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The Impact of Estate and Gift Taxes on Property Disposition

*Charles Looker**

MEN seek wealth not only for the material benefits which it brings, but also because of a desire to pass these benefits on to their families. How is this wealth transmitted to spouse and children? What are the present patterns of property disposition? Notwithstanding infinite variety in detail, broad patterns can be found. Some of them are the result of social restrictions of long standing, such as the Rule against Perpetuities, the Rule against Accumulations, restrictions on bequests to charity, and the statutory right of election of the surviving spouse.[1] A more recent social limitation is imposed by the estate tax and its companion gift tax. Whatever their revenue-raising purposes, these tax laws have had a considerable effect upon the patterns of property disposition.

Three times in the past seven years estate and gift tax developments have compelled lawyers to re-examine the wills, trusts and estate plans of their clientele. In 1942 the Federal tax laws relating to powers of appointment and life insurance were overhauled.[2] In 1948 the concept of the marital deduction was introduced.[3] In 1949 the Supreme Court handed down the *Church* and *Spiegel* decisions[4] and the Congress then enacted the Technical Changes Act of 1949.[5]

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[1] Perpetuities and Accumulations: see RESTATEMENT, PROPERTY, Chapters 26-28, 35-36 (1944). Restrictions on charitable bequests: see *e.g.*, N. Y. DECED. EST. LAW § 17. Right of Election: see, *e.g.*, N. Y. DECED. EST. LAW § 18.

[2] REVENUE ACT OF 1942, §§ 403, 404, 452, 56 Stat. 942, 952 (1942), amending INT. REV. CODE §§ 811(f), 811(g), 1000(c).

[3] REVENUE ACT OF 1948, Pub. L. No. 471, 80th Cong., 2d Sess. §§ 361(a), 372, 374, adding INT. REV. CODE §§ 812(e), 1000(f), and 1004(a)(3).

[4] Comm'r v. Estate of Church, 335 U. S. 632 (1949); Estate of Spiegel v. Comm'r, 335 U. S. 701 (1949).

[5] Pub. L. No. 378, 81st Cong., 1st Sess. §§ 7, 8 (effective Oct. 25, 1949). The bill was known as H. R. 5268.

The present patterns of property disposition (insofar as they are shaped by the impact of gift and estate taxes) are largely the product of these three developments.

Several introductory reservations should be noted:

(1) We here assume continuance of inheritance of wealth as an institution and of the estate and gift taxes as limitations. The social desirability of inheritance, with or wtihout the estate and gift tax, will not be considered.[6]

(2) In the case of living gifts, it is somewhat unrealistic to speak only of estate and gift tax considerations—income tax considerations are almost always an important, perhaps a more important, part of the motivation.[7] Savings in estate tax may seem remote to a living donor;[8] the possibility of immediate savings in income tax may be much more persuasive. A donor may be more willing to pay gift tax when he can foresee immediate or early recoupment through income tax savings to the family group.

(3) No statistical analysis of patterns of wealth disposition is here attempted. This paper is limited to non-community property states, in which the marital deduction provisions of the 1948 Act have made pre-1948 data obsolete. The patterns must, therefore, be found in the impact of the tax law itself.[9]

In the basic pattern, the property is kept until death and after estate taxes are paid, the widow and children take appropriate shares of the net estate outright. This is repeated on their deaths. The estate is moderate in size and taxes are of little or no moment. As taxes

6 *Cf.* HARLAN E. READ, ABOLITION OF INHERITANCE (1919); Rudick, *A Proposal for an Accessions Tax,* 1 TAX L. REV. 25, 27 (1945).

7 The income from the property given will be taxed to the new owner (the donee), unless the gift takes the form of a revocable trust (INT. REV. CODE § 107), or a so-called "Clifford" trust (INT. REV. CODE § 522(a); Helvering v. Clifford, 309 U.S. 331 (1940).

8 With due respect to the Treasury's constant hunt for "contemplation of death," there seems to be a general disinclination to contemplate one's own death as an imminent possibility or indeed as anything but a most remote possibility.

9 Probated wills are not a true reflection of current practices. The average decedent is naturally in the older age brackets (see Harriss, *Estate Taxes and the Family Owned Business, infra* p. 127 *et seq.*) and his will may bave been executed years ago; neglect or resistance to change may account for outmoded and obsolete testamentary plans. The wills of living persons are unavailable for examination, and similarly living trusts and other non-testamentary gift devices are in the main not matters of public record. Statistical analyses have been attempted from time to time: see POWELL, CASES AND MATERIALS ON TRUSTS AND ESTATES c. 2 (1932); POWELL, CASES ON TRUSTS 6 (1940); statement of Secretary Snyder, note 121, *infra.*

The search for patterns in the impact of the tax law assumes, of course, that donors and testators will have expert tax advice! It would be utterly impossible to foretell the forms of property disposition that may result from incompetent advice.

become material, the pattern begins to change. The desire to leave as much as possible to the family leads to a desire to leave as little as possible to the Government. The first broad shift in pattern involves distribution of property by living gift instead of by will.

