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Qualifying the Homestead Exemption as a Federal Estate Tax Marital Deduction

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QUALIFYING THE HOMESTEAD EXEMPTION AS A FEDERAL ESTATE TAX MARITAL DEDUCTION

INTRODUCTION

One goal of effective estate planning is to keep the final estate taxes as low as possible. Keeping assets out of the estate will accomplish this goal. On the other hand, exempting included assets from estate tax computations reduces the base on which a tax is computed. For a married couple, the marital deduction is a common deduction from the gross estate of the first spouse to die.[1] Although the most common source of assets for qualification under the marital deduction is property bequeathed to a surviving spouse, the use of statutory exemptions and allowances provided by various state statutes furnishes a second source of qualification.

The statutory interest addressed in this note is the homestead exemption. Where the marital deduction is available the homestead exemption can be an effective tool for the removal of taxable assets from the impact of the federal estate tax. Qualification of a state homestead exemption does not follow automatically from its being a statutory exemption. The benefits of the marital deduction are restricted by the terminable interest rule which limits the reduction of estate assets.[2] It is the terminable interest rule that is the most

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1. I.R.C. § 2056(a):

(a) *Allowance of Marital Deduction.* For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsections (b) and (c), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

2. I.R.C. § 2056(b):

(b) *Limitation in the Case of Life Estate or Other Terminable Interest.*

(1) *General Rule.* Where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction shall be allowed under this section with respect to such interest—

(A) if an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than severe limit on some state homestead exemptions. Interpretation of the applicable state homestead exemption law and the corresponding federal terminable interest statute thus becomes the key to understanding the scope of qualifying homestead interests for the marital deduction.

This note introduces the background of the homestead exemptions and of the federal estate tax laws dealing with the marital deduction and the terminable interest rule. Next, the combination of federal and state law is analyzed from the view of Congress, the Internal Revenue Service, and the courts to determine the reasons for allowing or excluding the homestead interests in the few states where these three bodies have discussed the marital deduction in the homestead context. The objective of this analysis is a methodology for determining the deductibility of specific state homestead awards. In an appendix, the guidelines thus derived will be applied to the various state statutes for those states that recognize the homestead interest in a surviving spouse. Thus, the reader can grasp the concepts of the homestead exemption from the note and use the appendix to locate his state of interest. Initially, an understanding of homestead law is needed in order to lay a foundation for discussing the federal estate tax ramifications.

BACKGROUND OF HOMESTEAD EXEMPTIONS

Homestead may be defined as "a family residence owned, occupied, dedicated, limited, exempted, and restrained in alienability," as prescribed by statute.[3] The family residence normally constitutes

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> such surviving spouse (or the estate of such spouse); and
> (B) if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse;
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> and no deduction shall be allowed with respect to such interest (even if such deduction is not disallowed under subparagraphs (A) and (B))—
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> (C) if such interest is to be acquired for the surviving spouse; pursuant to directions of the decedent, by his executor or by the trustee of a trust.

3. R. WAPLES, A TREATISE ON HOMESTEAD AND EXEMPTION 1 (1893). State homestead exemption laws must be distinguished from federal homestead legislation which encourages the settling of remote areas of the United States by granting the settler an amount of land after a certain period of occupancy and cultivation. The only exemption for these lands would be from debts contracted prior to the "homesteading" of the land. However, the land would not be exempt from debts incurred subsequent to gaining title. On the state level, the homestead laws affect land already owned and debts after notice of the exemption protection. *Id.* at 924-53.

a dwelling house along with the land on which it is located.[4] The quantitative and monetary limits on the homestead vary among the states. However, unlike many laws which have a common law tradition, the homestead exemption arises from statutory or constitutional provisions enacted by legislatures.[5]

Purpose of Homestead Exemptions

The legislative purpose underlying homestead statutes is to protect the family by conservation of the "home."[6] Conservation of the home is provided by excepting the homestead from those assets available for the payment of the ordinary debts of the owner.[7] The homestead laws do not exonerate the debtor from his liabilities, but rather give the creditor notice that the homestead property is unavailable to satisfy these debts.[8] Therefore, the homestead exemption does not have an amnesty intent, even though there are charitable characteristics. The intent of the homestead exemption laws is to secure the permanency of the "home" and protect it from forced sale.

Interest of the Surviving Spouse in the Homestead

Upon the death of the person owning the homestead, the property is subject to the claims of creditors. However, the legislature steps in where there is a surviving spouse and extends the homestead interest of the decedent to the surviving spouse and places the property within the protection of the statute.[9] Thus, the property received by the surviving spouse is not subject to creditors' claims. The type of interest retained by the surviving spouse is dependent upon the specific state law. These interests range from the complete estate or interest that was vested in the

4. 2 H. TIFFANY, THE LAW OF REAL PROPERTY § 577 (3d ed. 1939).

5. *Id.* The assorted and contrasting homestead laws among the states may be related to the statutory nature of the homestead laws. Common law was often carried from state to state by the settlers. Statutory law, however, was created within the state.

6. R. WAPPLES, A TREATISE ON HOMESTEAD AND EXEMPTION 3 (1893).

7. *Id.* at 8.

8. *Id.*

9. 2 H. TIFFANY, THE LAW OF REAL PROPERTY § 577 (3d ed. 1939). In most states the homestead exemption passes to the surviving spouse rather than being renewed in the surviving spouse after the decedent's death. Along with the decedent's exemption, some states allow the spouse to have a homestead in her own property. Such homestead is separate from the interest received from the decedent.

deceased homesteader[10] to an interest in the nature of a life estate.[11] Some states provide that certain subsequent conditions such as remarriage[12] or failure to occupy[13] would terminate the interest. Nevertheless, protection of the home is provided the surviving spouse for as long as the conditions are met. The interest in the surviving spouse is an important factor in determining qualification for the marital deduction.

The Property Included in the Homestead

As with other aspects of the homestead statutes, the limitations on the property awarded to a surviving spouse are dependent upon the awarding state. In many states the interest is a strict limitation defined by area.[14] In contrast, many statutes provide a homestead allowance of cash with no reference to, or in lieu of, the underlying homestead property.[15] Often the statutory limitation is a combination of an area limit of land and a limit in terms of value of the property.[16] Under a statute which provides a maximum limita-

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10. Cal., CAL. PROB. CODE § 663 (West Supp. 1977); Nev., NEV. REV. STAT. § 146.050 (1977); S.D., S.D. COMPILED LAWS ANN. § 43-31-73 (Smith 1976); Utah, UTAH UNIFORM PROB. CODE § 75-2-401 (1978); Wis., WIS. STAT. ANN. § 861.41 (West 1971).

11. Ala., Grisham v. Rothholz, 219 Ala. 434, 122 So. 649 (1929); Ark., ARK. CONST. art. 9, § 6; Fla., FLA. CONST. art. 10, § 4; Ill., ILL. ANN. STAT. ch. 52, § 1 (Smith-Hurd Cum. Supp. 1978); Iowa, IOWA CODE ANN. § 561.12 (West 1950); Ky., KY. REV. STAT. ANN. § 427.070 (Baldwin 1978); Mass., MASS. ANN. LAWS ch. 188, § 4 (Michie/Law. Co-op 1969); Mich., MICH. CONST. art. 10, § 3; Minn., MINN. CONST. art. 1, § 12; N.H., N.H. REV. STAT. ANN. § 480: 3-a (1961); N.Y., N.Y. CIV. PRAC. LAW § 5206 (McKinney 1978); N.D., N.D. CENT. CODE § 30-16-02 (1976); S.C., S.C. CONST. art. 3, § 28; Tenn., TENN. CODE ANN. § 31-104 (Cum. Supp. 1978); Tex., TEX. CONST. art. 16, § 52; Va., VA. CODE § 34-10 (1976).

12. Kan., KAN. STAT. § 59-402 (1976); Mass., MASS. ANN. STAT. ch. 188, § 4 (Michie/Law. Co-op 1969); N.C., N.C. CONST. art. X, § 2(3); Ohio, OHIO REV. CODE ANN. § 2329.75 (Baldwin 1975); Va., VA. CODE § 34-10 (1976).

13. Colo., COLO. REV. STAT. § 38-41-203 (1973); Kan., KAN. STAT. § 59-401 (1976); Miss., MISS. CODE ANN. § 91-1-19 (1972); Ohio, OHIO REV. CODE ANN. § 2329.75 (Baldwin 1975); Ore., ORE. REV. STAT. § 114.005 (1977); Vt., VT. STAT. ANN. §§ 101, 106 (1967); Wyo., WYO. STAT. § 1-20-102 (1977).

14. Ark., ARK. CONST. art. 9, § 6; Kan., KAN. CONST. art. 15, § 9; Minn., MINN. CONST. art. 1, § 12; S.D., S.D. COMPILED LAWS ANN. § 43-31-4 (Smith 1967).

