ORIGINAL

OFFICIAL TRANSCRIPT

PROCEEDINGS BEFORE

THE SUPREME COURT

OF THE

UNITED STATES

CAPTION: COMMISSIONER OF INTERNAL REVENUE, V ESTATE OF OTIS C. HUBERT, DECEASED, ET AL.

CASE NO: 95-1402

PLACE: Washington, D.C.

DATE: Tuesday, November 12, 1996

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IN THE SUPREME COURT OF THE UNITED STATES

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COMMISSIONER OF INTERNAL :
REVENUE, :
Petitioner :
v. : No. 95-1402
ESTATE OF OTIS C. HUBERT, :
DECEASED, ET AL. :

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Washington, D.C.

Tuesday, November 12, 1996

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 11:48 a.m.

APPEARANCES:

KENT L. JONES, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D.C.; on behalf of the Petitioner.

DAVID D. AUGHTRY, ESQ., Atlanta, Georgia; on behalf of the Respondent.

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P R O C E E D I N G S

(11:48 a.m.)

CHIEF JUSTICE REHNQUIST: We'll hear argument next in No. 95-1402, the Commissioner of Internal Revenue v. the Estate of Otis C. Hubert.

Mr. Jones.

ORAL ARGUMENT OF KENT L. JONES

ON BEHALF OF THE PETITIONER

MR. JONES: Mr. Chief Justice, and may it please the Court:

This case involves the marital and charitable deductions to the Federal estate tax. As with some other tax cases, and perhaps more so than most, this case involves the central logical principle that is surrounded and almost obscured by a wealth of technical detail. I would therefore like to focus first on the central logical principle and discuss the technical issues later.

The gross estate is defined as the value on the date of death of the property owned by the decedent. The marital and charitable deductions to the gross estate are defined by statute as the value of the property that passes to the spouse and charity.

When, as in this case, the bequest left to the spouse or charity is burdened by the obligation of paying some expense or administration expense or other claim

against the estate, the value of the property that passes under the bequest is obviously less than the full face value of the bequest. It is the face value of the bequest, reduced by the cost of satisfying the obligations that have been imposed on it.

Thus, in 1963, this Court explained in United States v. Stapf that when the burden of paying administration expenses or other claims against the estate is placed on the marital bequest, the decedent has in effect left that portion of the estate not to the spouse, but has designated it for payment of the claims of others.

QUESTION: And in that case it was the decedent's act that did it, as I recall. Wasn't it the provision of the will that required it in that case?

MR. JONES: It was -- actually if I remember Stapf correctly, there was an option given to the heir as to how to take under the will or not take under the will, and it dealt with the specifics of the Texas community property rules. In this --

QUESTION: In any case it didn't involve a charge which was wholly contingent at the time of death and which simply arose later and then, under the statutory option, was charged against the marital share.

MR. JONES: No, nor does this case. In this case, as several courts have explained, the obligation to

pay administration expenses is fixed on the date of death. It is about --

QUESTION: But we don't know what the expenses are --

MR. JONES: Exactly.

QUESTION: -- and we don't know that there's going to be a -- for example, a will contest or something like that.

MR. JONES: Exactly. It's the valuation of that later on that has to be conducted.

But in Stapf, the Court in speaking specifically of administration expenses, said that they, like claims against the estate, represent -- I'm sorry -- when the obligation for administration expenses or to pay claims against the estate is placed on the marital bequest, that that reduces the value of the marital bequest because the decedent has in concept set aside a portion of the bequest not to go to the spouse, but to someone else. And obviously, the portion of the bequest that's to go to someone else is not within the scope of the marital deduction.

QUESTION: Mr. Jones, if we value the estate at the time of death, why don't we also value these encumbrances at the time of death? That is one part of your argument that I don't follow. If you say it's an

encumbrance on the estate at the time of death, then if one were planning to pay it, one would have an amount that would yield, say, 4 years later what these expenses are. But you are arguing for a dollar-for-dollar deduction and not the --

MR. JONES: Yes.

QUESTION: -- present value of --

MR. JONES: Right, and to understand that, you have to understand almost every issue in the case, most of which we haven't touched on yet, but there is a short answer to that.

Administration expenses are themselves a deduction under the Federal estate tax on a dollar-for-dollar basis even though administration expenses may be incurred 10 years later. We do not make the estate bring those expenses back to the present value in determining the administration expense deduction for the -- now, if we did, then it would make some sense to also bring back to present value the reduction from the marital deduction that occurs because of the administration expenses, but we don't do either. We do a dollar-for-dollar basis on administration expenses. We do a dollar-for-dollar reduction of the marital deduction to take into account the administration expenses.

QUESTION: Well, but the executor has the

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election, does he not?

MR. JONES: Absolutely. This is --

QUESTION: And if the executor elects to pay the deduction out of the estate, I can see why that should reduce the estate.

But you're telling us that if there's a $50,000 administrative expense that we can anticipate down the line, that it's the same thing, cases A, if $50,000 is deducted from the corpus that ever goes to the beneficiary, so he gets a corpus less $50,000; and case B, he gets the full corpus and the income is fully sufficient to pay the $50,000.

I'd much rather be the beneficiary in case 2 than case 1. I just don't see -- they are just not the same.

MR. JONES: Well, they -- I think I can give you an example that would suggest, if I understood your point, that they are the same.

If you had two alternative bequests, the decedent calls you in his study and says, I'm going to let you choose. I'm writing a will and here are the choices. In both cases I'm going to give you a bank account with $100,000 in it, and in both cases, you're not going to be able to make withdrawal from those accounts for a year. But in the first case, the interest earned by that account

at 10 percent is going to be added to it, so at the end of the year you can withdraw $110,000, but in the second case, the interest earned by that account is not going to go to you. It's going to go to the payment of administration expenses. So, at the end of the year, you'll still just get $100,000.

You'd say, I would like the first bequest because the present value, the real value, of that bequest is higher. It's $100,000 on the date of death. It's $110,000 a year later. The second bequest, the real value, as the Court said in Stapf, is about $90,000 because it -- recognizing the time value of money, if the income is going to be spent on something else, the present value of the bequest on the date of death is reduced by --

QUESTION: But your dollar-for-dollar theory doesn't recognize discounted value -- time value at all.