LIVING GIFTS

The relative advantages and disadvantages of disposing of wealth by living gift rather than by will require re-examination in the light of the 1948 Act, its marital deduction and related provisions.[10]

Advantages

1. A donor has a lifetime $30,000 gift tax exemption[11] as well as a $60,000 estate tax exemption.[12] The married donor under the 1948 Act has, in effect, a $60,000 gift tax exemption, since his wife can elect to treat half of any gift made by him as though it had been made by her. He should take advantage of this exemption only if his wife's wealth is substantially less than his own.[13] If the donor does not use this $60,000 exemption during his lifetime, his estate will pay estate tax in the top bracket on $60,000 which could have been given to his children wholly tax free.

2. Gifts are advantageous even after the gift tax exemption has been exhausted. Gift tax rates are only about three-quarters of the comparable estate tax rates,[14] and each additional gift effects a shift of property from the donor's top estate tax bracket to his considerably lower gift tax bracket. Where the wife elects to treat half the gift as though it were made by her, the shift is half to his gift tax bracket and half to her (presumably) even lower bracket.

3. Even more important than this difference in rates is the fact that the estate tax is a tax on the *gross* testamentary gift whereas the gift tax is upon the *net* living gift. In other words, the amount of

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10 See note 3 *supra*.

11 INT. REV. CODE § 1004(a)(1).

12 INT. REV. CODE § 935(c). This exemption applies to the "additional tax" imposed by § 935, which contains the high rates. There is a $100,000 exemption for the purposes of the relatively low basic tax imposed by § 810. INT. REV. CODE § 812(a).

13 INT. REV. CODE § 1000(f); U. S. Treas. Reg. 108, § 86.3a. If the wife has considerable wealth, she will need her own exemption and no saving will be effected by joining in her husband's gifts.

14 *E.g.*, the top gift tax bracket (on net gifts over $10,100,000) is 57¾%, as compared with a top estate tax bracket (on the excess of the net estate over $10,100,000) of 77%. INT. REV. CODE §§ 935(b), 1001.

estate tax is itself subject to estate tax,[15] whereas the amount of gift tax paid is subject to no tax at all.[16]

Thus, although the maximum gift tax rate is 57%, it is the equivalent of only 36% of the total of gift plus tax. If a man gives $1 in the top bracket he will pay $.57 in tax, representing 36% of the total of $1.57 with which he has parted. On the other hand, a man leaving $1.57 in the top estate tax bracket will pay $1.22 in tax—an effective rate of 77%, more than twice the "effective" gift tax rate.

This factor has great significance. For example, assume that a father has $1,000,000 which he wishes to turn over to his son. If he gives the son $815,000 by living gift he will pay approximately $185,000[17] in gift tax and leave no estate. On the other hand, if he leaves the entire $1,000,000 by his will, his estate will pay $303,500[18] in estate tax, leaving only $696,500 for the son, who is therefore $118,500 ahead if a living gift is made. Even if the gift is held to be in contemplation of death, a substantial advantage remains; the estate tax on the $815,000 gift would be about $235,000, but the gift tax would be allowed, substantially in full, as a credit against this tax, so that only $50,000 of estate tax will be payable, and the son will receive $765,000 net.

A peculiar situation results if the donor's wife elects to report half of a gift which is later held to have been made in contemplation of the donor's death, and if the entire gift is held includible in the donor's gross estate.[19] Under these circumstances the son is actually worse off than if the father had reported the entire gift.[20]

15 No deduction from the gross estate is allowed for federal estate taxes. U. S. Treas. Reg. 105, § 81.37; Old Colony Trust Co. v. Malley, 19 F. 2d 346 (1st Cir. 1927), *cert. denied*, 275 U. S. 563 (1927).

16 Even if the donor dies before the gift tax is due and payable, the amount of the tax is a debt, deductible from the gross estate. INT. REV. CODE § 812(b)(3); U. S. Treas. Reg. 105, §§ 81.36, 81.37, Reg. 108, § 86.34.

17 This assumes that the father had not previously used any part of his $30,000 exemption, and that he reports the entire gift.

18 Except where otherwise noted, this and subsequent figures represent approximate federal estate tax before credit for state inheritance taxes.

19 The Government would probably contend that the entire gift is includible, on the ground that the property was the husband's, and that the wife's election to treat half of the gift as hers is merely a measure of gift tax relief. But *cf.* Estate of Sullivan v. Com'r., 175 F. 2d 657 (9th Cir. 1949): A gift was made to a son out of the parents' joint account, all of which had originally been contributed by the father. Upon a finding that the gift had been made in contemplation of the father's death, the Tax Court [10 T. C. 961 (1948)] held the entire gift includible in his gross estate. The court of appeals reversed, holding only half the gift includible.

20 The total tax payable by the donor and his estate is: (a) gift tax + (b) estate tax — (c) gift tax (credit). A reduction in (a) results in a corresponding and offsetting

4. Only a few states impose a gift tax.[21]

5. As already noted, when the donee is in a lower bracket than donor, there may be appreciable saving in family income tax.

Disadvantages

1. Gifts to a spouse are largely discouraged by the 1948 Act. *One half* of the amount of each gift to a spouse is exempt from gift tax[22] but *all* of the testamentary bequests (up to half of the adjusted gross estate)[23] to a spouse are exempt from estate tax. If a man with $240,000, wishing to leave half to his wife and half to his son, makes a living gift to his wife of $120,000, he will pay $1,935 gift tax on $27,000 of the gift (half of $120,000 less $30,000 exemption and $3,000 exclusion); on the other hand, if he leaves her half of his testamentary estate, she will receive the bequest of $120,000 wholly tax free.[24]

The split-income provisions of the 1948 Act[25] also tend to discourage gifts to the donor's wife, since the former advantage of separate income tax returns is now of little importance. Except in unusual cases,[26] the minimum tax will be payable on a joint return and split-income basis.

