

This action is pursued by the surviving spouse of Atlas Duncan Williams, on behalf of the estate (Appellee), against the appellant, Joe B. Huddleston, in his capacity as Commissioner of Revenue of the State of Tennessee, challenging the latter's assessment of inheritance tax which reflects a reduction in the allowable marital deduction by one-third of the decedent's secured debts.

Mr. Williams died testate on May 17, 1989, leaving a gross estate of \$102,702,150,¹ encumbered to the extent of approximately \$37,000,000 in secured debts. Ms. Williams was appointed executrix of the estate. After choosing to reject the provisions made for her in the will, she petitioned the Probate Court of Shelby County for an elective share, in accordance with T.C.A. § 31-4-101, exempt property and a year's support.² The probate court determined the deceased's net estate for purposes of establishing the elective share at \$94,867,563.47 and awarded Ms. Williams an elective share in the amount of \$31,306,295.95. The court expressly held, however, that any assets comprising the elective share which were encumbered by valid mortgages or security interests would remain subject to such encumbrances. The court subsequently approved the executrix's allocation of unencumbered stock and cash to fund the elective share.

The state inheritance tax return filed for the estate claimed a marital deduction that included the entire amount of the elective share. Upon review, the Commissioner adjusted the amount of the marital deduction as hereinabove set forth and assessed additional inheritance tax. Appellee paid the additional tax under protest and then filed a claim for refund in the amount of \$1,601,368, which was denied by the Commissioner. The instant litigation resulted with Appellee alleging that the Commissioner erroneously reduced the amount of the marital deduction. Appellee alleged that the amount of the elective share as determined and awarded by the probate court, without any reduction for a pro rata share of secured debt, was binding on the Commissioner.

¹This is the amount on the date of death as tabulated by the state in determining the inheritance tax due. The probate court, however, arrived at a gross estate of \$102,902,698.02. For our purposes, the difference is inconsequential as the parties agree as to the amount now in dispute.

²Ms. Williams was granted a year's support in the amount of \$1,250,000.

The chancellor entered a judgment³ awarding Appellee \$1,601,368 with interest after determining the following:

[Appellant] stipulated that he does not dispute the correctness of the Probate Court's calculations of the elective share, but asserts that the impact of secured debt on the elective share is determined by statutes other than [T.C.A. § 31-4-101].

[Appellant] did not dispute [Appellee's] assertion that the electing spouse may pick and choose assets to fund the elective share or may be given the choice of accepting a fund, any property in kind, cash, or any combination of the foregoing.

....

The parties stipulated that the assets selected by the electing spouse to fund the elective share determined by the probate court were unencumbered.

....

The Court concludes that under [T.C.A. § 31-4-101] the amount of the elective share is to be equal to one-third (1/3) of a decedent's net estate, as defined therein, reduced only by funeral and administration expenses, homestead, exemptions and year's support, and that the elective share is not to be reduced by a proportionate part [i.e., one-third] of secured debts.

[Appellant's] contention that under [T.C.A. § 30-2-305] and under Tennessee decisions the elective share must bear a pro rata share of a decedent's secured debt, whether or not encumbered assets fund the elective share, is overruled.

An electing spouse may pick and choose assets to fund the elective share or may be given the choice of accepting a fund, any property in kind, cash, or any combination of any of the foregoing.

Under Tennessee law a secured creditor is not entitled to a preferential right to be paid from general unencumbered assets of a decedent's estate ahead of other unsecured creditors or the electing spouse.

The elective share of surviving spouse is not reduced by any debts, secured or unsecured, if encumbered assets are not used to fund the elective share.

We perceive the issue on appeal as whether the trial court was correct in overturning the Commissioner's assessment of inheritance tax, which reduced the marital deduction, as calculated by Appellee, by a pro rata portion of the decedent's secured debts, even though the elective share was funded totally with unencumbered assets. The pertinent statutes to which we will look for guidance

³The judgment was rendered final in accordance with Rule 54.02 T.R.C.P. as an issue regarding the awarding of attorney's fees remained.

include the following: T.C.A. § 31-4-101, commonly referred to as the "elective share" statute, which reads:

Right to elective share. -- (a) A decedent's surviving spouse has the right to elect to take an elective share. The elective share is one third (1/3) of the decedent's net estate as defined in subsection (b). The right to elect an elective share is available to the surviving spouse of an intestate decedent and a testate decedent if the surviving spouse elects against the decedent's will. When the elective share is determined, it is exempt from the unsecured debts of the decedent incurred after April 1, 1977. In determining the elective share, it is not reduced by any estate or inheritance taxes.