MR. JONES: The dollar-for-dollar --

QUESTION: It's completely arbitrary.

MR. JONES: The dollar-for-dollar theory, as you have described it, recognizes that this issue serves at the border between the estate tax and the income tax. The estate tax, as I've tried to state earlier, allows the administration deduction on a dollar-for-dollar basis. If that $10,000 that I talked about just a minute ago was

spent at the end of the first year, they would be entitled to a deduction for that entire $10,000 in valuing the estate if they -- unless they attempted to take that deduction on the income tax return.

Normally these time value of money things aren't anywhere near as significant as they appear to be in this case because normally you don't have a will contest followed by a tax issue that goes to the Supreme Court. Normally we're talking about estates being resolved within a year or so.

As a practical mechanical matter --

QUESTION: You're not suggesting that a relatively large estate is usually resolved within a year.

MR. JONES: Well, I don't know how to answer that in terms of the size of the estate. What's really turns -- what extends the length of the administration is the nature of the property I suppose.

QUESTION: May I ask you a question? I wonder if I'm just dead wrong on this.

You sort of treat all administrative expenses as fungible. They all could be deducted against income or all could be deducted against the estate tax.

I had thought that when an estate is -- includes a substantial asset as an ongoing business, that some estate expenses could not -- administrative expenses could

not be deducted against the income tax return. Is that correct?

MR. JONES: I --

QUESTION: Presumably the cost of filing a will, something like that.

MR. JONES: The cost of what?

QUESTION: Filing a will or probate court fees, something like that. It couldn't be deducted against the income earned by the ongoing business.

MR. JONES: Right. And indeed the expenses of the ongoing business would not be administration expenses under the estate tax.

QUESTION: So that necessarily some expenses could be deducted against income and some could not.

MR. JONES: We're only talking here --

QUESTION: Is that correct?

MR. JONES: Well, absolutely, but let me --

QUESTION: And that's why I can't understand your hypothetical in your reply brief.

MR. JONES: Let me see if I can help you. The definition of administration expenses is in 2053(a) in the regs under that, and it lists the things that you would think of as administration expenses, arranging for the disposition of the property and things of that nature.

QUESTION: Right.

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MR. JONES: Those are the kinds of administration expenses that we're talking about in this case. If there was a cost of running a business after death during the period of administration, those would not represent administration expenses for this purpose. And so, in my example, when I said that the will required that the income be used to pay administration expenses, I was talking about those kinds of probate and in this case tax -- will contest, tax litigation expenses that relate to the disposition of the estate.

QUESTION: Mr. Jones, throughout your brief, you put the marital deduction and the charitable deduction together. And I hope you can explain to me how your example in your reply brief would work out if you had chosen to use as your illustration a charitable deduction instead of a marital deduction, it seems to me it would lead to a rather bizarre result of a taxable estate of $50,000. If the only beneficiary is a charity, that it gets -- all of the income would be exempt --

MR. JONES: Well, the point is that it need not produce a taxable estate. It's the -- what -- because as administration expenses are incurred, they may be deducted on the estate. The administration expenses being incurred here today need have no effect whatever on the taxable estate because as the administration --

QUESTION: Well, I just asked a question. Would the bottom line on page 3 be different if the example that you had given us was a charitable deduction rather than a marital deduction? You say that the result is -- a taxable estate of $500,000 results in this example. Would the same follow if your example had used, instead of the marital deduction, the charitable deduction?

MR. JONES: Yes, because what the -- in that example, the problem that is addressed is that you get a choice. You can take the deduction either on the estate tax or on the income tax. We don't think that you're allowed to take both. 642(g) says you're not allowed to take both.

The point is their contention gives them a tax benefit both on the income tax return by claiming the deduction there and on the estate tax return by, as the case is described, purchasing the encumbrance and obtaining additional value through the bequest by purchase rather than inheritance.

QUESTION: So, if in fact they have some patents or something that are worth $11 million, but it costs $10 million to make them valid, all they have to do is pay tax, income tax, on $11 million, i.e., come up with about $4 million they don't have.

If they don't want to do that, their other

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alternative is that you subtract the $10 million which they had to expend from the estate, wiping out the value of the estate. That's what seems unfair about it. It seems that when they have an awful lot of money to spend, to make the income really appear, they're forced to give up either the estate --

QUESTION: We'll resume there at 1 o'clock, Mr. Jones.

(Whereupon, at 12:00 p.m., oral argument in the above-entitled matter was recessed, to reconvene at 1:00 p.m., this same day.

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AFTERNOON SESSION

(1:00 p.m.)

CHIEF JUSTICE REHNQUIST: Mr. Jones, I believe you were about to answer Justice Breyer's question tendered just before lunch.

QUESTION: You just should say no.

(Laughter.)

MR. JONES: Well, I don't recall frankly whether to say yes or no, but what I recall is that your hypothetical was where an asset of the value of $11 million is left to the spouse and it takes $10 million thereafter to, shall we say, perfect title to the asset.

This is a classic example that the Court dealt with in the Stapf case where the net value of the marital bequest is the $11 million reduced by the obligation left under the will to pay the administration expenses, which turned out to be $10 million. The net value of the bequest was $1 million. That's the marital deduction. The spouse is entitled also to take an administration expense deduction on the estate tax return, so there is no taxable estate.

What happened in this case is that, in your hypothetical, let's say $10 million in income was earned by this asset after death. In that case, the executor could elect to take the administration costs against the

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estate tax return and have zero income tax liability on the $10 million of income.

And our point is that that doesn't affect the calculation of the marital deduction. The marital deduction on the estate tax return is still $1 million. They have elected not to take the administration expense deduction on the estate tax return. So, the taxable estate in that situation is $10 million, but there's no income tax.

So, under 642(g) you get to choose. You can take your administration expenses against the estate tax or you can take them against the income tax. You can't get a credit for both, which is what they're asking for in this case.

QUESTION: Mr. Jones, could I follow up your discussion of how although the marital deduction is evaluated as of the time of death, you can take account of later developments and make them retroactive back to the time of death, such as the administrative expenses?