15. Ariz., ARIZ. REV. STAT. § 14-2401 (Cum. Supp. 1978-79); Colo., COLO. REV. STAT. § 38-41-201 (Supp. 1976); Hawaii, HAW. REV. STAT. § 560: 2-401 (1977); Idaho, IDAHO CODE § 15-2-401 (Supp. 1975); Mich., MICH. COMP. LAWS ANN. § 709.62 (1968); Mo., MO. ANN. STAT. § 474.290 (Vernon Supp. 1979); Mont., MONT. REV. CODES ANN. § 91A-2-401 (1977); Neb., NEB. REV. STAT. § 30-2322 (1975); Wash., WASH. REV. CODE ANN. § 11.52.010 (Supp. 1977).

16. Ala., ALA. CODE tit. 6, § 6-10-60 (1975); Ill., ILL. ANN. STAT. ch. 52, § 1 (Smith-Hurd Cum. Supp. 1978); Ky., KY. REV. STAT. ANN. §§ 427.070, .090 (Baldwin

tion on the homestead exemption, whether it is in terms of area, value or dollars, the possibility of the property exceeding these limitations is continuous. If the limitation is an area or value limitation, the statutory solution of partitioning of the land is needed to meet the limitation. Without partitioning, sale of the property is the only other alternative available to meet the homestead exemption limitation.

Of particular difficulty is the situation where the property fails to be partitioned and must be sold to satisfy the statute. With partitioned land, the interest of the surviving spouse remains the same before and after the partitioning; such interest is usually a life estate. However, where the land is sold and the proceeds are awarded in lieu of the homestead interest, a question arises as to whether the interest in the cash proceeds is the same interest as that of the prior homestead property.[17]

Similarly, it is important to determine whether the interest in the cash in lieu of the homestead interest came from the decedent or whether the cash represents a payment for the sale of the homestead interest owned by the surviving spouse. The difference will determine whether the cash interest vested at the date of death of the decedent or at a later date. By asserting that vesting occur-

1978); Mass., MASS. ANN. LAWS ch. 188, §§ 1, 4 (Michie/Law. Co-op 1969); N.H., N.H. REV. STAT. ANN. §§ 480: 1, 3-a (1968); N.Y., N.Y. CIV. PRAC. LAW § 5206 (McKinney 1978); N.C., N.C. CONST. art. X, § 2(3); N.D., N.D. CENT. CODE §§ 30-16-02, 47-18-01 (1978); Ohio, OHIO REV. CODE ANN. § 2127.26 (Baldwin 1978); S.C., S.C. CODE §§ 34-1, -11 (1962); Tenn., TENN. CODE ANN. §§ 31-104, 26-301 (Cum. Supp. 1978); Tex., TEX. PROB. CODE ANN. § 273 (Vernon Cum. Supp. 1978-79); Utah, UTAH UNIFORM PROB. CODE tit. 75, §§ 75-2-401, -404 (1978); Vt., VT. STAT. ANN. tit. 27, § 101 (1967); Va., VA. CODE §§ 34-4 (Cum. Supp. 1978), § 34-10 (1976); Wis., WIS. STAT. ANN. § 861.41 (West 1971); Wyo., WYO. STAT. § 1-20-104 (1977).

17. An interesting sidelight develops when the homestead property is sold and the surviving spouse has a homestead interest in that property. The sale of the homestead property presents problems of distribution of the proceeds. At the date of death the spouse has an interest in the land up to the statutory limitation and the heirs, devisees, or creditors have an interest in the excess over the limitation. However, in most estate situations the property will not be sold on the date of death, but at a later date. Often, appreciation of the value of the property occurs between the date of death and the date of sale. The question is should the spouse benefit from the appreciation in value? Annot., 6 A.L.R.2d 515 (1949). As an example, if the limit is $10,000 and the date of death valuation is $20,000, does the spouse have a $10,000 interest in the property or a 50% interest in the property? If the later sale produced cash of $30,000 would the spouse receive $10,000 or $15,000 of the proceeds? Although these problems are not within the scope of this note, they pose interesting questions for the estate administrator. No doubt the state law would control and dictate the outcome.

red at the date of death, a spouse can comply with the rules of the marital deduction since vesting from the decedent is one of the criteria for determining if the interest passes or has passed from the decedent.[18]

The property constituting the homestead exemption plays a significant role in the marital deduction analysis. If the statute allows only an area of land for the exemption, then any cash received for the interest in the land would not be considered eligible for the marital deduction. However, if the statute allows more than an area of land, then the term homestead property may include the land, cash in lieu of the land, or some other property.

Summary of the Homestead Exemption

The homestead exemption offers the surviving spouse the same protection from creditors which the decedent enjoyed. Often the exemption is conditional depending on life, occupancy, or remarriage. The primary objective of a study of the homestead law of a particular state is to determine what property is received by the surviving spouse and what her interest is in that property. The ultimate goal of qualification as a martial deduction for estate tax purposes depends on the transmitted interest in the property from the decedent to the surviving spouse. Essentially, the state statute controls the marital deduction for federal estate tax purposes.

FEDERAL ESTATE TAX

An estate tax is one levied on the privilege of transmitting property at death.[19] Its purpose is not to raise revenues or stabilize the economy as is the case with other taxes, but rather, the purpose of an estate tax is the equalization of wealth.[20] Federal estate taxes meet the equalization objective with the general policy that wealth will not be transmitted tax-free at death.[21] The initial inquiry is whether a homestead interest passed from a decedent to a surviving spouse is part of the wealth that should be subject to the estate transfer tax. The Internal Revenue Code of 1954 (Code), section

18. I.R.C. § 2056.

19. B. BITTKER & L. STONE, FEDERAL INCOME ESTATE AND GIFT TAXATION 990 (4th ed. 1972). While the estate tax is a transmission tax, it is a tax on the transmitting of property by the decedent to a recipient. The opposite occurs with an inheritance tax which burdens the recipient with a tax on property inherited.

20. *Id.* at 983.

21. United States v. Stapf, 375 U.S. 118, 131 (1963).

2033, defines the property to be included in the gross estate of the decedent as "the value of all property to the extent of the interest therein of the decedent at the time of his death." The Treasury Regulations clarify the Code section with the statement that "Property subject to homestead or other exemptions under local law is included in the gross estate."[22] Therefore, the Code looks to the interest in the decedent at death to determine inclusion of a homestead interest rather than to whom the homestead will pass or what interest will be received by the donee.

Once the homestead interest is included in the decedent's estate, the next step in preparing an estate tax return is to determine if the included interest can be deducted from the value of the estate. For a homestead interest passing to a surviving spouse, the appropriate deduction would be the marital deduction.[23]

Marital Deduction

Code section 2056(a) provides:

> For purposes of the tax imposed by section 2001, the value of the taxable estate shall, [subject to limitations], be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.[24]

Although the wording of the statute has the appearance of being generous by giving special treatment to a surviving spouse, in fact, the intention of section 2056 is not charitable. The marital deduction provision was enacted to solve a critical conflict between states that have community property laws and those with common laws.[25] The effect of this conflict had been that estates in common law states carried a greater tax burden than estates of community property states. The greater tax burden arose because when a decedent died in a community property state, one-half of the community property was treated as belonging to the decedent and one-half as belonging to the surviving spouse. Therefore, because the federal estate tax

22. Treas. Reg. § 20.2033-1(b), T.D. 6684, 28 Fed. Reg. 11,409 (1963).
23. I.R.C. § 2056.
24. I.R.C. § 2056(a).
25. S. REP. No. 1013, 80th Cong., 2d Sess., *reprinted in* 2 U.S. CODE CONG. & AD. NEWS 1163 (1948).

laws followed the state laws, only one-half of community property was included in the gross estate of the decedent.[26] On the other hand, a decedent from a common law state was required to include the entire amount of his property in his gross estate, even though the property may have been the joint product of a marriage.[27]

To remedy this disparity Congress acted in 1948 to change section 2056. Congress could not repeal the 1942 law without further action because the original inequities would exist where the community property estates did not bear their share of the tax burden.[28] The 1948 Revenue Act repealed the 1942 statute with the effect of putting the property laws back into the hands of the state rather than in the Federal Code. Additionally, the approach taken was to give the common law state estates the same estate-splitting advantage enjoyed by the community property states.[29] Therefore, although section 2056(a) allows a deduction from the gross estate for interests in property which pass to a surviving spouse, section 2056(c)(1)(A)(ii) limits the deduction to one-half of the value of the adjusted gross estate.[30]

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26. S. REP. NO. 1013, 80th cong., 2d Sess., *reprinted in* 2 U.S. CODE CONG. & AD. NEWS 1167 (1948).

