of the year in question);

   (c) the tax to be paid would be the higher of (a) and (b).

APPENDIX

[Sec. 812(c)]

(c) Property Previously Taxed.—An amount equal to the value of any property (1) forming a part of the gross estate situated in the United States of any person who died within five years prior to the death of the decedent, or (2) transferred to the decedent by gift within five years prior to his death, (where such property can be identified as having been received by the decedent from the donor by gift, or from such prior decedent by gift, bequest, devise, or inheritance, or which can be identified as having been acquired in exchange for property so received.) Property includible in the gross estate of the prior decedent under section 811(f) and property included in total gifts of the donor under section 1000(c) received by the decedent described in this subsection shall, for the purposes of this subsection, be considered a bequest of such prior decedent or gift of such donor. This deduction shall be allowed only where a gift tax in-
posed under Chapter 4, or under Title III of the Revenue Act of 1932, 47 Stat. 245, or an estate tax imposed under this chapter or any prior Act of Congress, was finally determined and paid by or on behalf of such donor, or the estate of such prior decedent, as the case may be, and only in the amount finally determined as the value of such property in determining the value of the gift, or the gross estate of such prior decedent, and only to the extent that the value of such property is included in the decedent's gross estate, and only if in determining the value of the net estate of the prior decedent no deduction was allowable under this subsection, section 861(a)(2), or the corresponding provisions of any prior Act of Congress, in respect of the property or property given in exchange therefor.

The following property shall not, for the purposes of this subsection, be considered as property with respect to which a deduction may be allowed: (A) property received from a prior decedent who died after December 31, 1947, and was at the time of such death the decedent's spouse, (B) property received by gift after the date of the enactment of the Revenue Act of 1948 from a donor who at the time of the gift was the decedent's spouse, and (C) property acquired in exchange for property described in clause (A) or (B).

Where, under the provisions of section 1000(f), a gift received by the decedent was considered as made one-half by the donor and one-half by the donor's spouse, one-half of the gift shall be considered as received by the decedent from each such spouse.

Where a deduction was allowed of any mortgage or other lien in determining the gift tax, or the estate tax of the prior decedent, which was paid in whole or in part prior to the decedent's death, then the deduction allowable under this subsection shall be reduced by the amount so paid. The deduction under this subsection shall be reduced by an amount which bears the same ratio to the amounts allowed as deductions under subsections (a), (d), and (e) and the amounts of general claims allowed as deductions under subsection (b) as the amount otherwise deductible under this subsection bears to property subject to general claims. If the property includible in the gross estate to which the deduction under this subsection is attributable is not wholly property subject to general claims—

(1) before the application of the preceding sentence, the amount of the deduction under this subsection shall be reduced by that part of such amount as the value, at the time of the decedent's death, of such property (to which such deduction is attributable) subject to claims but not to general claims is of the value, at the time of the decedent's death, of such property, and

(2) in the application of the preceding sentence in reducing the balance, if any, of such deduction, "the amount otherwise deductible under this subsection" shall be only that part of such amount otherwise deductible (determined without regard to clause (1) of this paragraph) as the value, at the time of the decedent's death, of such property (to which such deduction is attributable) subject to general claims is of the value, at the time of the decedent's death, of such property.

For the purposes of the two preceding sentences and this sentence, "general claims" are the amounts allowed as deductions under subsection (b) which, under the applicable law, in the final adjustment and settlement of the estate
may be enforced against any property subject to claims, as defined in subsection (b), and "property subject to general claims" is the value, at the time of the decedent's death, of property subject to claims, as defined in subsection (b), reduced by the value, at the time of the decedent's death, of that part of such property against which amounts allowed as deductions under subsection (b) which are not general claims may be enforced, under the applicable law, in the final adjustment and settlement of the estate. Where the property referred to in this subsection consists of two or more items the aggregate value of such items shall be used for the purpose of computing the deduction.