Now, that's certainly true in the estate tax area, but what (b)(4)(B) requires here is that -- shall be taken into account in the same manner as if the amount of a gift to such spouse if such interests were being determined.

Now, for purposes of the gift tax, let's assume

that there's a gift, an inter vivos gift. A trust is established with income to the spouse and the remainder to somebody else. Now, for purpose of the -- and the trustee has the option of either charging the administrative expenses of the trust to income or against the corpus of the trust. He has that option.

Would you, for purposes of the gift tax, wait and see what he did whether he charged it against the income or not and then retroactively evaluate the value of the gift to the spouse on the basis of whether that option was exercised or not?

MR. JONES: Because the -- in your hypothetical, because the obligation to pay these expenses is on the marital gift, you have to value that obligation in valuing the gift.

QUESTION: It isn't on the gift. It's up to the trustee, just as it's up to the --

MR. JONES: But in your hypothetical, the income would accrue to the marital gift. It was income that would either go to the spouse or would be used to pay administration expenses.

It's like the $100,000, $200,000 accounts that I mentioned at the beginning. If one of those $100,000 accounts requires that administration expenses be paid out of it, that reduces the value of that account on the date

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of the gift.

QUESTION: But it isn't clear at the date of the gift whether the trustee will charge it against the income or not.

MR. JONES: It doesn't matter in valuing the gift, but what matters in valuing the gift is knowing that this obligation is in fact imposed on the marital interest, the marital -- the property transferred, whether it is imposed out of corpus or out of income.

Let me go back just one step because some of these questions are more conceptually difficult as we're discussing them than they need to be because in United States v. Stapf, the Court authoritatively explained the language of the statute that you're referring to and explained in Stapf that the focus of the marital deduction is on the value of the property that passes to the spouse. And the Court said -- and I'm quoting -- the appropriate reference, therefore, is not to the value of the property moving from the decedent. It is, as the Court said, to the net value of the property passing to the spouse.

QUESTION: Why was the Commissioner so late in discovering Stapf?

MR. JONES: The Commissioner has cited Stapf in prior cases, and I think that you --

QUESTION: But in the lower court proceedings in

this case?

MR. JONES: When the case came up to this Court, it had already been cited in the Commissioner's favor by three or four other circuits, and I think that the other circuit decisions were directly on the point of administration expenses.

QUESTION: Whereas Stapf wasn't?

MR. JONES: Stapf was not directly on that point, although Stapf answers that question by the Court's discussion at the end which says that administration expenses are like other claims against the estate, and when -- in that when the marital bequest is burdened by the obligation of paying those expenses, that in effect leaves that portion of the estate to someone else rather than to the spouse.

QUESTION: Was the language in Stapf dependent upon the widow's option at all?

MR. JONES: No. It was only --

QUESTION: It's simply the fact that the administrative expenses were paid out.

MR. JONES: Having taken that option, the question then was how to calculate the deduction.

The logical principle of Stapf and that applies in this area is what was the net value -- what was the gross value of the bequest, reduced by the cost of the

obligation imposed on it. All of the applicable statutes and regulations embody that principle. Section 2055(c) and 2056(b)(4)(A) specify that when the obligation of paying estate taxes is placed on the marital or charitable bequest, that that reduces the value of those bequests and therefore the amount of those deductions, without regard to whether that tax is later paid with income or with corpus.

In section 2056(b)(4)(B), Congress specified the same result when any encumbrance or obligation is placed on the marital bequest. And the legislative history of that provision states crystal clearly that this reduction in the value of the marital bequest and in the amount of marital deduction must be made without regard to whether that payment is ultimately made out of corpus or out of income attributable to the corpus of the bequest.

QUESTION: Mr. Jones, may I go back to a point I raised this morning and perhaps you can straighten me out on it. I'm referring to page 28 of your brief where you give us the example. You say that these expenses are a burden on the estate at the time of the death, and you give us an analogy to the executor setting aside a portion of the residuary estate to pay those future expenses. And I think that one of the Tax Court judges too, Judge Dubina, said that administrative expenses are deemed to

accrue on the date of death.

In both your set-aside example and the dissenting -- or was it -- it was the Sixth Circuit Judge Dubina, was it not?

MR. JONES: In Estate of Street.

QUESTION: Yes.

Said they're deemed to accrue at the date of death. Well, if that is so, will you explain to me again why you are not using a present value, a discounted value notion, and why you are using the dollar-for-dollar in this context as opposed to what you explained before when you actually incur the expense and you take it as a deduction? You take it in the year that you incur it. But why on this set-aside --

MR. JONES: No. Excuse me.

QUESTION: -- analogy don't you use discounted value?

MR. JONES: When you take an -- when you incur an administration expense, and you claim it on the estate tax return, you don't take it in the year that you expended it. My point was that you get a dollar -- if I have an estate that occurred in 1982 -- a death occurred in '82 -- and I have an administration expense in 1990, if I take that administration expense on my estate tax return, I take a dollar-for-dollar amount. I don't reduce

the 1990 administration expense back to present value in determining the administration expense deduction on the estate tax return.

And since we don't take it back to present value in determining the administrative expense deduction on the estate tax return, we also don't take it back to present value in determining the reduction in the marital deduction.

QUESTION: Well, why shouldn't the match be between the value of the estate at the date of the death? Why isn't that the proper match to look at? If you're evaluating the assets at the date of death, why don't you evaluate the encumbrances at the date of death?

MR. JONES: Congress has not directed us to make that kind of calculation. What Congress directed -- and the best example is 2055(c). Congress specifies that when the amount of estate taxes are paid and those burden the marital or charitable deduction, you get a dollar-for-dollar reduction in the marital deduction as a result. So, I mean, in some other world, you might have a --

QUESTION: What has Congress specified for the charity? I asked you --

MR. JONES: That was for the charity. That was 2055(c).

The --

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QUESTION: I thought you said something -- didn't you just say something about marital deduction?

MR. JONES: 2056(b)(4)(A) and 2055(c) are respectively the marital and charitable provisions that deal with the reduction in those deductions when the estate taxes are ultimately paid when those liabilities -- when that obligation burdens those interests.