27. *Id.*

28. In 1942 Congress attempted to solve the conflict by denying recognition of the community property state laws. B. BITTKER & L. STONE, FEDERAL INCOME ESTATE AND GIFT TAXATION 1101 (4th ed. 1972). Thus, the entire community property was included in the gross estate unless the decedent's representative could show separate interests in the surviving spouse. However, the nonrecognition of the state law did not equalize the conflict as legislators thought it would. For example, an estate could be subject to a tax liability in excess of the assets available to pay the tax since federal law required inclusion of the total community property in the estate, when at the same time the community property state law gave an interest in only one-half of those included assets from which to pay the tax. S. REP. NO. 1013, 89th Cong., 2d Sess., *reprinted in* 2 U.S. CODE CONG. & AD. NEWS 1188-89 (1948). The possibility of a tax greater than the assets available to pay the tax developed because of the progressive nature of the federal estate tax rates. As shown in I.R.C. § 2001, the maximum marginal tax rate on an adjusted gross estate is 70%. Therefore, on an estate of $10,000,000 the tentative estate tax computes to $6,050,800. Yet a community property law would give the estate assets of $5,000,000 (1/2 of $10,000,000) from which to pay the tax. If the community property was the only asset of the estate, there could possibly be a deficiency of $1,050,800 in estate tax from the insolvable situation created by the 1942 amendment. The inequality preceding the amendment was reversed by the 1942 statute to a position where the advantage was to the estate of a decedent in a common law state.

29. 4 J. RABKIN & M. JOHNSON, FEDERAL INCOME GIFT AND ESTATE TAXATION 5339 (1977).

30. I.R.C. § 2056(c)(1)(A)(ii). The complete limitation on aggregate of deductions is:

The end result desired by Congress, to equalize estate taxes regardless of the state of residence, was effectively implemented by the marital deduction provisions. Yet, the marital deduction section as written allowed a broad range of interests, such as life estates, to become sheltered from estate tax. Because the deduction of such interests was beyond the equalization purpose of the marital deduction, Congress created the terminable interest rule to place a limit on the marital deduction.

Terminable Interest Rule

Even with the deduction limited to one-half the adjusted gross estate, a homestead interest would qualify as an interest passing from the decedent but for an additional limitation on the marital deduction. This additional limitation is the terminable interest rule found in section 2056(b).[31] Generally, the marital deduction excepts property from the decedent's estate because the property will be taxed at the death of the surviving spouse if not consumed prior to death.[32] The terminable interest rule was written to insure that property would be taxed in at least one of the spouse's estates.[33]

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(1) *Limitation.*

(A) In General. The aggregate amount of the deductions allowed under this section (computed without regard to this subsection) shall not exceed the greater of—

(i) $250,000, or

(ii) 50 percent of the value of the adjusted gross estate.

31. Note that the Regulations distinguish between property and an interest in property. The terminable interest rule applies to an interest in property passing at death. Treas. Reg. § 20.2056(b)-1(e)(2) (1958). The words "interest" and "property" as used have entirely separate meanings. The word "property" includes all objects or rights which are subject to ownership. The word "interest" indicates the extent of the ownership. "Interest" expresses the quality or amount of ownership in a particular piece of property. Thus, if a spouse has a life estate in a farm, the "property" is the farm, and the "interest" in the farm is the life estate. 2 J. LASSER, ESTATE TAX TECHNIQUE 1430 (1966).

32. Baker, *The Marital Deduction and the Terminable Interest Rule*, 40 TENN. L. REV. 195, 196 (1973).

33. In Estate of Pipe v. Comm'r, 23 T.C. 99 (1954), *aff'd*, 241 F.2d 210 (2d Cir.), *cert. denied*, 355 U.S. 814 (1957), the court presents an excellent summary of the terminable interest rule:

> Generally speaking, the terminable interest concept was devised for the purpose of assuming that if the property bequeathed to the spouse was to be excluded from the gross estate with respect to the decedent, it would be adequately integrated in the spouse's estate so that on her death it would not escape the death tax a second time. . . . The basic principle . . . is that the spouse first to die shall be permitted to pass onto the

The underlying theory is that, unless consumed, either gift or estate taxes will tax the property during the same generation which would be in either the decedent's estate or the estate of the surviving spouse.[34] But if the interest is not vested in the surviving spouse such that she does not have control or another person has been given an interest in the property, then the rule calls such an interest terminable and excludes it from the marital deduction.[35] The specific provisions of the terminable interest limitation are:

> Where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction shall be allowed under this section with respect to such interest—
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> (A) if an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse; and
>
> (B) if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse; . . . .[36]

Some examples of terminable interests controlled by the occurrence or non-occurrence of an event are life estates, leases, joint tenancies, or estates for years.[37] As terminable interests they are excluded from the marital deduction. Even if a terminable interest is "whole," but fails because of its nature, it will not qualify for the marital deduction. "Whole" means the interest will not terminate by the occurrence or non-occurrence of an event; rather, it terminates for some other reason. Patents are examples of interests that are "whole" yet are terminable interests which do not qualify for the marital deduction.[38]

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surviving spouse free of estate tax up to one-half of his or her estate, provided only that the terms of the transfer are such that this property will be taxable in the estate of the surviving spouse. *Id.* at 104.

34. 4 J. RABKIN & M. JOHNSON, FEDERAL INCOME GIFT AND ESTATE TAXATION 5357 (1977).

35. Baker, *The Marital Deduction and the Terminable Interest Rule*, 40 TENN. L. REV. 195, 196 (1973).

36. I.R.C. § 2056(b)(1).

37. 2 J. LASSER, ESTATE TAX TECHNIQUES 1431 (1966).

38. *Id.*

Although section 2056(b)(1) excludes most terminable interests, there are some that can qualify for the marital deduction. If the only interest a decedent has in the property is a terminable interest and the entire interest is given to the spouse, the deduction is permitted.[39] Conversely, an interest which is terminable at the decedent's death which later becomes non-terminable is not provided for by the Code and, therefore, such an interest may be taxable in the decedent's estate *and* in the surviving spouse's estate upon death.[40] This distinction is critical where the homestead interest in the land is a life estate, but the interest in cash received from the sale of the land is an absolute interest. If the interest was terminable and becomes non-terminable at a later date, the terminable interest rule still disqualifies such an interest from the marital deduction. Thus, terminability for the terminable interest rule is determined as of the time of death of the decedent.[41]

The marital deduction and terminable interest rule are specific in controlling the exclusion of estate assets from taxation. For the homestead exemption, the qualification of a marital deduction hinges on the determination of whether an interest is terminable or non-terminable. Consequently, the wording of the state homestead statutes is critical to this distinction. For the marital deduction requirements, the hurdle is to show that the homestead passed from the decedent to the surviving spouse. In many cases "passing from the decedent" will not be enough to obtain the deduction. The terminable interest rule may stand in the way of an interest such as a life estate which may satisfy "passing," but which is disqualified as being "terminable." Only when the words of the statute satisfy the

39. S. REP. NO. 1013, 89th Cong., 2d Sess., *reprinted in* 2 U.S. CODE CONG. AD. NEWS 1190 (1948).

40. Jackson v. United States, 376 U.S. 503, 509-10 (1964). Under California law a widow is provided an allowance for support during the settlement of the decedent's estate. The assets from which the allowance is drawn are estate assets and are included in the decedent's estate for tax purposes. The Supreme Court of the United States held these payments as terminable at the decedent's death since a subsequent death of the widow would terminate the allowance payments. The widow argued that the payments actually received were not terminable under California law. In response, the distinction relied upon by the Court centered on the fact that such payments were terminable interests at the death of the decedent which later became non-terminable interests upon receipt by the widow. Therefore, since such interests are determined as of the date of death, the interests are terminable interests for computing the marital deduction. The *Jackson* decision thus leaves open the possibility of transfers between the decedent and the spouse being taxed in the decedent's estate *and* in the widow's estate.

41. *Id.* at 508.

marital deduction *and* terminable interest requirements will the estate tax be reduced. Not only do homestead statutes require analysis, but often the underlying state court decisions play an important part in the qualification or exclusion of a homestead interest as a marital deduction.

Influence of State Law on Section 2056

When analyzing a state homestead statute to determine the interest of a surviving spouse it is crucial to determine if the state court's interpretation of the statute will be binding on the determination of federal estate tax liabilities. This is especially important since the state statute is the basis for applying the federal law. In the landmark case, *Erie Railroad Co. v. Tompkins,*[42] the Supreme Court of the United States decided that a federal court in a diversity case may apply its own rules of procedure, but must apply the substantive law of the state in which it sits. *Erie* addressed the issue where the applicable law in the case was state law. In federal estate tax cases the law being applied is primarily federal and not state law, although state law plays a part in determining the interest which passes.

The influence state court decisions should have on federal tax law was determined in *Commissioner of Internal Revenue v. Estate of Bosch.*[43] *Bosch* drew from *Erie* the argument that the states should decide their own laws, but went further to state that if the United States was not a party to the state proceedings, the court's interpretation of a statute would be binding only if rendered by the highest court of the state.[44] In other words, the states are best suited to determine state law, but until the highest court has spoken, a final determination has not been reached. Therefore, a federal court deciding an estate tax question may sit as if it were a state court in determining the underlying interest based on state law.[45]

The *Bosch* decision stands in the background in the following analysis of the various state homestead statutes. If the highest court of the particular state has rendered a decision concerning the interest that has passed from the decedent, then that decision will be binding when considering the marital deduction or terminable in-

42. 304 U.S. 64 (1938).
43. 387 U.S. 456 (1967).
44. *Id.* at 465.
45. *Id.*

terest rule. However, if only a lower state court has ruled, the estate should be concerned that even though the decision may preliminarily be in its favor, a later and final determination may be made to the contrary. A federal court could reverse the ruling of the state court when the federal court applies the state law to a homestead interest. Such a determination could eliminate a marital deduction which the estate thought allowable under the state court decision.