If there are no children and the donor wishes to leave his wife all his assets, he may find it advantageous taxwise to give her part of his assets during his lifetime.[27] However, there may be offsetting non-

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reduction in (c); an increase in (a) means a corresponding and offsetting increase in (c). But a reduction in (a) means a larger taxable estate and thus an increase in (b); an increase in (a) means a smaller taxable estate and thus a decrease in (b). Where the donor reports the entire gift, (a) and (c) are increased and (b) is reduced, thus reducing the overall tax.

It should, however, be noted that where the gift tax is reduced (by the wife's election to report one-half), the donor has the use of the tax-saving until his death: this "postponement" is akin to that discussed *infra* note 89 and related text, in connection with the marital deduction.

21 California, Colorado, Louisiana, Minnesota, North Carolina, Oklahoma, Oregon, Rhode Island, Tennessee, Virginia, Washington, and Wisconsin.

22 INT. REV. CODE § 1004(a)(3); U.S. Treas. Reg. 108, § 86.16a.

23 INT. REV. CODE § 812(e); U.S. Treas. Reg. 105, § 81.47a. The "adjusted gross estate" is defined as the gross estate less the deduction allowed under § 812(b) for funeral and administration expenses, debts, dependents' support, and casualty losses.

24 This assumes that the $120,000 distributable to the son will be a testamentary disposition and included in the gross estate in either case.

25 INT. REV. CODE §§ 12(d), 51(b).

26 See CCH STD. FED. TAX REP. ¶ 454B.10 and ¶ 454B.11 (1949).

27 Since only half the estate can descend to the wife tax-free (see note 23 *supra*), any reduction in the amount of the gross estate will reduce the amount of estate tax payable.

tax considerations, such as the possibility of subsequent matrimonial difficulties, growing interest in charity, fear of business reverses or plans for retirement.

2. The possibility that the donee may predecease the donor is another deterrent. Whatever their relative ages and expectancies, life is uncertain and the possibility that one person may predecease another is often a matter of chance rather than of mortality tables. A return bequest to the donor involves a waste of the gift tax paid by the donor and of the estate tax on the donee's estate.

3. Uncertainty as to the future is a further deterrent. Circumstances may, and do change, and if a return gift is necessitated, there is a waste of two gift tax payments. The situation is illustrated by reported proceedings under the New York statutes permitting revocation of a trust upon the consent of all living beneficiaries.[28] Under the statutes recourse to the courts is necessary only in unusual cases.[29] The considerable number of such proceedings[30] is indicative of a much larger number of trusts which hindsight has shown to have been mistakes. Circumstances have changed, and donors want their property returned to them. In the process, the consenting beneficiaries become subject to gift tax upon the values of their respective interests.[31]

4. There is immediate loss of the income on the amount of gift tax paid by the donor. However, this comes off his top bracket and generally is offset by the saving resulting from the donee's separate report of the income from the property given.[32]

5. Such factors as loss of parental control over children with independent income from parental gifts will be considered below.[33]

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[28] N.Y. PERS. PROP. LAW § 23, N.Y. REAL PROP. LAW § 118.

[29] *E.g.*, where there is some doubt as to the meaning of the instrument, and, therefore, as to whether the consent of all the beneficiaries has been obtained. The most frequent question is whether the ultimate interest is a remainder in a third person, whose consent is required, or whether it is a reversion in the settlor. See, *e.g.*, Richardson v. Richardson, 298 N.Y. 135, 81 N.E. 2d 54 (1948); Worm v. U.S. Trust Co. of N.Y., 299 N.Y. 351, 87 N.E. 2d 293 (1949). See generally, Comment, 37 CALIF. L. REV. 283 at 285 (1949).

[30] See annotations in McKINNEY'S PERS. PROP. LAW § 23 and REAL PROP. LAW § 118.

[31] *Cf.* Cerf. v. Comm'r, 141 F. 2d 564 (3rd Cir. 1944), holding that where a trust beneficiary, whose consent was necessary to all amendments, consented to an amendment giving the settlor sole power to amend or revoke, the beneficiary had made a taxable gift of her interest in the trust.

[32] This would not be true, of course, where the gift is to the donor's spouse.

[33] See notes 46, 47, *infra*, and related text.

The Volume of Gifts

The volume of gifts reported through 1945 is surprisingly small.[34] The accuracy of these figures, however, is subject to some question:

1. There are no regular annual returns[35] as under the income tax, and there is no tax waiver system comparable to that operating at death.[36] There may be a substantial volume of gifts of which the Treasury remains ignorant.

2. The volume of unreported gifts equal to the annual $3,000 exclusion must be considerable. For example, a donor with wife and three children and six grandchildren can give $30,000 of Series "E" bonds year after year, without filing a gift tax return. However, more data may henceforth become available, since if a donor wishes to take advantage of the $6,000 exclusion under the 1948 Act, returns will be required in order to show the wife's election.[37]

3. No sharp line has been drawn between maintenance and gifts. Which of the following is a reportable gift: a $250 watch; a $3,000 automobile (which the suburbanite wife needs when husband decides to drive to the office daily); a $5,000 mink coat (which is needed for cold weather as well as to keep up with the Joneses); a $50,000 necklace? Even relatively modest gifts of jewelry at anniversaries, birthdays and holidays may, over the years, add up to a considerable sum. Of course, there may be a marked difference between the decrease in the husband's wealth and the realizable increase in the wife's wealth; there may be a considerable spread between purchase price, appraised or insurance value, and the price actually realizable in the event of sale.