Justice Ginsburg, it might be possible -- I mean, it would -- frankly, it would be possible to have all of this done on a present value basis. That's -- and if we started from scratch, that system might well make a lot of good sense, but you can't fit part of that present value approach into a system that is a dollar-for-dollar approach on all other items.

Congress by -- when they enacted 2056(b)(4)(B), they did so as part of an effort to enlarge the system to clarify the system of valuation that had derived from 2055(c), that had derived from this estate tax deduction valuation approach. So --

QUESTION: Of course, what (b) tells you to look at again is not to the treatment of the charitable deduction under 55(c), but rather to the treatment of the gift.

MR. JONES: And again, this is real -- this is critical, Justice Scalia. The Court in Stapf

authoritatively explained what that language meant and said that you don't look, as you might, to what the value of the gift from the husband was in this case. You look to the net value of what passes to the spouse because the focus of this is on a deduction. It's on the marital deduction, what passes to the spouse.

QUESTION: And in your view that was not predicated at all upon the special election that the wife had to make in that case because it seemed to me at first reading that you were turning the present election that the executor has into a purchase case. You'd make every election a purchase. The Stapf case proceeded on the assumption that the wife, by making her election, was in effect purchasing her property.

MR. JONES: It really --

QUESTION: And it seems to me you're just extrapolating that and saying every election is a purchase.

MR. JONES: It really doesn't matter how the administrative expense obligation is paid. The spouse could simply write a check for all the administration expenses, or she could use post-death income, or she could use corpus. Those obligations have to be paid. It doesn't matter how they're paid.

What matters is how much are they, and under

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Stapf and under the statute, how much they are is a reduction in the value of what passes to her under the bequest. If she pays off those obligations with any other source of income, that's what the courts describe as purchasing the encumbrance rather than inheriting it.

QUESTION: But the meaning then of the introductory phrase in (b)(4)(B), where the interest in property, et cetera, is encumbered, I guess has to be read to mean it will always be encumbered by an administrative expense.

MR. JONES: If it is encumbered. I mean, the --

QUESTION: Unless there's a contrary direction.

MR. JONES: Well, the marital interest isn't necessarily subject to administration expenses. In these residuary bequests --

QUESTION: But in a -- certainly in a residuary case --

MR. JONES: In --

QUESTION: -- if there's no contrary instruction, it always will be.

MR. JONES: Yes.

QUESTION: And it will always fit within your so-called purchase analysis.

MR. JONES: It -- that obligation is what the

statute refers to as an obligation in connection with the passing of the interest. Any obligation in connection with the passing of the interest has to be reduced from the face value of the bequest to determine what Stapf calls the net value.

I would like to --

QUESTION: May I just ask you one more question? Why didn't they say just what you said, any obligation, as opposed to any encumbrance?

MR. JONES: Well, they said both, Justice Souter.

QUESTION: Well, the initial phrase refers to encumbrance.

MR. JONES: And the second phrase says any obligation imposed in connection with the passing of the interest.

I just want to point out that under -- there is a regulation that applies here, and it applies squarely and specifically. And this regulation was adopted in 1949, the year after the statute was enacted. It has been consistently applied. It is a longstanding, contemporaneous regulation. It is entitled to substantial deference.

And I would like to reserve the balance of my time for rebuttal.

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QUESTION: Is that the regulation that deals with marital deduction? It doesn't deal with charitable.

MR. JONES: That is correct.

QUESTION: You say the two are to be treated alike.

MR. JONES: The same principles apply because in all of these situations --

QUESTION: So that you could have a case where the entire -- everything is left to a charity and you could end up on the example that you gave with a taxable estate.

MR. JONES: Only if they avoid taxes on the income side. There's no need for there to be a taxable estate. They can take the administration -- administrative expense deduction with the estate taxes. It's only when they try to shelter the income that this gap appears on the estate tax side, as our brief explains in some detail.

QUESTION: Even if the expense is incurred for the production of that income. You don't match the expense against the income.

MR. JONES: if it's incurred for -- solely for the production of income, then we have a question about whether it's truly an administration expense. In this case, we haven't gotten into that. We have accepted all

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of the claimed expenses as administration expenses. It's the Service's view that expenses incurred in the operation of a business are not administration expenses.

QUESTION: Isn't that the solution for the Government, to define more closely and carefully what is the administrative expense, distinguishing it quite clearly from those expenses --

MR. JONES: That would not be a solution because in this case it's our understanding that substantial amounts were expended in a will contest and in litigation concerning the estate. That's a normal kind of administration expense. This issue comes up frequently. It isn't -- the problem isn't limited to the question where administrative expenses are bloated by improper charges. We accept these as proper charges, and this is the problem that comes up all the time under these cases that have addressed this now five times.

QUESTION: Very well, Mr. Jones.

Mr. Aughtry, we'll hear from you.

ORAL ARGUMENT OF DAVID D. AUGHTRY

ON BEHALF OF THE RESPONDENT

MR. AUGHTRY: Thank you. Mr. Chief Justice, and may it please the Court:

The difference between the course taken by 15 out of 17 of the United States Tax Court judges and the

majority opinion in the Eleventh Circuit and the course urged by the Commissioner in this litigation is that the Tax Court and the Eleventh Circuit followed the actual flow of the property. It followed the actual flow of the corpus as determined under controlling State law and as determined under the testamentary document which the Commissioner properly stipulated controlled the actual flow of the property.

The Commissioner in this case urges a Federal fiction that overrides the controlling testamentary documents, that overrides the State property and probate law, that overrides frankly her own estate tax regulations and rulings --

QUESTION: If the expenses are payable -- administrative expenses are payable from the corpus, I take it there's still a deduction on the fiduciary return?

MR. AUGHTRY: There comes a point in time when it must go on the fiduciary return, but in our view if it goes -- if a dollar of corpus goes to administrative expenses, it cannot go to the wife and it cannot go to charity.

QUESTION: No. I was just talking about the fiduciary return.

MR. AUGHTRY: Yes.

QUESTION: Let's say that you elect not to take

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the expenses, the administrative expenses, from the estate. You elect to deduct them from the income --

MR. AUGHTRY: Yes, Your Honor.