Summary of the Federal Estate Tax

An estate tax will be levied on any property included in the decedent's estate unless some means can be used to reduce the estate. Initially, the homestead interest is a property interest included in the estate. Foremost among the means for excluding the homestead interest, where it passes to a surviving spouse, is the marital deduction. Recognition of the terminable interest rule, however, is needed to effectuate the exclusion of a homestead interest. Bridging the gap between the marital deduction and the homestead interest is the specific state statute. Interpretation of this statute is the key to the ultimate goal of reducing the estate tax.

Consequently, the estate must consider the sources of statutory interpretation. *Bosch* indicates that the highest state court is the best authority on state law.[46] Absent such a decision, the federal court may fill the role of a state court in the interpretation of the state statute. In short, the marital deduction can be used as a tool to qualify a homestead interest as an exclusion which would reduce the estate tax. The terminable interest rule, however, may be a weapon against the estate. If the terminable interest rule operates, three events will occur: the estate tax of the decedent will be denied a reduction in amount, the non-excluded assets will be included in the decedent's estate, and the same assets will be included in the surviving spouse's estate. The tremendous impact of such a possibility requires the estate planner to closely analyze the interrelationships between the federal law, represented by the marital deduction and terminable interest rule, and the state homestead exemption statute.

FEDERAL ESTATE TAXES AND THE HOMESTEAD EXEMPTION

The homestead exemption has received little direct interpretation in the context of federal estate taxes and the marital deduction.

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

On the other hand, the broader category, statutory interests, of which the homestead exemption is a part, has received much attention. On the federal level many of the arguments for exempting other statutory interests will apply equally to the homestead interest. Some of the other statutory interests from which these arguments may be drawn are dower, curtesy, widow's allowance, and family allowance.

The analysis of the relationships between the homestead exemption and the marital deduction requires division of the homestead exemption into two parts. This division is needed because of the distinctions made in many statutes. The first part is the property award. When the state homestead statute produces an interest in the actual homestead property for the surviving spouse, the statute is awarding the homestead property to the spouse. In contrast, the second part of the exemption statute often provides an award in lieu of the homestead property. This award is often in the form of cash.[47] The cash award has many of the characteristics of the property award, such as vesting. Its difficulties stem from the fact that cash is often treated as a substitute for the property award rather than as an equal alternative.

Moreover, the adversary position taken by the Internal Revenue Service in many disputes over the homestead interest as a marital deduction assumes the cash award represents proceeds from the sale of the interest in the property. Contrary to this assumption, the interest of the property award of homestead and the cash award are separate and distinct interests of a surviving spouse and should be treated as such in those jurisdictions allowing both interests.

The guidelines developed for the property award and for the cash award are used on each of the separate state homestead laws in an appendix to determine whether an estate in such a state could possibly exclude the interest as a marital deduction. In the application to state laws, the first determination to be made must be to

47. The most common award in lieu of homestead is a cash award. However, the award could be of property of the estate other than the homestead property such as a diamond ring or securities. The proper terminology for the award is the "award in lieu of homestead" interest. However, since the interrelationships of the award of homestead and award in lieu of homestead are independently complex, they would be further confused by using such similar labels as "award of homestead" and "award in lieu of homestead" for two distinct interests. To help clarify the confusion for the purposes of this note the term "cash award" will be substituted for "award in lieu of homestead" and the term "property award" will be substituted for "award of homestead."

establish if the state provides a homestead exemption. If it does, the next step is to examine the statute to see if these are separable interests of an award of property and cash. Then the interests will be examined for marital deduction qualifications. Since the property award and the cash award are substantially different interests, each is treated separately in determining the guidelines for analyzing a state homestead statute.

A. Property Award

The separate interest of the property award derived from a homestead exemption statute extends the exemption to an interest in the homestead property. At the decedent's death the surviving spouse has an interest in her husband's exempted property. To satisfy this interest, a statute awarding the homestead property will provide the spouse with an estate in the same homestead property in which the decedent had an interest. Since the marital deduction requires the interest to be passed from the decedent, the property award must also pass or vest from the decedent to qualify. As with any interest qualifying as a marital deduction, the property award must meet the terminable interest rule provisions. Within the terminable interest rule the homestead interest must not only avoid terminability in terms of the life of the surviving spouse, but must also escape other conditional rights of a spouse such as occupancy or remarriage. Qualification for the property award requires a combination of avoidance of the terminable interest rule and retention of the vesting from the decedent.

Vesting in the Surviving Spouse

To qualify for the marital deduction the homestead property must have been included in the adjusted gross estate of the decedent.[48] Along with the compulsory inclusion of the property award by the Treasury Regulations,[49] the Code requires a vested and indefeasible interest in the property by the surviving spouse.[50] Without such a vested interest the property award would be deemed to come from the estate rather than from the decedent, a result that would not satisfy the Code's vesting requirement. This does not mean the property cannot be distributed by the estate; rather, it

48. I.R.C. § 2056(a).

49. I.R.C. § 2033; Treas. Reg. § 20.2033-1(b), T.D. 6684, 28 Fed. Reg. 11,409 (1963).

50. Jackson v. United States, 376 U.S. 503, 509 (1964). *See* note 40 *supra.*

means the spouse must have had a vested interest in the property at the decedent's death.[51]

For example, in California a statutory award called the family allowance is a right of a surviving spouse.[52] However, the spouse does not receive the right until it is granted by a court order.[53] Therefore, the court has two functions regarding the family allowance in California: (1) to grant the right to the spouse; and (2) to determine the amount or value of that right. The Supreme Court of the United States in *Jackson v. United States* pointed out that since the court has to grant the right, nothing accrues to the spouse prior to the grant.[54] The result is that the right is not vested at the death of the decedent and so is not available for the marital deduction.[55] If the surviving spouse had died prior to obtaining a court order, nothing would have been payable to her estate, thus supporting the decision that the right did not vest at his death.[56] The function of the California family allowance statute is to give the spouse the right to apply to the court for the allowance and to give the court the power to grant the allowance to the spouse.

Jackson turned on the determination of when the interest vested and not when the interest was valued. Vesting occurred upon the granting of a court order. Similarly, the homestead interest must vest at the decedent's death in order to qualify for the marital deduction. The *Jackson* family allowance vested in the spouse a right to apply for the allowance although such application could not physically occur until after the decedent's death. The post-mortem claim of a spouse would appear to be a condition of receiving any statutory interest and, being conditional, the claim would seem to be a terminable interest. If this logic were followed almost all statutory interests in a surviving spouse would fail as marital deductions because of terminability.

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51. Jackson v. United States, 376 U.S. 503, 509 (1964).

52. CAL. PROB. CODE § 680 (West Supp. 1978).

53. The California Probate Code's specific language indicates a court-granted right when section 680 states "in the discretion of the court or judge granting it." The only right a surviving spouse has at the decedent's death is the right to apply for an allowance, but the right to the allowance distribution does not accrue until after a court order grants it. Cunha's Estate v. Commissioner of Internal Revenue, 279 F.2d 292, 297 (9th Cir. 1960), *cert. denied*, 364 U.S. 942, *rehearing denied*, 368 U.S. 870 (1961).

54. 376 U.S. 503, 506 (1964).

55. *Id.*

56. *Id.* at 507.

The administrative filing dilemma for statutory interests was resolved in a dower situation. In response to a dower claim, the court in *Hawaiian Trust Company v. United States*[57] stated that when a state provides a statutory right for a surviving spouse, the formal procedural requirement of claiming such a right, although post-mortem, does not make the right conditional so as to be terminable. In distinguishing *Jackson*, the court noted that the California family allowance was *not* a vested right at death, whereas the dower right in *Hawaiian Trust* had vested at death.[58] The procedural filing requirement in *Jackson* was moot since the right itself lacked the prerequisite vesting. The filing of a claim in *Hawaiian Trust* was for the purpose of admeasurement of the dower interest rather than to establish the vesting of the interest.[59] To satisfy the *Jackson* and *Hawaiian Trust* holdings for statutory interests, a property award must be vested in the surviving spouse at the date of the decedent's death although the claim and admeasurement could be subsequent to the death.

Terminability

A homestead statute awarding a terminable interest to a spouse will keep the estate from taking a marital deduction for the interest. Florida's strictly quantitative[60] homestead statute illustrates a terminable interest in the form of a life estate:

> [I]f the decedent is survived by a spouse and lineal descendants, the surviving spouse shall take a life estate in the homestead, with a vested remainder to the lineal descendants in being at the time of the decedent's death.[61]

Since Florida provides a life estate in the surviving spouse, the interest is terminable and would defeat the attempt to claim a marital deduction for the interest.