4. An additional type of non-reported gift is permitted under the 1948 Act: the husband can pay the full income tax shown on the joint return without incurring gift tax with respect to that portion of the tax which would otherwise be payable by the wife.[38]

Whether the volume of gifts will increase as a result of the 1948 Act is not certain. In moderate estates, the great increase in the estate

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[34] See Harriss, *Estate Taxes and the Family-Owned Business*, *infra* p. 135; Surrey, *supra* p. 11; also note 121 *infra*.

[35] Gift tax returns are required only where gifts exceed the annual exclusion. INT. REV. CODE § 1006, U. S. Treas. Reg. 108, § 86.20.

[36] See, *e.g.*, N. Y. TAX LAW § 249-cc; U. S. Treas. Reg. 105, § 81.62.

[37] INT. REV. CODE § 1000(f)(2)(a); U. S. Treas. Reg. 108, § 86.3a. Returns will also be necessary to show the marital deduction with respect to $6,000 gifts to the wife. See INT. REV. CODE § 1006.

[38] U. S. Treas. Reg. 108, § 86.2(a). The same is true where the husband pays the full gift tax on a gift which the wife has elected to treat as made half by her. *Ibid.*

tax exemption (*i.e.*, one half of the estate plus $60,000 is exempt from tax)[39] is a deterrent, since the estate tax saving with respect to any gift is reduced; on the other hand, the annual exclusion of $6,000 (where the wife joins in the gift for tax purposes) may prove an irresistible temptation. If the donor intends to take the testamentary marital deduction, the tax saving from a gift to a child is reduced because one half of the gift would not have been subject to estate tax even if the gift had not been made; in estates in the high tax brackets, however, there is postponement, rather than family saving, in estate tax under the 1948 Act,[40] and gifts to children therefore still afford a very substantial saving in over-all family tax.

We should expect that gifts will be made by the older and richer of the spouses. However, where the spouse is too old or too ill (where "contemplation of death" may be a factor), we may find other arrangements. An extreme but illustrative example will bring this out. A husband and wife each owns $1,000,000 and the husband intends to leave his entire estate to his son, thus incurring approximately $260,000[41] of Federal estate tax. The same purpose can be accomplished with less tax expense as follows: the wife makes a gift of $400,000 to the son, paying approximately $85,000 of gift tax; the husband then leaves half of his estate to his wife and half to his son; after allowing the marital deduction an estate tax of approximately $100,000 will be paid; the net result in rough figures is that the son ends up with $800,000 instead of $740,000 and the wife has $1,015,000 in place of her original $1,000,000; a family saving of about $75,000.[42] We have assumed that the gift from wife to son is voluntary; that the husband is under no contractual duty to leave half of his estate to his wife.[43] If such a contract were made, would the Government contend that the marital deduction in his estate should be

[39] Assuming that the maximum marital deduction is taken.

[40] See note 89 *infra* and related text.

[41] After credit for state inheritance tax.

[42] In these computations, it is assumed that the wife had exhausted her $30,000 gift tax exemption; if not, there would be a further saving of approximately $8,000 in gift tax; if the total of the husband's net gifts were small and he elected to report half of the gift to the son, the gift tax saving would be approximately $25,000. The filing of this election would probably not lead to inclusion of half the gift in his gross estate (as made in contemplation of death), since he did not actually transfer any property. See note 19 *supra*.

[43] But in states giving the surviving spouse a right of election (see, *e.g.*, N.Y. DECED. EST. LAW § 18), although there may be no *duty* on the part of the husband to make the minimal provisions for his wife, the statute has the same effect as though there were such a duty.

reduced by the amount paid by his wife to acquire the bequest? The Regulations specifically cover an agreement by the widow to make payments out of the bequest after the death of the testator.[44] The Treasury might endeavor to apply this principle by analogy to contracts involving performance by the wife before the death of the testator.

GIFTS: OUTRIGHT OR IN TRUST?

The disinclination to employ living gifts (to the full extent to which the tax mathematics indicate they should be used)[44a] may be attributed to three R's: Reticence, Reluctance and Reservation.

Reticence: Many clients are reticent with respect to the dollars involved in estate planning. The natural desire for privacy, coupled perhaps with a fear of higher professional charges, leads to a vagueness as to details and often an understatement of value. The complicated interrelation of the estates of the husband and wife under the 1948 Act makes it imperative for the estate planner to overcome this reticence.[45] While the figures will change from time to time, the best

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[44] U. S. Treas. Reg. 105, § 81.47a-(b)(2).