QUESTION: -- that's attributable to the corpus. Under State law, the expenses are paid from the corpus. Can you still take the deduction?

MR. AUGHTRY: You can take the deduction, but if you use corpus there, it does reduce the available corpus to go --

QUESTION: No, no. I'm just -- all I'm talking about is the Federal fiduciary income tax return.

MR. AUGHTRY: Yes, sir.

QUESTION: Can you still take the deduction from the income tax?

MR. AUGHTRY: Yes, sir. And in fact there comes a point in time where you must. Once the statute of limitation goes on the final State tax return, the income tax return is the only place you can take --

QUESTION: Let me ask one more question.

MR. AUGHTRY: Yes, sir.

QUESTION: Suppose the State law provides that the expense of administration is to be paid from corpus, and it's a $50,000 expense.

MR. AUGHTRY: Yes, sir.

QUESTION: But the income is so great that it

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greatly exceeds $50,000 and they credit all of the income at the end of the year to corpus. So in event -- in any event, the wife gets the same. What results under your view of this case?

MR. AUGHTRY: In speaking of corpus, we have to speak in terms of the corpus as it existed as of the date of death. To the extent that that corpus is used to pay expenses and claimed as an expense as it may be on the income tax return, that corpus is not available to pay the marital or the charitable estate tax. The marital and the charitable estate tax is by statute restricted to the date-of-death corpus.

QUESTION: All right, so that even though the wife ends up in both cases with the same, in the example where the administrative expenses must be paid from corpus, that does reduce the marital deduction.

MR. AUGHTRY: In our view, yes, and that I believe was the effect of --

QUESTION: Well, it isn't really restricted to the date-of-death corpus. I mean, it's date-of-death corpus less administration expenses deducted from the corpus. Isn't it?

MR. AUGHTRY: No, Your Honor. We measure -- and as this Court held in Maass v. Higgins and Bull v. United -- you take -- the State tax regime takes a snapshot of

what comes into the estate at the date of death, and then you trace that corpus. Now, you may take that corpus and pay it to the wife, if you're permitted to do so by the testamentary documents, or you may take and pay it against corpus, if permitted to do so by the testamentary documents and State law, but if you do that, it can't go in both places.

QUESTION: No, I don't understand now. Let's assume a $2 million estate. It all goes to the wife. The expenses paid by the administrator in the course of administrating -- administering the estate are $200,000.

MR. AUGHTRY: Yes, sir.

QUESTION: What is the marital deduction?

MR. AUGHTRY: If those expenses are paid out of income, the marital deduction is the full amount of the corpus. If they're paid out of corpus, then the marital deduction is --

QUESTION: They're paid out of corpus.

MR. AUGHTRY: The marital deduction is reduced in that instance.

QUESTION: So, it is not the corpus as of the date of death. It's the corpus as it's reduced by the administration expenses.

MR. AUGHTRY: If -- the hypothetical was there were $2 million in date-of-death corpus that comes in, and

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we know for distribution purposes we use the exact same date for valuing. If $1.8 million goes to the wife and two of it goes to administration expenses, the wife has a $1.8 million deduction.

QUESTION: You don't know that $200,000 goes to administration expenses until 3 years later.

MR. AUGHTRY: No, but --

QUESTION: As of the date of death, it says all $2 million goes to the wife.

MR. AUGHTRY: But you have to trace it under -- as I read Ballantine, Roney, and that line of cases, you have to trace it. You have to trace the actual flow of the corpus, the date-of-death corpus.

QUESTION: And you're saying -- you're oversimplifying by saying everything is looked at from the date of death. It surely isn't. You do take account of the administration expenses and then go back and reduce the date-of-death corpus by those expenses.

MR. AUGHTRY: You absolutely trace it wherever it goes.

QUESTION: Is it normally -- in an estate if suppose the person dies and they have $10 million in assets, but they know that $200,000 will inevitably be spent on administration, is the value of that estate $9,800,000 at date of death?

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MR. AUGHTRY: The value of -- and if we assume it's all going to wife.

QUESTION: Yes.

MR. AUGHTRY: Then --

QUESTION: Forget where it's going. I'm just saying how do they evaluate an estate. If $10 million and we know in advance $200,000 in expenses, is the value at date of death then $9.8 million?

MR. AUGHTRY: Then you would do it precisely as we did in this estate. You would set aside --

QUESTION: But I'm saying for purposes of tax is the estate valued at $9.8 million?

MR. AUGHTRY: No. The estate -- the date-of-death value of the property is the $10 million.

QUESTION: Even if we know for sure there will be $200,000 of administrative expenses.

MR. AUGHTRY: You just trace the corpus.

QUESTION: So, they evaluate it at $10 million.

MR. AUGHTRY: Yes, sir.

QUESTION: Okay.

MR. AUGHTRY: There are three points, time permitting, that we'd like to focus on is, one, the single most important point in reaching the right decision in this case may be the most basic. The difference between those courts that got the answer right and those that

didn't, those that got it right took the time to carefully define their terms, as the Tax Court did in its first footnote, before rushing to analysis. And as a consequence, they avoided the false equation that's been so sharply criticized by the commentators, the false equation that equates marital share with marital deduction. Marital deduction consists solely of date-of-death corpus. Marital share consists of both the corpus and income.

Two, the statutory structure of the Federal estate tax regime is built upon the sound, sensible foundation of symmetry, and that symmetry is achieved by taking the same statutory term for measuring property coming in and leaving the estate, value, and applying it at the same precise point in time. Indeed, we feel like we believe that that's a constitutionally driven proposition. This is a transfer tax that we're working with, and we take a picture at the effective transfer date by operation of law which is the date of death, unless of course the decedent -- excuse me -- the executor elects an alternate valuation date.

To show you how closely tied this inclusion and distribution concept is, there's a specific statute that says if my fiduciary, when I die, elects the alternate valuation date, that alternate valuation date must be used

not only for inclusion purposes, it must also be used for charitable contribution and for marital deduction purposes.

We, time permitting, hope to demonstrate the practical application of these principles to reality and how it renders the result of order and symmetry. Indeed, time permitting, we will demonstrate to you how the Government's position in this case is designed. The object of that position is to create what we call a disappearing residuary.