A statute such as Florida's clearly is terminable and not subject to the marital deduction of Code section 2056. The marital deduction would be available only if the decedent also had a ter-

57. 412 F.2d 1313, 1314 (U.S. Ct. of Cl. 1969).
58. *Id.*
59. *Id.*
60. FLA. CONST. art. 10, § 4, describes the homestead quantitatively as 160 acres if located outside a municipality and one-half acre if in a municipality. The award does not allow for commutation of the homestead interest which would complicate the illustration.
61. FLA. STAT. ANN. § 732.401 (West 1976).

minable interest in the homestead property such as a lease or life estate.[62] If the decedent had a lease, it would be subject to a homestead exemption by him and also by the surviving spouse.[63] However, because Code section 2056(b)(1) classifies a lease as a terminable interest no marital deduction is allowed. A life estate in the decedent terminates at his death even though he could have had homestead protection during his life.[64] If the surviving spouse obtained a life estate in the same property it would not affect the estate taxes because such property would not be included in the gross estate.[65] Also, if the decedent owned a life estate the marital deduction would not be allowed because the spouse's homestead interest would come from a previous grantor rather than from the decedent. The spouse may have a vested interest in the form of a remainder, but it would vest from the previous grantor, not from the decedent.

The typical conditional homestead statute makes survival the condition on which the interest is awarded. Survival, as a condition, gives rise to a life estate in the property which would clearly be a terminable interest.[66] In applying the terminable interest rule, however, survival is not the only condition that would render an interest terminable. For example, in Illinois the homestead interest is made conditional upon the continued occupancy of the homestead property by the surviving spouse.[67] Consequently, if the spouse would lose the exemption by abandoning the homestead the exempted property would be subject to a terminable interest. Along with occupancy or remarriage is another terminable condition which will cut short the homestead protection. Another condition is a term of years whereby the protection is afforded the spouse for a statutory period at the lapse of which time the property reverts according to the law as if the homestead exemption had not been applied. In short, any condition attached to the property award prevents a marital deduction by creating a terminable feature in the homestead award.

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62. S. REP. NO. 1013, 89th Cong., 2d Sess., *reprinted in* 2 U.S. CODE CONG. & AD. NEWS 1190 (1948).

63. R. WAPLES, A TREATISE ON HOMESTEAD AND EXEMPTION 113 (1893).

64. *Id.* at 116.

65. I.R.C. § 2033. The only life estate that would be included in the gross estate would be property that was transferred by the decedent during his life, where he retained a life estate in such property. I.R.C. § 2036.

66. I.R.C. § 2056(b)(1); 2 J. LASSER, ESTATE TAX TECHNIQUES 1431 (1966).

67. ILL. STAT. ANN. ch. 52, § 2 (Smith-Hurd 1967). "Such [homestead] exemption shall continue after the death of such householder, for the benefit of the husband or wife surviving, so long as he or she continues to occupy such homestead . . . ." *Id.*

Whether or not the condition actually occurs is irrelevant to the terminable interest rule. As pointed out in *Hamilton National Bank of Knoxville v. United States,*[68] the critical factor in applying the terminable interest rule is the *possibility* of the failure of the interest rather than the *actual* failure. For example, if a state's homestead statute employs remarriage as a condition, the spouse may live her remaining life in widowhood and never break the remarriage condition. But preserving the remarriage condition will not save the marital deduction because the Code judges the condition from the date of death of the decedent and does not look at future events or the lack of future events. Accordingly, the Code sees remarriage as a possibility and thus as a terminable condition that removes the potential of a marital deduction. Therefore, a statute must provide an absolute, unconditional interest in the surviving spouse or the marital deduction will not be allowed.

Summary of the Property Award

The property award, being an award of an interest in the homestead property, qualifies for the marital deduction if it vests from the decedent and is not a terminable interest. Vesting requires the property award to pass from the decedent rather than from some other source such as a court order granting an interest to the surviving spouse. The vesting will not be defeated by a formal, procedural statutory requirement of claiming the property award as long as the award vested at the time of death. A procedural filing will relate back to the decedent's date of death and satisfy the vesting requirement.

Moreover, terminability is an important but negative aspect of qualifying the property award for the marital deduction. An interest which is terminable will bar a marital deduction. Terminability is based on conditional features such as life estates, continual occupancy, remarriage, or a term of years in the homestead interest. Qualifying a property award incorporates vesting at death followed by an absolute, unconditional interest in the surviving spouse.

B. Cash Award in Lieu of the Homestead Interest

Like the homestead award, an amount of property or cash given in lieu of the homestead interest will be included in the gross estate of the decedent.[69] However, commutation of the homestead in-

68. 353 F.2d 930, 931-32 (6th Cir. 1965), *cert. denied,* 384 U.S. 939 (1966).
69. I.R.C. § 2056(a).

terest creates more problems than the simple award of the homestead property. The typical homestead statute will limit the amount or value of the homestead interest. For example, the Wyoming homestead statute provides as follows:

> When any person dies seized of a homestead leaving as survivor a widow [or] husband, . . . the survivor is entitled to the homestead . . . .[70]
>
> The homestead may consist of a house and lot or lots, in any town or city or of a farm consisting of any number of acres . . . the value of which does not exceed six thousand dollars ($6,000.00).[71]

The Wyoming statute illustrates the problem created by a cash award in lieu of the homestead interest. If a Wyoming homestead is valued at an amount greater than six thousand dollars, the interest is limited. A problem arises as to the interest remaining in the surviving spouse. One alternative solution could be partitioning the property and giving a parcel within the limitations to the spouse. In such a case the spouse would retain the same interest as in the homestead property whether it is absolute or conditional. Wyoming provides that if the value exceeds the limitation, the property can be sold with the proceeds up to the six thousand dollar limit going to the spouse.[72] However, in Wyoming the homestead interest in the property operates only so long as there is continued occupancy of the property by the spouse.[73] Such an interest in the property would be a terminable interest not subject to the marital deduction.[74] Following a sale of the homestead property which has a value exceeding six thousand dollars, the spouse now holds cash-in-hand rather than property in return for her interest. Applying the occupancy statute to the "cash" would be meaningless. This demonstrates that the questions to be answered in analyzing the cash awards are more complex than the qualification of the award of the homestead property.

In addition to the problems common to the property award of vesting and terminability, other problems unique to the cash award must be overcome to insure qualifications as a marital deduction.

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70. WYO. STAT. § 1-20-103 (1977).
71. WYO. STAT. § 1-20-104 (1977).
72. WYO. STAT. §§ 1-20-101, -107 (1977).
73. WYO. STAT. § 1-20-102 (1977).
74. I.R.C. § 2056(b).

The examination is not entirely separate and distinct from a discussion of the property award since the problems originate to some extent from the relationship between the property award and the cash award. Finding an equality of interests in the property award and the cash award would allow the surviving spouse to use the chose in action concept, thereby giving her a vested right at the decedent's death. Thus, the award of the homestead property or an award of cash represents her choice of the alternative means of satisfying her vested interest. On the other hand, if the homestead statute indicates dominance of the property award in the relationship such that the cash award is actually proceeds from the sale of her property award, then a marital deduction would be disallowed since it did not vest from the decedent.

While considering the relationship of the property award and the cash award, the terminable interest rule lurks in the background to deny the surviving spouse an otherwise vested marital deduction. The conditional nature of the cash award must also be considered. While the typical conditions for the property award were occupancy or widowhood, the conditions of a statute for the cash award are often reinvestment in another homestead, investment in securities or some other holding device so that the spouse derives the benefits from the proceeds yet the cash reverts to the proper heirs if the condition is met.

Beyond the conditional restrictions, the cash award must also be of a mandatory nature rather than payable at the court's discretion. Similarly, the homestead statute, and not an agreement between the spouse and the estate administrator, must be the source of the cash award. A discretionary award will bring about terminability, and as a result of the terminability problem and the relationship between the property award and the cash award, the cash award requires more scrutiny to qualify it for the marital deduction.

Chose in Action

The concept of "chose" constitutes a broader meaning of the term property and includes all rights which are of value.[75] Normally, a right is thought of as a right to tangible property. In the larger definition of property a "right" consists of claims by the owner against a third party.[76] Since these rights can be enforced by action

75. R. Brown, The Law of Personal Property 11 (3d ed. 1975).
76. *Id.*

and the rights have value, they are property to the owner.[77] Choses can be divided into two categories; "choses in possession" and "choses in action." Applying the concept of "chose" to homestead laws, a "chose in possession" would be a right of the surviving spouse to the award of the actual homestead property. On the other hand a "chose in action" would imply that the spouse had a right to take action with respect to the homestead interest. This right has value and comes from the decedent. Upon claiming this right, the spouse could elect to have the right assigned. However, the value could be assigned in the form of possession of the property or in the form of a cash award in lieu of the homestead interest. With this interpretation of a homestead statute, the form of the assigned property, possession or cash, is irrelevant to the determination of vesting from the decedent. Assignment is only relevant to the property received; thus, in many statutes possession is a life interest, whereas cash is an absolute or unconditional interest.