[44a] A factor which should always be carefully considered in making a living gift is unrealized changes in value; *i.e.*, appreciation and depreciation. Insofar as tax savings are concerned, no generalization can be made that living gifts of appreciated or depreciated property (or property which is expected to appreciate or depreciate) are either advantageous or disadvantageous. Too many individual factors are present. Furthermore, estate and income tax considerations are too closely tied in. *E.g.*, donors frequently select property which is expected to appreciate in value as the subject matter of living gifts. If such property had been retained until death, it would have been included in the estate at its appreciated value and subject to tax at higher rates. (Both estate and gift taxes are based on fair market value.) Thus a living gift of such property would entail tax savings to the estate. However, in these situations the donor should consider the potential income tax on any capital gains realized by the donee as a result of a subsequent sale of this property. The basis of such property to the donee would be the donor's basis. The donee would incur an income tax on the difference between this basis and the price received on the sale. On the other hand, if the same property were retained until death, the donee would receive the appreciated fair market value of the property at the date of death (or the optional valuation date) and a subsequent sale of this property by him would incur a smaller capital gains income tax. This could be a very pertinent factor for the donor to consider in choosing between a living and testamentary gift, especially if the donee is in a high income bracket.

If the property is expected to depreciate in value, any estate tax savings contemplated by making a living gift may be illusory; if no gift had been made, the depreciated value of the property would have caused a smaller estate tax base. However, the living gift would give the donee a larger basis than the testamentary disposition.

For a detailed consideration of this and related problems, see generally MONTGOMERY, FEDERAL TAXES, ESTATES, TRUSTS AND GIFTS 15-17 (1949-1950).

[45] Reasonably accurate and detailed information is necessary in determining whether to take the maximum marital deduction, whether to use a formula bequest, what specific

possible estimate of the actual amounts involved should be made at the time decisions are reached.

Reluctance: Assuming that reticence has been overcome, the figures analyzed, and the desirability of living gifts shown, the next hurdle is the reluctance of the donor to give up part of his wealth while he is still living. Psycho-analysis has suggested that the maturity of the child is a threat to the father; a son's attainment of full mental and physical stature means the waning of the father's superiority and the approach of old age (and death).[46] Whether or not one accepts the principle of these subconscious drives, it is readily evident in everyday experience that the father is most often the last person to recognize the maturity of his child and the arrival of the time when the child should make his own decisions, good or bad. At least once in the author's experience, a client of great dynamism and achievement, who had set up a trust for his young son, expressed deep regret later, because as the boy approached majority and the end of the accumulation period, he had begun to reach decisions independent of his father; he knew he would shortly receive a living income and need not fear his father's displeasure. Query whether the father's original decision to set up the trust was not wiser than his later regret? Where does wise parental control end and the apron string begin?[47]

Reservation: The donor may overcome part but not all of his reluctance. What remains is a desire to retain as much control as possible after the gift is made. The customary pattern is the living trust, in which beneficial ownership and legal control can be separated.

Estate tax litigation over the last twenty years or more has dealt in large part with the Government's attempt to impose estate tax on living trusts upon the basis of "reservations" by the donor. Successively, the Government has frustrated the tax saving hopes of donors who had reserved income for life, powers to revoke, to amend or to accelerate (even where these powers were conditional upon the consent of an adverse beneficiary). The high-water mark to date is the dictum of Mr. Justice Black in the *Spiegel* case.[48] In order to avoid inclusion of the corpus of a trust in the settlor's taxable estate:

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assets, if any, should be bequeathed to the spouse, etc. See notes 93-96 *infra* and related text.

[46] See *e.g.*, J. C. Flügel, Psychological Study of the Family c. 14 (1935).

[47] See E. A. Strecker, Their Mother's Sons (1946); Philip Wylie, Generation of Vipers (1942).

[48] Estate of Spiegel v. Comm'r, 335 U.S. 701, 705 (1949).

> After such a transfer has been made, the settlor must be left with no present legal title in the property, no possible reversionary interest in that title, and no right to possess or to enjoy the property then or thereafter. In other words, such a transfer must be immediate and out and out, and must be unaffected by whether the grantor lives or dies. . . . it is immaterial whether such a present or future interest, absolute or contingent, remains in the grantor because he deliberately reserves it or because, without considering the consequences, he conveys away less than all of his property ownership and attributes, present or prospective.

Nine months of widespread debate over the meaning and effect of this language, and general demand for legislation,[49] have ended in revision of Section 811(c) of the Internal Revenue Code (which taxes transfers "to take effect on death"):

1. Trusts measured by the life of the donor are henceforth taxable regardless of whether he reserved any right or interest in the property transferred.[50]
2. Where the trust is not measured by the donor's life, reservation of a reverter will not result in the taxability of the *trust*; the actuarial value of the *reverter* will, of course, be taxable under Section 811(a) of the Code, like any other asset owned by the decedent.[51]

It is to be expected that trusts will no longer be created providing (a) for accumulation of income during the donor's life, or (b) for

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[49] See, *e.g.*, Looker, *Estate Taxation of Living Trusts; the Church and Spiegel Decisions*, 49 COL. L. REV. 437 (1949); Bittker, *The Church and Spiegel Cases; Section 811(c) Gets a New Lease on Life*, 58 YALE L. J. 825 (1949). Other articles are cited by Mr. Bittker in 58 YALE L. J. 826, n. 12.

[50] INT. REV. CODE § 811(c)(3), added by the Technical Changes Act of 1949, note 5 *supra*. This provision, however, applies only to trusts created after October 7, 1949. Trusts created on or prior to that date are not taxable unless the decedent had an express reversionary interest worth (immediately prior to his death) more than 5% of the value of the property.

Trusts in which the donor has reserved the income for life are taxable except where the trust was created on or before March 3, 1931, and the donor dies before December 31, 1949. See Technical Changes Act of 1949 § 7(b) for special rules relating to this type of trust.