QUESTION: At some point in your discussion, would you explain to me why the Government is wrong in deciding Stapf as controlling in this case, or do you think we have to modify Stapf in order to reach the result you propose?

MR. AUGHTRY: Actually, Your Honor, we applied Stapf in this case in the distribution of the property here. It just doesn't apply to the impact of administration expenses on the burden borne by corpus or the income beneficiary. What Stapf -- as we read Stapf -- and indeed the Government has in effect deemed by way of a revenue ruling -- is that you look at the value. You look if there's a mortgage or something of that sort, and we had substantial mortgages in this case. And then you look at the equity received by either the wife or the

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charity.

Stapf, however, as pointed out by several of the questions raised during my colleague's presentation, focused upon the situation where the obligation existed at the date of death. As a matter of certainty as to existence, it was in existence in the will, and it was an obligation imposed upon corpus not upon income. And so, in --

QUESTION: I don't understand what difference that makes. What I don't understand about your case is why you acknowledge as -- I'm correct that you acknowledge that if this obligation were placed upon corpus --

MR. AUGHTRY: Yes.

QUESTION: -- it would reduce the marital deduction.

MR. AUGHTRY: Corpus has to go there, yes, Your Honor.

QUESTION: Why is it different if it's placed upon income?

MR. AUGHTRY: Two reasons. One, the statute, and it takes a little bit of effort to work through this. 2056(b)(4)(B) speaks only to obligations on corpus. We know that because 2056(b)(4) only speaks to that marital share for which a deduction is allowable.

What does that mean? Well, let me take a step

back. 2056(b)(4)(B) says any obligation or encumbrance on, quote, such property or interest.

What does such property or interest mean? We take a step upstream to 2056(b)(4) to the introductory paragraph, and it says that property passing to the spouse for which a deduction is allowable.

And what does that mean? You go to the introductory paragraph of 2056(a) and it says that the deduction that is allowable is only to the extent that it's included in the gross estate.

These two statutory provisions are the statutory genesis for the undisputed point that you measure the distribution by the exact same measure that's used for inclusion in the gross estate. And so, we say to you that 2654(b) itself clearly or at least establishes that the obligation must be on corpus.

The regulation which the Commissioner relies upon in this case --

QUESTION: Yes, but I mean, an obligation -- it is certainly an encumbrance upon corpus to say that all of the interest from this corpus must be used for a certain purpose. Certainly that renders the corpus less valuable to me. You say, here, this whole corpus is yours, provided however that the interest from it for the first 5 years must be given to somebody else. Is that not an

encumbrance upon the corpus?

MR. AUGHTRY: That proceeds on the assumption that it's an absolute commitment at the time of the date of death that all must go. It -- what we look to -- and indeed what the Commissioner has acknowledged by revenue rulings appropriate -- you look to State law to see -- and this is Revenue Ruling 88-12. You look to State law to see who bears this burden. If it is the corpus beneficiary, then the corpus beneficiary must bear the burden. If it is the income beneficiary, then it's the income beneficiary, and it does not impact the corpus.

Indeed, there is a second ruling by the Commissioner that is at odds with an answer that we received earlier that says when you have that situation, the granting -- as we do here, the granting of a power to allocate expenses between the corpus beneficiary and the income beneficiary, quote, it shall result in no disallowance or diminution of the marital deduction, close quote, for gift tax purposes -- the gift tax rules that you stressed earlier are invoked here by statute -- or for estate taxes.

So, we know under these rulings that it makes a difference, that you look to State law, and then --

QUESTION: They say that only applies to the existence of the power and not to its exercise.

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MR. AUGHTRY: Actually, no, Your Honor, because in that particular circumstance, it's a gift tax ruling. The grant of the power occurs at the same time that the transferring the gift tax does.

For example, if I'm making out a marital deduction trust and I'm making a transfer, a gift today, to my wife and if I provide this provision, the value is measured today. The value is measured today. If there's going to be a diminution in my gift tax obligation, it's going to occur today. It's not going -- you know, what happens down the road doesn't alter that. And we know that that particular principle is incorporated in these estate tax provisions by statute to provide a continuing symmetry between the estate tax provisions and the gift tax provisions.

The third point we wish to note is that the Government's position here works a statutory impossibility in most cases, works a factual impossibility in this case, and indeed renders bizarre results every time this Federal fiction is pitched in conflict with the majority rule embraced by at least 42 of the 50 States.

Let me speak for a moment, if I could, about certain of the other points that were raised during the earlier presentation.

I want to stress this. The Government in this

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ruling I alluded to I think has essentially conceded the spirit of this case. In Revenue Rule 69-56, the Government says there is no diminution in the marital deduction. You tie that into Revenue Ruling 88-12, which says you look -- in determining the impact of debts and expenses in calculating the net value -- in calculating the net value -- of the marital deduction, State law is determinative.

The other aspect that arises is this concept that we are somehow equating the treatment under 2053 with the treatment under 2056(b)(4)(B). They are different.

2053, the administrative expense that the Commissioner referred to -- and I think this was your concern, Justice Ginsburg, between present value and dollar-for-dollar reduction -- is where the corpus goes. It is a dollar-for-dollar concept. This is not our situation here.

Here the Commissioner relies upon 2056(b)(4)(B) which by its own terms -- and at long last by the Government's contention -- is a valuation concept. You should know that the Government denied that this was a valuation concept in the Tax Court and in the Eleventh Circuit.

Yes, sir.

QUESTION: May I ask one question which I think

is -- let's take a normal estate, a smaller estate.

MR. AUGHTRY: Yes, sir.

QUESTION: Much -- $2 million. And it's worth $2 million at the date of death and everybody is sure there would be $200,000 worth of expenses. I take it under ordinary reasoning, the widow, if it was the man who died, would get $1.8 million, forgetting other deductions, and they'd pay $200,000. Now, suppose that's what would happen normally and that other $200,000 would normally be deducted as a category of administrative expense. I'm right so far, right, basically? Okay.

MR. AUGHTRY: It may proceed that way. It need not.

QUESTION: Now, suppose a Martian comes along -- a Martian, somebody not related -- and happens to pay the $200,000 and therefore the estate is now really $2 million instead of $1.8 million. Okay, because the wife now gets the $2 million.