The significance of applying a chose in action theory to homestead exemption laws is that the receipt of a cash award by the spouse for her homestead interest would not be considered a sale of her non-deductible life interest. Rather, the cash award would represent an assignment of the right (chose in action) received from the decedent. Since the interest in the cash award would normally be absolute, the chose in action would be absolute. Thus, cash from the commutation of the homestead interest would be qualified for the marital deduction as a non-terminable interest passing from the decedent.

United States v. Traders National Bank of Kansas City[78] applied the chose in action theory to homestead exemption law. In *Traders* the estate attempted to deduct the commuted value of the homestead interest as a marital deduction on the federal estate tax return.[79] Upon audit, the deduction was disallowed by the Commissioner.[80] The estate then paid the tax deficiency and filed a claim for refund based on the argument that the commuted value of the homestead right was a valid and legitimate marital deduction from the decedent's gross estate.[81] The pertinent portion of the Missouri homestead statute applied in *Traders* stated that the "widow shall

77. *Id.*
78. 148 F. Supp. 278 (W.D. Mo. 1956), *aff'd*, 248 F.2d 667 (8th Cir. 1957).
79. *Id.* at 280.
80. *Id.*
81. *Id.*

have the right to occupy such homestead during her life or widowhood, and upon her remarriage or death it shall pass to the heirs of the husband."[82] On the surface this statute appears to give the surviving spouse a terminable interest which the Commissioner might rightly reject as a marital deduction due to the conditions of widowhood and survival. However, the court searched deeper into Missouri law to establish the interest in the spouse upon commutation of the homestead interest.

A separate Missouri statute provides an option for the surviving spouse. When a life estate is owned the spouse can retain the life interest or elect to receive cash in lieu of the life interest.[83] The court held that if the widow elected to receive the commuted value the homestead property would be free from the statutory terminable interest restrictions.[84] Thus, there is a statutory option in Missouri for the widow and the life estate provision relates only to the alternative of possession of the homestead property.[85] Therefore, at the option of the surviving spouse, the election to receive cash renders the interest absolute. Assignment of the homestead interest in the form of cash is non-determinative in establishing the absolute right of the spouse; it only determines the interest in the cash received.

The chose in action approach to homestead statutes may be the most effective means of qualifying a cash sum as a marital deduction. As in *Traders*, the scope of the analysis of the state statutes should encompass more than an examination of the specific homestead statutes; it should also entail a search of all related statutes to determine the interest acquired.

Terminable Interest

As with the award of the homestead property, the cash award would be excluded from the marital deduction if deemed a ter-

82. MO. ANN. STAT. § 513.495 (Vernon 1952). Although the *Traders* case is the primary court decision used in adopting the chose in action theory for homestead exemptions, it is no longer applicable in Missouri. The law under which *Traders* was decided was repealed and replaced by a cash award statute. By statute the cash award may consist of money, or real or personal property and vests absolutely in the spouse. Under the new law, as with the repealed law, an award of cash from the decedent would vest absolutely in the surviving spouse and would qualify such an amount as a marital deduction. MO. ANN. STAT. § 474.290 (Vernon Supp. 1979).

83. MO. ANN. STAT. § 442.530 (Vernon 1952).

84. United States v. Traders National Bank of Kansas City, 148 F. Supp. at 283.

85. *Id.*

minable interest.[86] Terminability could be established if the cash represented the proceeds from the sale of a terminable homestead interest, such as a life estate. If the cash is an assignment of a chose in action, then the assignment could be terminable even though it vested from the decedent. The Michigan homestead statute provides for options depending on the value of the homestead property.[87] However, even if the cash option is elected the proceeds must be reinvested in either the purchase of a new homestead or securities for the benefit of the spouse.[88] The new homestead or securities take on the same homestead exemption qualities as the original homestead which is a life estate.[89] Therefore, the circuitous Michigan statute allows a cash award, but the cash has a terminable restraint. Homestead statute anaylsis requires an absolute or terminable determination even if the assignment of the interest is in the form of cash. A terminable interest determination denies the spouse a marital deduction when cash is received.

Sale of a Life Interest in the Homestead Property

Where the interest in the homestead property is a terminable interest such as a life estate, cash proceeds given to the spouse may

86. I.R.C. § 2056(b).

87. MICH. COMP. LAWS ANN. § 709.62 (1968).

Same sale or divison Sec. 62. Upon the confirmation of the report, the probate court shall proceed as follows:

(1) If the appraised value of the homestead . . . shall not exceed $3,500.00, no further action shall be taken . . . .

(2) If the appraised value of the homestead . . . shall exceed $3,500.00, and . . . the premises can be divided, and that a homestead not exceeding in value $3,500.00 can be set apart . . . the probate court shall order that the latter homestead be set apart for the benefit of the . . . wife. . . .

(3) If the appraised value of the homestead . . . shall exceed $3,500.00, and if . . . the premises cannot be so divided that a homestead not exceeding the value of $3,500.00 can be set apart, . . . the probate court shall order the whole of such premises to be sold according to law . . . .

88. *Id.* The section continues:

The fiduciary shall reserve and retain from the proceeds of such sale the sum of $3,500.00 for the benefit of the . . . widow. . . . The sum so reserved and retained by the fiduciary shall be invested by the fiduciary with the approval of the probate judge, either in the purchase of a new homestead, or in proper securities for the benefit of the . . . widow . . . .

89. *Id.* The section continues:

The property or securities in which it shall be invested, shall remain exempt from the payment of debts and the expenses of administering his estate in like manner as a legal homestead would have remained exempt, and shall finally go to the persons, who, upon termination of such exemption, would have been entitled to the homestead if it had not been sold.

be considered as proceeds from the sale of that interest. The Alabama statute was treated as such in *United States v. Hiles.*[90] The estate in *Hiles* deducted the commuted value of two statutory interests, dower and homestead, as marital deductions.[91] The Internal Revenue Service disallowed both deductions, arguing that each interest was a life estate and that the cash represented proceeds from the sale of the life interests.[92] The Fifth Circuit Court of Appeals decided in favor of the taxpayer on the dower issue and against the taxpayer on the homestead issue.

As to the commutation of the dower, the court applied the chose in action theory whereby the cash represented an assignment of an equity right vested at the decedent's death.[93] Conversely, the court distinguished the homestead from the dower.[94] Citing a Supreme Court of Alabama decision[95] the court considered the homestead property right as vesting in the widow at the time of death.[96] The homestead interest, a life interest, was therefore a terminable interest not subject to the marital deduction provisions, and the amount received for the homestead interest was "in the nature of a payment for her homestead life interest."[97]

Cash as proceeds from the sale of the homestead interest can be distinguished from cash as an assignment of a vested interest. The cash proceeds from the sale come through the property award and do not vest from the decedent. Whereas a cash assignment is a payment for a chose in action vested in the surviving spouse at the decedent's death, the cash award is one equal alternative or option to the property award. Thus, a cash award which is deemed proceeds from the sale of the homestead property interest will not qualify as a marital deduction.

Mandatory or Discretionary Sale of the Homestead Property

Another criterion for examining a statute is whether the sale of the homestead is required by law or allowed at the option of the

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90. 318 F.2d 56 (5th Cir. 1963).

91. *Id.* at 58.

92. *Id.*

93. *Id.* at 60.

94. *Id.*

95. Grisham v. Rotholz, 219 Ala. 434, 122 So. 649 (1929). This court satisfied the *Commissioner of Internal Revenue Service v. Estate of Bosch* requirement of being the highest court of the state.

96. United States v. Hiles, 318 F.2d 56, 60 (5th Cir. 1963).

97. *Id.*

surviving spouse. The Treasury Department has been very specific in this area of homestead analysis. Revenue Ruling 72-153 was promulgated to specifically qualify the State of Washington cash award as a marital deduction.[98] The Revised Code of Washington, section 11.52.101, provides:

> If it is made to appear to the satisfaction of the court that no homestead has been claimed in the manner provided by law, either prior or subsequent to the death of the person whose estate is being administered, then the court, after hearing and upon being satisfied that the funeral expenses, expenses of last sickness and of administration have been paid or provided for, and upon petition for that purpose, *shall* award and set off to the surviving spouse, if any, property of the estate, either community or separate, not exceeding the value of twenty thousand dollars at the time of death . . . .[99]

The Revenue Ruling characterized the statute as being mandatory rather than permissive.[100] This distinction is important because the Supreme Court of Washington in *In re Poli's Estate*[101] stated the time of vesting of a property interest granted to a surviving spouse is dependent on whether the language of the statute is mandatory or discretionary. Following the *Poli* decision, the cash award vests immediately on the decedent's death. Accordingly, Revenue Ruling 72-153 held that the cash award "is not a nondeductible terminable interest and therefore the value of the property awarded qualifies for the [marital] deduction."[102] The lesson from this Revenue Ruling is that the specific language of a statute is important in order to claim the cash award as a marital deduction.