(b) The net estate includes all of the decedent's real and personal property subject to disposition under the terms of the decedent's will or the laws of intestate succession reduced by funeral and administration expenses, homestead, exemptions and year's support.

The assessment and collection of inheritance tax is addressed in T.C.A. § 67-8-301 et. seq. Section 67-8-315 discusses the allowable deductions, stating:

(a) For the purpose of determining the net estate subject to tax, the following deductions shall be deducted from the value of the gross estate;

....

(6) An amount equal to the value of any interest in property which passes or has passed from the decedent to the surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate. In determining the amount qualifying for the deduction under this subdivision, the limitations, restrictions, definitions, elections and requirements set out in § 2056(b) and (c) of the Internal Revenue Code (26 U.S.C. § 2056(b) and (c)) shall be applicable to the deduction allowed by this subsection;

26 U.S.C. § 2056(a) and (b)(4)(B) provide:

(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 subsection (b), 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.

....

(4) Valuation of interest passing to surviving spouse.-- In determining for purposes of subsection (a) the value of any interest in property passing to the surviving spouse for which a deduction is allowed by this section --

....

(B) where such interest or property is encumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined.⁴

Finally, T.C.A. § 30-2-305 states, "**[d]ebts chargeable against all assets.** -- Every debtor's property, except such as may be specially exempt by law, is assets for the satisfaction of all his just debts."

Appellant asserts that no issue is taken with the calculation of the elective share, but only with how much of that share qualifies as a marital deduction for determining inheritance tax liability. Appellant argues that a correct marital deduction equals the amount of the elective share less one-third of the decedent's secured debts. To support his position, Appellant places particular emphasis on the language of T.C.A. § 30-2-305 and the legislative history and current reading of T.C.A. § 31-4-101, as well as the United States Tax Court decision, *Estate of Williams v. Commissioner*, 103 T.C. 451 (1994), which interpreted these statutes to conclude that a reduction of the elective share by one-third of the decedent's secured debts is necessary in determining the maximum allowable marital deduction under 26 U.S.C. § 2056(a).⁵

Appellant is correct that until the amendment in 1985, the elective share statute expressly exempted the elective share from "the debts and charges of the decedent incurred after April 1, 1977." Upon amendment the statute now authorizes the exemption of the elective share from the decedent's "unsecured debts" incurred after April 1, 1977, once such share is determined. Clearly, the foregoing establishes that if an elective share is funded with encumbered assets, it is taken subject to such encumbrances. Appellee does not contend otherwise.

⁴As held in *Alexander v. United States*, 640 F.2d 1250, 1251 (Ct. Cl. 1981), a gift of mortgaged property is valued at the excess of its fair market value over the amount of the mortgage outstanding at the time of the gift.

⁵The same parties and facts were before the court in *Williams* as before us, although obviously the issue there concerned the assessment of federal estate taxes.

T.C.A. § 30-2-305 provides that every debtor's property may be utilized to satisfy all of his debts unless it is specially made exempt by law. There being no express exemption for secured debts, Appellant asserts that the elective share must, therefore, bear a pro rata share of the decedent's secured debts. This was the rationale employed by the tax court in *Williams* to conclude:

When considering both passages together, we find it difficult to accept [Appellee's] view. The removal of the secured debt exemption from the elective share statute in 1985, coupled with the specific direction in [T.C.A. §] 30-2-305 (1984) that all nonexempt assets are liable for the payment of decedent's debts, support [Appellant's] argument that the elective share must be reduced by a pro rata portion of the decedent's secured debts. [Appellee's] reliance on the ambiguity caused by the absence of an enumerated reduction for secured debts in [T.C.A. §] 31-4-101(b) (Supp. 1993)⁶ does not preclude us from determining that apportionment of decedent's secured debts is otherwise required pursuant to [T.C.A. §] 31-4-101(a) (Supp. 1993) and [T.C.A. §] 30-2-305 (1984).

....

... we think the absence of an enumerated reduction for secured debts in the current net estate statute does not preclude us from apportioning decedent's secured debts in this case; on the contrary, we think the debt payment statute, coupled with the removal of the secured debt exemption from the elective share statute, requires us to do so.

Williams, 103 T.C. 451 (1994). (Footnote omitted.)