For a general discussion of the new Act, see Looker, *The Church and Spiegel Cases and the Technical Changes Act of 1949*, EIGHTH ANNUAL N.Y.U. INSTITUTE ON FEDERAL TAXATION (1950).

[51] INT. REV. CODE § 811(c)(3) now provides that post-1949 trusts shall be taxable "if and only if" the beneficiaries must survive the decedent in order to take (note 52 *infra*). There is no specific provision covering the taxability of *reverters* where the *trust* is not taxable, but since the reverter is owned by the decedent at the time of his death, it seems covered by § 811(a) and Reg. 105, § 81.13; *cf.* the proposed Revenue Revision Act of 1948, H. R. 6712, § 202, 80th Cong., 2d Sess., which passed the House but did not pass the Senate. Reg. 105, § 81.10(i) provides a method of valuation of reversionary interests.

payment of income to the beneficiary until the death of the settlor, with principal then vesting. As a rule of thumb, the donor's life henceforth should not be used to measure anything in the trust. This rule is not apt to hinder the skilled draftsman. A trust continuing until the beneficiary attains a stated age may accomplish much the same purpose if the donor's life expectancy covers approximately the same period. Of course, the donor's death must not be stated as an alternative contingency—if the donor should die first the trust would then be taxed under the specific provisions of the statute.[52]

Notwithstanding the relief afforded by the statute, it would still seem unwise, except in extraordinary cases, for the donor to reserve a reverter, express or implied. In most cases it would be better to provide for an ultimate remainder to charity or to the estate of a beneficiary. The reverter is seldom of practical significance. It may raise an unnecessary valuation question under Section 811(a) of the Code. Even if reverters as such are not again placed under attack in some future legislation, it is still the path of wisdom to heed the *Spiegel* dictum and to remove the trust as far as practicable from the present and future control of the donor.

Similarly, the donor would be well advised to reserve as little power as possible over the trust. As the number and importance of the donor's "strings" are increased, it becomes more likely that the Treasury will attempt to attack the trust on the ground that in practical effect the donor has either reserved a power to amend under Section 811(d), or a power "to designate the persons who shall possess and enjoy the property or the income therefrom" under Section 811(c)(1)(B).[53]

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52 Under INT. REV. CODE § 811(c)(3), a post-October 7, 1949, trust is taxable

. . . if and only if—

(A) possession or enjoyment of the property can . . . be obtained only by surviving the decedent; or

(B) under alternative contingencies provided by the terms of the transfer, possession or enjoyment of the property can . . . be obtained only by surviving the earlier of (i) the decedent's death or (ii) some other event, and such other event did not in fact occur during the decedent's life.

53 See, *e.g.*, Comm'r v. Estate of Hager, 173 F. 2d 613 (3rd Cir. 1949), holding that the sum total of certain "administrative" powers held by the donor *as trustee* was equivalent to a power to amend; Industrial Trust Co. v. Comm'r, 165 F. 2d 142 (1st Cir. 1947), holding that the donor's discretionary power, *as trustee*, to accumulate income, made the trust taxable under what is now § 811(c)(1)(B).

There may be an additional warning for the future in the fact that the Supreme Court in the *Spiegel* case considered (without deciding) whether the broad approach taken in Helvering v. Clifford, 309 U. S. 331 (1940) (taxing to the donor the income of

If "reservations" by the donor must be so curtailed, has the living trust lost its attractiveness? *No*. Trustees other than the donor[54] can exercise financial control over the donor's children; distribution of principal can be postponed to stated ages, or until occurrence of emergencies, etc. The trust can continue until the death of the child and thus save estate tax on the transmission of the corpus from child to grandchild; indeed, if the grandchild is in being at the creation of the trust,[55] termination of the trust can be postponed until his death, thus avoiding estate tax on transmittal to the third generation. The choice of living trust, rather than outright gift, may well be based on tax advantages to later generations.

Gifts to minor children present special problems. The annual $3,000 gift tax exclusion applies to present but not to future interests. If the trust provides for accumulation until majority, there is, therefore, no exclusion.[56] If the income is payable to the infant's legal guardian (under local law), a present interest in the income is created and the exclusion applies;[57] the guardian, however, is usually limited to investing the income in legals, and may be required to account annually to the court.[58] If large sums are involved, the donor may choose to create an accumulation trust and take the annual exclusion separately; *e.g.*, purchase of $3,000 of "E" bonds in the name of the child. It is possible to make gifts of non-legal securities to a minor if a friendly broker will accept the donor's indemnity against liability for not insisting on legal guardianship. Registration of securities in the name of the parent, with appropriate written evidence fixing the child's ownership, has been permitted,[59] but the law does not appear well enough settled to encourage this informal practice. By

an irrevocable trust, by reason of his general control over the trust) might be applied for estate tax purposes.

[54] But see note 112 *infra* and related text, concerning powers to distribute principal, held by an "interested" trustee.

[55] Thus avoiding violation of the Rule against Perpetuities. See RESTATEMENT, PROPERTY § 374 (1944).

[56] INT. REV. CODE § 1003(b); Fondren v. Comm'r, 324 U.S. 18 (1944); Comm'r v. Disston, 325 U.S. 442 (1945).