A later Revenue Ruling, 76-166,[103] uses the mandatory/discretionary distinction in allowing a marital deduction for the Arizona cash award. It cites Revenue Ruling 72-153 and the fact that the Washington statute considered the interest of the spouse as vested because of the mandatory language.[104] However, in the discussion of

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98. Rev. Rul. 72-153, 1972-1 C.B. 309.

99. WASH. REV. CODE ANN. § 11.52.010 (Supp. 1977) (emphasis added).

100. Rev. Rul. 72-153, 1972-1 C.B. 309.

101. In re Poli's Estate, 27 Wash. 2d 670, 179 P.2d 704 (1947). This court satisfies the *Commissioner of Internal Revenue Service v. Estate of Bosch* requirement of being the highest court of the state.

102. Rev. Rul. 72-153, 1972-1 C.B. 309.

103. Rev. Rul. 76-166, 1976-1 C.B. 287, 288.

104. *Id.*

the Arizona statute no mention is made of any *Arizona* state law that requires vesting if the language is mandatory. The Ruling states that under the Arizona statute the spouse must elect to take her interest and that it is a vested interest since there are no substantial conditions or limitations on her right to ownership of the allowance.[105] The Arizona law states, "A surviving spouse of a decedent who was domiciled in this state is entitled to an allowance of six thousand dollars."[106] Therefore, from the analysis of Revenue Rulings 72-153 and 76-166, any statute providing a cash award will qualify for the marital deduction if the language of the statute is mandatory.[107]

Statutory Source of the Cash Award

Along with the other factors, the source of the cash award must be a statute rather than an agreement between the spouse and the estate. If the source of the cash award is a statute, then the passing of the statutory interest would relate back to the date of death of the decedent.[108] The importance of the source of the cash award is discussed in *Estate of Nachimson.*[109] Under New Jersey dower law, the widow had a dower interest which could be commuted with a lump-sum cash award.[110] However, the widow bypassed the court system which would have awarded the lump-sum, and as a result of arm's length bargaining, the representatives of the estate and the widow entered into an agreement as to the amount of the lump-sum payment.[111] In consideration of the lump-sum the widow released all her claims of dower.[112] The tax court agreed that the state law had provisions for a lump-sum award in lieu of the dower interest, but the court said the spouse did not use

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105. *Id.*

106. ARIZ. REV. STAT. § 14-2401 (Supp. 1978-79).

107. It should be noted that the Washington and Arizona statutes do *not* allow the awarding of the homestead property, but only an allowance in lieu of the homestead interest in the form of a cash award. Providing only an allowance provision avoids the problem in some state statutes where the statute provides a property award or a cash award.

108. United States v. Crosby, 257 F.2d 515, 519-20 (5th Cir. 1958) (The fair equivalent of dower was an interest which passed from the decedent under Alabama law and was properly included as a part of the marital deduction and was not subject to federal estate tax).

109. 50 T.C. 452 (1968).

110. *Id.* at 454.

111. *Id.* at 453.

112. *Id.*

the judicial procedure for making the award.[113] Therefore, the award was not a statutory award which would have passed from the decedent.[114] The cash award was actually in the form of proceeds from the sale of her dower interest.[115] Applying this rationale to homestead interests, in order for a cash award to pass from the decedent and so be eligible for the marital deduction, the *source* of the cash award must be a statute and not an agreement between the estate and the surviving spouse.

Summary of the Cash Award in Lieu of Homestead

The cash award in lieu of the homestead interest presents a more difficult analysis than the simple award of the homestead property. Due to this complexity the cases and rulings regarding homestead and the marital deduction have focused primarily on the cash award. However, a prediction of qualification for the marital deduction is not precluded by the entanglement of interests and awards. The basic marital deduction requirements of passing from the decedent to the spouse and terminability lay the foundation for exclusion of the homestead interest in the form of a cash award. For vesting, the analysis must go beyond that of the property award to a level where the awarding of either the property or the cash is an assignment or payment for an interest vested at death in the form of a chose in action. From the cash award branch of the chose in action, the cash must satisfy the terminable interest rule so as not to be contingent on some later-occurring event such as reinvestment or death. The chose in action theory will be of little benefit if the cash award is obtained past the vesting requirement but is stopped by a condition of terminability.

Notwithstanding the chose in action theory, the cash award will not qualify for the marital deduction if the cash represents a sale of a homestead interest. Proceeds from a sale are not considered as vested from the decedent. Additionally, the statute must mandate a sale of the homestead to satisfy the cash award to the surviving spouse since a discretionary sale will contravene Revenue Rulings 72-153 and 76-166. Finally, the cash award must be derived from a statutory source because property received by the surviving spouse as a result of an agreement with the estate administrators does not vest from the decedent.

113. *Id.* at 454.
114. *Id.*
115. *Id.*

Based on the factors contributing to qualification or disqualification of the marital deduction, the appendix presents an analysis of each state's homestead exemption statute. In the appendix the property award and the cash award are independently analyzed to determine if a marital deduction is allowed in each particular state.

ANALYSIS OF HOMESTEAD EXEMPTION STATUTES

An analysis of the state homestead exemption statutes entails a thorough search of the various state laws. In this search an initial determination must be made as to whether the state provides a property award and whether the state provides a cash award. Some states have property awards but no cash award provisions. Other statutes will grant an allowance of cash but give no interest in the homestead property. Still other states provide both the property award and the cash award. Some states have repealed homestead provisions in favor of other statutory interests such as the family allowance which grants the family an outright sum of money upon the decedent's death. No matter which situation is found in a particular state, the factors contributing to or precluding a marital deduction will affect the relationship between estate planning and the homestead exemption.

In the following appendix the property award and the cash award are treated separately for each state. The analysis of the particular state laws and court decisions relating to the property award where the surviving spouse retains an interest in the homestead property will include an examination of the vesting of the homestead interest in the surviving spouse. Coterminous investigation will determine if the interest is a terminable interest such that a marital deduction would be denied. In like manner, the cash award must meet the vesting and terminability requirements. However, a close look at the laws may reveal possibilities of applying the chose in action theory to qualify the cash as a marital deduction. Throughout the review of the statutes, the source of the cash award is noted. Also important is whether the cash award is a discretionary award which would disqualify any chance of becoming a marital deduction and whether the cash award truly constitutes proceeds from the sale of a homestead interest which negates likelihood of vesting from the decedent.

The language of the statute will satisfy the analytical factors. Absent any specific criterion from a marital deduction point of view, a study of the underlying court decisions which have interpreted the homestead statute will be undertaken. At all times during the venture into the court interpretations, the tenative nature of a decision other than that of the highest court of the state will be kept in mind. Any decision other than that of the highest court is susceptible to being overruled by a federal court.

For the property award or the cash award to qualify as a marital deduction, the state homestead statute or its interpretation by the courts will need to provide for passage of the interest from the decedent to the surviving spouse in order to satisfy Code section 2056(a). Also, to prevent exclusion of an interest which does pass from the decedent, the interest must not be a terminable interest of Code section 2056(b). The analysis reveals that a state homestead statute which provides a homestead exemption may also provide the estate and the surviving spouse with a marital deduction which will decrease the estate tax burden, the ultimate goal of estate planning.

CONCLUSION

The homestead exemption is one statutory interest passing to the surviving spouse which can be used to reduce the federal estate tax burden. The reduction in taxes will take place if the exemption qualifies as a marital deduction under Code section 2056(a). Not only must the exemption fulfill the requirements of section 2056(a), it must not be a terminable interest as described by section 2056(b).

The individual state homestead statutes can be analyzed as an award of the homestead property or as a cash award in lieu of the homestead interest. Many of the property award statutes are excluded from a possible marital deduction by application of the terminable interest rule. As indicated in the appendix, South Dakota, Utah, California and Nevada are the only states in which an exclusion of a homestead property award may possibly be attempted.

Aside from terminability, the greater problem with cash awards is meeting the vesting requirements of section 2056(a). Using the various tools of analysis developed, the possible states qualifying a cash award for a marital deduction are Alaska, Arizona, California, Hawaii, Idaho, Illinois, Missouri, Montana, Nebraska, New Hampshire, Ohio, Utah and Washington. Washington and Arizona are specifically allowed by the respective Revenue Rulings 72-153 and 76-166.

Although the amount of the homestead exemption may be minor in comparison to other estate distributions, effective estate administration requires taking every legitimate deduction in order to protect the estate assets. The homestead exemption as a marital deduction is one way to protect these assets from federal estate taxation.