But I take it their position is that last $200,000 came along by purchase. It came along in some other way. It wasn't obtained by the marital deduction portion of the estate, and it seems to work quite well and be reasonable in that ordinary case. I mean, there's nothing in the law that says that $200,000 came through the marital deduction. They're saying it ended up being

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part of the estate, but it wasn't part of the marital deduction. That's what the law is. It seems to work well with the small estate, and your case I think they would say is a fluke.

MR. AUGHTRY: Well, Your Honor --

QUESTION: And we shouldn't change the law normally because of your case.

MR. AUGHTRY: First of all, I would say --

QUESTION: Even if they concede that your case is a fluke. They wouldn't concede that I realize.

MR. AUGHTRY: I would say that -- I would say this, Your Honor. Certainly at first blush you'd say, well, you know, everything sort of matches up. I hope that I can demonstrate to your satisfaction that that analysis involves a double counting where the controlling testamentary documents and the State law permit that the expenses be paid out of income as do 42 of the 50 States. And let me see if I might draw some distinctions on this particular hypothetical.

$2 million estate. If under the controlling testamentary documents and State -- excuse me -- and State law, it has to be paid out of corpus, the surviving spouse gets $1.8 million. If, on the other hand, it permits a balancing in the allocation of expenses between the income beneficiary and the corpus beneficiary and if, for

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whatever reason, just for simplicity purposes let's assume that the whole expenses were permitted to be paid out of income and were properly under State law and properly under controlling testamentary documents, then I as the fiduciary am transferring $2 million of property to the spouse. That's got to be recognized, the date-of-death value of what's being included, the date-of-death value of what's being distributed. And I've got a check to various vendors that total $200,000, and so there's $2.2 million of reality that has flowed there.

Under the Government's approach, they would take that amount properly paid out of the expenses -- excuse me -- those expenses properly paid out of income and pretend it was paid out of capital so that the fiction would work that there's only $2 million of distributions when it's properly $2.2 million of distributions.

Your example with respect to the Martian is very much like the situation in Ballantine and Roney where there was an obligation on corpus and it's viewed -- and I agree with this completely. It's viewed that whereas the obligation on corpus if somebody else comes in and helps them out, it doesn't change the -- you cannot violate State law and the controlling testamentary documents and circumvent and alter the result. You got to follow what the commitments are on corpus, as the Commissioner said in

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Revenue Ruling 88-12.

And so, at first blush everything seems to stack up nicely, but what happens is you only get to that result and ignore the $2 million -- excuse me -- $200,000 properly paid out of income under State law and controlling testamentary documents if you double count, if you use $2 to create every $1 of deduction, and you ignore the payments.

See, the problem -- the additional problem with that is let's assume that in a situation there where the expenses are paid out of income, that we're going to pretend it reduces the marital corpus anyway, what that does is that creates this gap, this disappearing residuary.

And then that creates a tax which is -- you say, well, now where are we going to pay that tax from? Well, you already spent all your income on the expenses. You can't pay it out of there. The Government would presume it's paid out of corpus anyway. So, the tax on that $200,000 is taken back in to reduce the amount of corpus flowing to the wife which creates another tax which is taken back in to further reduce the marital deduction of the wife which creates another tax, spiraling downward, ever downward. This is the multiplier effect addressed by the amicus brief on behalf of the American Council on

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Education and United Way. And for that reason, it creates sort of a chaotic result which -- because you don't have any income left.

What's worse -- and this is sort of the point of the Government's position with respect to, well, you can always just sort of waive your election under 642(g) and leave it on the gift tax return, leave the expenses on the gift tax return. The difficulty with that is that, as the commentators have recognized, that operates to repeal 642(g). One of the articles that we cite in our brief says, Does a 642 Election Still Make Sense?

What that does is, sure, you can take the expenses that you paid out of income in your hypothetical, sir, the $200,000 expenses that were actually paid out of income and move them back over to the estate tax return.

What happens if you do that? And that's I think the Government's ultimate object. You end up with an income tax on gross income, on the full $200,000. By depriving the income beneficiary the benefit of those deductions, you create a tax on gross income, and that income beneficiary doesn't have any net income to pay those taxes with.

QUESTION: Isn't the Government correct in its reply brief in simply saying that election is always of value to the estate that doesn't -- that isn't large

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enough to quality for the estate tax?

MR. AUGHTRY: No.

QUESTION: That alone is a common enough situation to justify the existence of that option provision.

MR. AUGHTRY: Well, I mean, it's true that there are circumstances where there is no meaningful election, but you cannot --

QUESTION: There are circumstances.

MR. AUGHTRY: Right.

QUESTION: Most estates aren't big enough to have to worry about the estate tax anyway.

MR. AUGHTRY: Well, to be sure, the estate taxing is imposed on a very small sliver of the American population, but the fact of the matter is I don't think it's an answer to say we have a meaningful election available to all citizens, to say yes, there are some circumstances where it doesn't do you any good to exercise the election.

QUESTION: Is that right? Every election in the law has to be interpreted in such a way that it will be of benefit to everybody?

MR. AUGHTRY: Not that it will be of benefit to everybody, but I would say to proceed on the assumption that there are those who don't have a meaningful election

because they don't have an estate tax return that's due does not address the problem that those who need the meaningful election ought to garner some benefit from the election.

The circumstances that we think we face here are largely cured in our minds by the Fifth Circuit's opinion in Estate of Warren. In Estate of Warren, you'll recall the court noted that there is no preference in Federal tax law as to whether or not these expenses are borne by the income beneficiary or the corpus beneficiary. And you should know in this case the income beneficiary and the corpus beneficiary in the marital deduction QTIP trust, qualified terminable interest trust, are two different people. It's two completely different people.

What Warren says, that there is no preference, it's interesting to me as I read the Government's distinction. As I understood the Government's distinction, the Government said there in 1993, as they said in Revenue Ruling 88-12, well, we relied upon exclusively the controlling testamentary document. Well, if it is appropriate to rely exclusively upon the controlling testamentary document in 1993 in Warren, as the Government had relied exclusively upon State law and the controlling testamentary documents before or relied in large measure before in Ballantine, Alston, and Roney, why

is it not appropriate here? Why isn't it appropriate here?