[57] Comm'r v. Sharp, 153 F. 2d 163 (9th Cir. 1946); Jesse S. Phillips, 12 T.C. 216 (1949). The exclusion, however, applies only to the value of the right to receive the income. *Ibid.*

[58] See, *e.g.*, N.Y. DOMESTIC RELATIONS LAW § 85; N.Y. SURR. CT. ACT § 190.

[59] Prudence Miller Trust, 7 T.C. 1245 (1946); Lawrence Miller, 2 T.C. 285 (1943); Edward H. Heller, 41 B.T.A. 1020 (1940); Justin Potter, 47 B.T.A. 607 (1942), holding the gifts effective for income tax purposes (*i.e.*, income taxed to the children), where the facts showed that gifts actually had been intended and made.

and large, small gifts to infants are best made in "E" bonds which may raise no income tax problems for ten years[60] and which, under Federal regulations, can be redeemed by the child on his own signature.[61]

INSURANCE

The Federal law was amended in 1942, to provide that upon the death of an insured, insurance on his life, payable to beneficiaries other than his estate, is taxable if either (a) he has paid the premiums, or (b) he has retained incidents of ownership;[62] the statute expressly states that a reverter shall not be considered an incident of ownership for the purpose of test (b).[63] Where the insured paid part of the premiums, the preceeds are includible in the proportion that the amount paid by him bears to the total premiums; for this purpose if the insured had no incidents of ownership after January 10, 1941, any premiums theretofore paid by him are ignored.[64]

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60 Owners of "E" bonds have the option to treat the entire increase in redemption price as income in the year of redemption, or to report as income each year the amount of increase in redemption price for that year. INT. REV. CODE § 42(b); Reg. 111, § 29.42-6.

61 U. S. Treas. Regs. Concerning United States Savings Bonds, Dept. Circular No. 350 (Sixth Revision 1945), § 315.39.

62 INT. REV. CODE § 811(g)(2); Reg. 105, § 81.27.

63 Despite this express provision, the Tax Court, following the *Spiegel* decision, held in several cases that, without regard to the insurance provisions of the Code [§ 811(g)], the proceeds of insurance policies transferred by the insured during his lifetime, but in which he retained a remote possibility of reverter, are includible in his gross estate under § 811(c), dealing with transfers to take effect on death. Estate of Ruth B. Cutler, 13 T. C. 138 (1949); George W. Roberts, Tr., CCH 8 TCM 291 (1949); Estate of Charles H. Rolka, CCH 8 TCM 327 (1949). The Regulations have long provided that non-taxability of insurance under § 811(g) does not preclude taxability under other sections, such as § 811(c), Reg. 105, § 81.25; see, also, PAUL, FEDERAL ESTATE AND GIFT TAXATION § 10.39 (Supp. 1946).

Under the new provisions of § 811(c) (see notes 50-53 *supra* and related text) the reverter will henceforth be immaterial.

In the *Rolka* case, *supra*, the assignee of the policy had the power to surrender it, but the Tax Court, despite the express wording of the Regulations (Reg. 105, § 81.17, example (8)) and its decision in Estate of J. B. Weil, CCH 5 TCM 564 (1946), held the proceeds taxable in the insured's estate. See Goldstone v. United States, 325 U. S. 687 (1945). This rule has been changed by the Technical Changes Act of 1949, however; 811(c)(3) now contains the following provision:

> Notwithstanding the foregoing sentence, an interest so transferred shall not be included in the decedent's gross estate under paragraph (1)(C) of this subsection if possession or enjoyment of the property could have been obtained by any beneficiary during the decedent's life through the exercise of a power of appointment (as defined in section 811(f)(2) which in fact was exercisable immediately prior to the decedent's death.

64 But a reversionary interest *is* regarded as an incident of ownership for the purposes of this provision. U. S. Treas. Reg. 105, § 81.27(a).

The double-barreled test of the 1942 Act encouraged the spread of the pattern under which the policy is applied for, all ownership vested in, and all premiums paid by, the wife or an adult child of the insured.[65] The insured has no possible interest in the policy—he is the life insured and no more.

Avoidance of one tax problem generally raises another. In *Goodman v. Comm'r,*[66] the wife had taken out policies on her husband's life payable to the trustees of a trust which she could revoke until her husband's death but not thereafter; it was held that the termination of this right to revoke, on her husband's death, resulted in a taxable gift measured by the death proceeds (not the cash surrender value).[67] The same principles would appear to apply in the absence of a trust. If the wife takes out a policy on her husband's life, with the proceeds payable in a lump sum to the children, and if she reserves the right to change beneficiaries during her husband's lifetime, his death would appear to complete a taxable gift of the entire proceeds by the wife.[68] On the other hand, if the proceeds of the policy are payable in a lump sum to the wife or are payable to her on any of the exhaustive options (*e.g.,* life annuity to the wife or a stated number of instalments less than her expectancy) no gift tax will be payable. The *Goodman* case thus makes it advisable for the owner of the policy to receive the full economic benefits of the proceeds on the death of the insured.

Where the wife takes out the policy and receives the full benefits, it is evident that any proceeds still undisposed of at her death will be taxable as part of her estate[69] and that the death benefits reserved by the wife may be such that, had the policies been owned by the husband, they would have qualified for the marital deduction in his estate.[70]

This suggests that it might be advisable to set up the proceeds in

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65 Even before the 1942 Act, this method had been suggested as the only safe way of ensuring non-taxability of insurance. See PAUL, FEDERAL ESTATE AND GIFT TAXATION § 10.16 (1942).