Louis D. Fisher

APPENDIX

State	*Possible Marital Deduction*	*Reason*
ALABAMA		
Property award Grisham v. Rotholz 219 Ala. 434, 122 So. 649 (1929).	No	Terminable interest—estate in surviving spouse.
Cash Award U.S. v. Hiles 318 F.2d 56 (5th Cir. 1963).	No	Not vested from decedent—cash treated as proceeds from sale of life estate.
ALASKA		
Cash Award ALASKA STAT. § 13.11.125 (Supp. 1977).	Yes	Rev. Rule 76-166 or 72-153
ARIZONA		
Cash Award Rev. Rule 76-166 1976-1 C.B. 287	Yes	Rev. Rule 76-166.
ARKANSAS		
Property Award ARK. CONST. art. 9, § 6.	No	Terminable interest—life estate in surviving spouse.
CALIFORNIA		
Property Award I.R.C. § 2056(c)(2)(B)	No	Community property.
Cash Award CAL. PROB. CODE §§ 663, 664, 665 (West Supp. 1977).	Yes	Chose in action if property from the decedent (not community).
COLORADO		
Property Award COLO. REV. STAT. § 38-41-203, 204 (1973).	No	Terminable interest—period of years (only during occupancy).

State	*Possible Marital Deduction*	*Reason*
Cash Award COLO. REV. STAT. § 38-41-207 (1973).	No	Not vested from decedent—cash treated as proceeds from sale of homestead interest; Terminable interest—period of years (one year protection from creditors).
FLORIDA		
Property Award FLA. CONST. art. 10, § 4.	No	Terminable interest—life estate in surviving spouse.
HAWAII		
Cash Award HAW. REV. STAT. § 560: 2-401 (1977)	Yes	Rev. Rule 76-166 or 72-153.
IDAHO		
Cash Award IDAHO CODE § 15-2-401 (Supp. 1975).	Yes	Rev. Rule 76-166 or 72-153.
ILLINOIS		
Property Award ILL. ANN. STAT. ch. 52, §§ 1, 2 (Smith-Hurd Cum. Supp. 1978).	No	Terminable interest—life estate in surviving spouse.
Cash Award ILL. ANN. STAT. ch. 52, § 6 (Smith-Hurd Cum. Supp. 1978).	Yes	Chose in action.
IOWA		
Property Award IOWA CODE ANN. §§ 561.11,.12 (West 1950).	No	Terminable interest—life estate in surviving spouse.
KANSAS		
Property Award	No	Terminable interest—

State	*Possible Marital Deduction*	*Reason*
KAN. STAT. § 59-401-02 (1976).		period of years (occupancy or remarriage).
Cash Award KAN. CONST. art. 15, § 9.	No	Not vested from decedent—cash treated as proceeds from sale of homestead interest.
KENTUCKY		
Property Award KY. REV. STAT. ANN. § 427.070 (Baldwin 1978).	No	Terminable interest—period of years (occupancy).
Cash Award KY. REV. STAT. ANN. § 427.090 (Baldwin 1978).	No	Not vested from decedent—cash treated as proceeds from sale of life interest; Terminable interest—subject to reinvestment in another homestead property.
MAINE		
Property Award ME. REV. STAT. tit. 14, § 4554 (Supp. 1978-79).	Yes	Vests absolutely from decedent.
MASSACHUSETTS		
Property Award MASS. ANN. LAWS ch. 188, § 4 (Michie/Law. Co-op 1969).	No	Terminable interest—period of years (remarriage).
Cash Award MASS. ANN. LAWS ch. 188, § 8 (Michie/Law. Co-op 1969).	No	Not vested from decedent—cash treated as proceeds from sale of life interest.
MICHIGAN		
Property Award MICH. COMP. LAWS ANN. § 709.62 (1968).	No	Terminable interest—life estate in surviving spouse.

State	Possible Marital Deduction	Reason
Cash Award MICH. COMP. LAWS ANN. § 709.62 (1968).	No	Terminable interest—subject to reinvestment in another homestead property.
MINNESOTA		
Property Award MINN. CONST. art. 1, § 12.	No	Terminable interest—life estate in surviving spouse.
MISSISSIPPI		
Property Award MISS. CODE ANN. § 85-3-43 (1973).	No	Terminable interest—period of years (occupancy).
Cash Award MISS. CODE ANN. § 91-1-19 (1973).	No	Not vested from decedent—cash treated as proceeds from sale of homestead interest.
MISSOURI		
Cash Award MO. ANN. STAT. § 474.290 (Vernon Supp. 1979).	Yes	Vests absolutely from decedent.
MONTANA		
Cash Award MONT. REV. CODES ANN. § 91A-2-401 (1977).	Yes	Rev. Rule 76-166 or 72-153.
NEBRASKA		
Cash Award NEB. REV. STAT. § 30-2322 (1975).	Yes	Rev. Rule 76-166 or 72-153.
NEVADA		
Property Award I.R.C. § 2056(c)(2)(B)	No	Community property.
NEW HAMPSHIRE		
Property Award N.H. REV. STAT. ANN. § 480:3a (1975).	No	Terminable interest—life estate in surviving spouse.

State	*Possible Marital Deduction*	*Reason*
Cash Award Beland v. Goss, 68 N.H. 257, 44 A. 387 (1894); Gunnison v. Twitchel, 38 N.H. 62 (1859); N.H. REV. STAT. ANN. § 480:1 (1975).	Yes	Chose in action.
NEW YORK		
Property Award N.Y. CIV. PRAC. LAW § 5206 (McKinney 1978).	No	Terminable interest—life estate in surviving spouse.
Cash Award N.Y. CIV. PRAC. LAW § 5206 (McKinney 1978).	No	Terminable interest—period of years (one year).
NORTH CAROLINA		
Property Award N.C. CONST. art. X, § 2(3).	No	Terminable interest—period of years (remarriage).
Cash Award N.C. CONST. art. X, § 2(3).	No	Not vested from decedent—cash treated as proceeds from sale of homestead interest.
NORTH DAKOTA		
Property Award N.D. CENT. CODE § 30-16-02 (1976).	No	Terminable interest—life estate in surviving spouse; period of years (remarriage).
Cash Award N.D. CENT. CODE § 30-16-02 (1976).	No	Not vested from decedent—cash treated as proceeds from sale of homestead interest.
OHIO		
Property Award OHIO REV. CODE ANN. § 2329.75 (Baldwin 1975).	No	Terminable interest—period of years (occupancy and remarriage).
Cash Award OHIO REV. CODE ANN. § 2127.26 (Baldwin 1978).	Yes	Chose in action.

State	*Possible Marital Deduction*	*Reason*
OREGON		
Property Award ORE. REV. STAT. § 114.005 (1977).	No	Terminable interest—period of years (one year).
SOUTH CAROLINA		
Property Award S.C. CONST. art. 3, § 28.	No	Terminable interest—life estate in surviving spouse.
Cash Award S.C. CODE §§ 34-7, -11 (1962).	No	Terminable interest—subject to reinvestment in another homestead property; life estate in surviving spouse.
SOUTH DAKOTA		
Property Award S.D. COMPILED LAWS ANN. § 30-20-1, 43-31-4 (Smith 1976, 1967).	Yes	Unconditional vesting in the surviving spouse from the decedent.
TENNESSEE		
Property Award TENN. CODE ANN. § 31-104 (Cum. Supp. 1978).	No	Terminable interest—life estate in surviving spouse.
Cash Award TENN. CODE ANN. § 30-912 (1977).	No	Terminable interest—subject to reinvestment in another homestead property; life estate in surviving spouse.
TEXAS		
Property Award I.R.C. § 2056(c)(1)(B)	No	Community property.
Cash Award TEX. PROB. CODE ANN. § 273 (Vernon Cum. Supp. 1978-79).	No	Discretionary power of court to make a reasonable allowance to spouse.

State	*Possible Marital Deduction*	*Reason*
UTAH		
Property Award UTAH UNIFORM PROB. CODE § 75-2-401 (1978).	Yes	Absolute, unconditional interest vesting in surviving spouse.
Cash Award UTAH UNIFORM PROB. CODE § 75-2-404 (1978).	Yes	Absolute, unconditional interest vesting in surviving spouse.
VERMONT		
Property Award VT. STAT. ANN. tit. 27, §§ 101, 106 (1967).	No	Terminable interest—period of years (occupancy).
Cash Award VT. STAT. ANN. tit. 27, § 183 (1967).	No	Discretionary power of court to make an apportionment of proceeds or reinvest proceeds for other use.
VIRGINIA		
Property Award VA. CODE § 34-4 (Cum. Supp. 1978), § 34-10 (1976).	No	Terminable interest—life estate in surviving spouse; period of years (remarriage).
Cash Award VA. CODE § 34-16 (1976).	No	Not vested from decedent—cash treated as proceeds from sale of homestead interest.
WASHINGTON		
Cash Award Rev. Rule 72-153, 1972-1 C.B. 309	Yes	Rev. Rule 72-153.
WISCONSIN		
Property Award WIS. STAT. ANN. § 861.41 (West 1971).	No	Discretionary power on part of court.
Cash Award WIS. STAT. ANN. § 861.41 (West 1971).	No	Discretionary power on part of court.

State	*Possible Marital Deduction*	*Reason*
WYOMING		
Property Award WYO. STAT. § 1-20-102 (1977).	No	Terminable interest—period of years (occupancy).