Appellee contends that because the elective share was funded entirely with unencumbered assets it cannot be subject to any pro rata reduction based on the secured debts of the decedent. Appellee's brief suggests that the secured creditors of decedent were paid in full by the secured collateral. Thus, it is argued that they had no rights in the general unsecured assets of the estate and no apportioning could take place. Appellee further posits that, had the secured collateral been insufficient to satisfy the secured debt, the secured creditors would have become unsecured to the extent of the deficiency and any claim against the elective share to recover such is statutorily exempt. We agree with this latter contention.

⁶In *Williams*, the estate argued that in the absence of an enumerated reduction for secured debts in the definition of "net estate," none was required or intended. *See Williams*, 103 T.C. at 451.

Merchants & Planters Bank v. Myers, 644 S.W.2d 683 (Tenn. App. 1982), holds:

The procedure for establishing the elective share is set forth in § 31-603,⁷ and vests the trial court with discretion in determining the elective share. The elective share is to be determined in such manner as not to defeat the arrangements made by the will unless reasonably necessary to fully protect the dissenting spouse's share, *see Hamilton National Bank of Knoxville v. Allred*, 496 S.W.2d 497 (Tenn.App.1972), and where the value of the estate's assets are fixed and not in dispute the dissenting spouse should be given the choice as to whether to accept "a fund or property in kind or in cash". *See Flanigan v. Landmon*, 8 Tenn.App. 361 (1928).

Myers, 644 S.W.2d at 687-88.

Clearly, Ms. Williams was entitled to choose to fund the elective share solely with unencumbered assets. This is not disputed by the parties. Furthermore, we believe that no one would dispute that if, in fact, funding of the elective share had included encumbered assets, such would definitely be considered in reducing the elective share for purposes of determining the correct marital deduction to be taken. In this case, however, we are confronted with an elective share composed entirely of unencumbered assets.

For resolution, we agree with Appellant that calculation of the elective share for purposes of § 31-4-101 and determination of the maximum allowable marital deduction based on such elective share require separate considerations. *Jeschke v. United States*, 814 F.2d 568 (10th Cir. 1987), holds:

It is an established general rule, . . . that the marital deduction provided by section 2056 of the Code is reduced by expenses of administration and similar obligations which must or may be paid out of property passing from the decedent to the surviving spouse. . . . It is immaterial that such expenses may actually be paid out of non-marital share funds, so long as there exists discretion or an obligation to charge the marital share.

Jeschke, 814 F.2d at 576 (citations omitted). It has, likewise, been stated that when determining the appropriate marital deduction for Tennessee inheritance tax purposes, "[i]f any death taxes or debts

⁷This section is now codified at T.C.A. § 31-4-102.

are payable out of the property interests otherwise qualifying for the marital deduction, the marital deduction is reduced by the amount of such taxes and debts." 2 Harry Phillips & Jack W. Robinson, *Pritchard on Wills and Estates*, § 956 (1983).

Obviously, acceptance of Appellee's position entails a determination that the marital deduction would not be reduced, as held in *Jeschke*, because the funds comprising the elective share could not be utilized to pay decedent's secured creditors. Conversely, acceptance and application of the foregoing principle to the case at hand requires a determination that the elective share statute affords the surviving spouse a one-third fractional or undivided interest in every asset of the decedent's net estate, including those encumbered.⁸

The elective share statute grants the surviving spouse the right to elect to take a one-third share of decedent's net estate which, according to the statute, expressly includes "all of the decedent's real and personal property" subject to disposition under the decedent's will or the laws of intestate succession, less certain enumerated reductions. As the statute fails to expressly apportion or divide the property that is to be subjected to the one-third elective share, we conclude that for purposes of determining the maximum allowable marital deduction only, the amount of the elective share is to be reduced by a one-third share of the decedent's secured debts. This is so regardless of how the elective share is funded. We believe that our decision promotes uniformity in application and guards against post-death estate tax planning, a concern expressed by the court in *Williams*.⁹

The judgment of the trial court is hereby reversed and this cause remanded for any further proceedings herein consistent. Costs are taxed to the estate of Atlas Duncan Williams, deceased, Carolyn S. Williams, executrix, for which execution may issue if necessary.

FARMER, J.

⁸This was an alternative argument impressed upon the tax court in *Williams* by Appellant.

⁹We note that, although *Williams* is not binding on this Court, we reach the same result for the reasons as herein expressed.

CRAWFORD, P.J., W.S. (Concurs)

HIGHERS, J. (Concurs)