Isn't what the effect of the Government's position saying is that when I go determine who bears these administrative expenses as between my wife and my children on a different -- a marital bequest and a non-marital bequest, State law governs. But when I go to allocate expenses as between my wife and my children in a life estate in a remainder context, somehow State law does not obtain. And so, we say there's no basis, no material difference for altering the control of State law in those circumstances.

QUESTION: Mr. Aughtry, Justice Breyer raised a question of really does this matter much. Is this a fluke case? And, after all, even you should take the -- from now on you can take the expenses against the corpus.

MR. AUGHTRY: To the extent that I'm conforming with my State law fiduciary duties, yes, ma'am.

QUESTION: So, is this just a fluke case? What -- does it matter?

MR. AUGHTRY: I don't believe that it's a fluke case. I think it's a smaller case than the danger that's being created here.

QUESTION: What is that danger?

MR. AUGHTRY: The danger is that this concept of

date-of-death valuation is a concept that is being -- we think is being undermined here with the concept of opening the door to hindsight. But it -- and it's arisen in five cases by our count in 50 years -- five cases in 50 years -- in which the deductions are being shaved.

But that concept, that date-of-death valuation concept, impacts the inclusion of every asset on every estate in America. And so, if we open the door, contrary to this Court's holding in Ithaca Trust, contrary to this Court's holding on the inclusion side in Maass v. Higgins and Bull v. United States, to hindsight, I think the Government's going to lose far more revenue than they would gain by shaving these deductions in these five cases.

And so, I say to you I think it is a broad concept. I think we're dealing with fundamental principles of estate taxation, and it's a dangerous thing for a very small benefit here to open a door to a large loss there.

I don't know if that's at all responsive to your question.

The fact of the matter is, Your Honor, we subscribe to Justice Holmes' theory. Justice Holmes advocated in his lectures before Harvard -- they were ultimately embodied in the common law -- that the law

ought to be more concerned with the practical application to reality based upon experience than with detached logic or --

QUESTION: At that time he hadn't seen the Internal Revenue Code.

MR. AUGHTRY: I know.

(Laughter.)

MR. AUGHTRY: A fortunate soul, indeed. He did, however, apply that --

(Laughter.)

MR. AUGHTRY: He did, however, apply that wisdom in his decision in Ithaca Trust which is I think squarely on point in principle with this case. In Ithaca Trust, we were dealing with a deduction, a circumstance where a gentleman died. He left a life estate to his wife with the remainder interest to the charity. And the question was, how do we measure the value of that charitable deduction?

As events turned out, the wife regrettably died by way of accident 1 year later and the State wanted to come in and said, well, you know, the life estate is much smaller and therefore the remainder interest is much greater and therefore the charitable contribution deduction is much greater.

And Justice Holmes, on behalf of this Court in

Ithaca Trust said, I know the temptation to take what is now the readily known fact, the matter of certainty, to resolve the past event, but if we're to be true to this principle of date-of-death valuation for deduction purposes, distribution purposes, in addition to being true to this principle in Maass v. Higgins and Bull v. United States for inclusion purposes, we cannot succumb to the temptation of using hindsight. We cannot proceed to resolve those uncertainties that existed, that must exist in every valuation at the date of valuation.

QUESTION: Unless the charge is against the corpus, then we do use hindsight.

MR. AUGHTRY: You trace the corpus. You take the date of death, and wherever that corpus goes, you trace it. You don't use hindsight to erode the --

QUESTION: It's a universal principle, if you're willing to ignore it with respect to the corpus.

MR. AUGHTRY: No. No, Your Honor. You look to who gets that property. 2056 and 2055 both speak specifically to the property included as of the date of death in the gross estate, and they can only get a deduction equal to that amount of corpus that they ultimately got. And we measure what they got. It's a question of my wife got precisely what I gave here. What I gave her was --

QUESTION: Mr. Aughtry --

MR. AUGHTRY: Yes, sir.

QUESTION: -- in your brief you gave us seven independent insufficient reasons for affirming.

MR. AUGHTRY: Yes, sir.

QUESTION: Which one would you rely on if you had to pick one?

MR. AUGHTRY: Symmetry.

QUESTION: The number one.

MR. AUGHTRY: Yes, sir.

QUESTION: Thank you.

MR. AUGHTRY: Symmetry, I submit to you, is far preferable to the sort of chaos that we've tried to describe as best we could in our brief of a disappearing residuary, of the downward spiral, of multiplier effect, and of the unnecessary conflict created between the Commissioner's recent construction of this regulation adopted 40 years after the fact, the conflict between that construction, the Commissioner's own estate tax regulations and rulings -- we've cited 69-56. The ruling specifically says there's no diminution -- and indeed in conflict with the gift tax regulations and rules invoked here by statute. Symmetry and order we urge upon you is preferable to that form of chaos.

Thanks so very much.

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QUESTION: Thank you, Mr. Aughtry.

Mr. Jones, you have 1 minute remaining.

REBUTTAL ARGUMENT OF KENT L. JONES

ON BEHALF OF THE PETITIONER

MR. JONES: I have two points I will try to make very briefly.

The first is that Stapf by its terms applies its net value logic to administration expenses as well as to other claims against the estate. At page 134, the Court said in both instances, referring to both administration expenses and claims, by directing that payment be made of debts chargeable to another or to non-estate property reduces his net estate and in effect confers a gift or bequest upon another, which is exactly why we have to reduce the marital deduction because the net value of the bequest has been burdened by this encumbrance.

I need to say very briefly that the regulations and rulings that the Tax Court and that the taxpayer rely on are a classic example of apples and oranges. The regulations and rulings that the Tax Court relied on were under 2056(b)(5) which relates to a marital deduction when a gift is left in trust, where the spouse gets --

CHIEF JUSTICE REHNQUIST: Thank you, Mr. Jones. Your time has expired.

The case is submitted.

(Whereupon, at 1:48 p.m., the case in the above-entitled matter was submitted.)

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CASE NO. 95-1402

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BY Ann Riani Federico

(REPORTER)