It must be noted, however, that the wife must use her independent funds for the payment of premiums, so that there is no possibility of tracing them as an "indirect" payment by the insured. INT. REV. CODE § 811(g)(2); Reg. 105, § 81.27; PAUL, *op. cit. supra* § 10.36 (Supp. 1946).

66 156 F. 2d 218 (2d Cir. 1946).

67 The value of the wife's reserved life estate in the proceeds was, of course, deducted.

68 See U. S. Treas. Reg. 108, § 86.3.

69 Since she has retained, for her life, the possession or enjoyment. INT. REV. CODE § 811(c)(2); Reg. 105, § 81.18.

70 See INT. REV. CODE § 812(e)(1)(G).

such a way as to qualify for the marital deduction: if there is any tax weakness in the program (*e.g.*, danger that an assignment from the insured to the wife may be attacked as made in contemplation of death, or that the funds used by the wife for premium payments may be traced to the insured), the fact that half the proceeds will be free of tax in any event,[71] because of the marital deduction, may avoid tax litigation.

If the insurance qualifies for the marital deduction, should the insured take out and retain ownership of the policies and pay the premiums, thus reducing his assets rather than his wife's? *No.* The effect of such a plan would be to increase the insured's taxable estate by the excess of death proceeds over premium cost; if the maximum marital deduction were taken, only one half of this excess would be free of tax. On the other hand, if the wife owns the policies and pays the premiums, she will acquire this excess completely free of estate tax at the insured's death.

If the proceeds are eventually to be given to the children, it may be advantageous to make them the direct beneficiaries. Gift tax will then be payable by the wife at the insured's death,[72] rather than estate tax at her own death.[73] In this manner, part of the wife's inheritance (received tax-free by virtue of the marital deduction) will be expended for gift tax, and will never be subjected to estate tax.[74]

JOINT TENANCIES

The joint bank account and jointly held home may still be the poor man's substitute for a will, but from a tax standpoint, joint ten-

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[71] Assuming, that is, that the will provides for the full marital deduction, by formula or otherwise. INT. REV. CODE § 812(e)(1)(H); see notes 92-96 *infra* and related text. To the extent that the full marital deduction is not provided for in the will, a correspondingly greater portion of the proceeds will be tax-free.

[72] See notes 66, 67 *supra*.

[73] It would seem difficult for the Treasury to contend that the wife's gift of the proceeds, which takes effect upon the *insured's* death, was made in contemplation of *her* death.

[74] If, instead of merely naming the children as beneficiaries, the wife creates a funded insurance trust for their benefit, there may also be an income tax advantage, since the income used to pay premiums will be taxed to the trust instead of in the wife's higher bracket. INT. REV. CODE § 162.

A funded insurance trust created by the husband presents no tax advantages, since the income used to pay premiums on his own life will be taxed to him instead of to the trust (INT. REV. CODE § 167(a)(3)), and since the proceeds will be taxable in his estate (U. S. Treas. Reg. 105, § 81.27(a)).

For suggestions concerning tax-savings in connection with insurance on the lives of the donor's children, see Mannheimer & Wheeler, *Trusts of Insurance on Relatives' Lives*, 27 TAXES 453 (1949).

ancies (and tenancies by the entirety) provide few or no benefits, and many disadvantages. Their continued use is largely a matter of sentiment and tradition.[75] There is no more reason for husband and wife to own their home jointly than for them to own a block of stocks or bonds jointly. Indeed, in the event of divorce the house cannot be divided; securities can.

Even before the 1948 Act joint assets were at a disadvantage taxwise: (1) on the death of the husband the asset was fully taxed unless the widow established not only the amount of her contribution but also that her contribution had not been given to her by her husband some time earlier;[76] (2) if the wife died first, the same rules applied against the husband;[77] (3) notwithstanding imposition of estate tax (based on date of death value), the original cost, not date of death value, remained the income tax basis for computing gain or loss;[78] (4) if husband and wife decided to make a gift of the property, complicated problems arose in determining who was subject to gift tax, how much of the property was to be taxed, and how the credit for gift tax was to apply if one of the joint tenants was later held to have made the gift in contemplation of death;[79] (5) difficult gift tax problems arose if a tenancy by the entirety were converted into a tenancy in common, *e.g.*, was the younger tenant making a gift to the older tenant?[80]

It is true that disadvantages (1) and (2) may now be eliminated in joint tenancies (and tenancies by the entirety) since the survivor's

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[75] Even in small estates, the merits of joint ownership have been exaggerated. Jointly held assets (like other assets) are frozen at the death of one of the owners, until tax waivers have been obtained. Expenses of administration are trivial (*e.g.*, in New York no executorial commissions are paid on devised real estate), and the surviving spouse is normally the executor or administrator; the saving is, therefore, often insignificant.

[76] INT. REV. CODE § 811(e); U. S. Treas. Reg. 105, § 81.22.

[77] *Id.*

[78] Lang v. Comm'r, 289 U. S. 109 (1933) (tenancy by the entirety); Helen G. Carpenter, 27 B. T. A. 282 (1932) (joint tenancy). But *cf.* Rudick, *Federal Tax Problems Relating to Property Owned in Joint Tenancy and Tenancy by the Entirety*, 4 TAX L. REV. 3, 30-32 (1948), suggesting that where the surviving spouse received her interest by gift, the basis for computing loss may be the lower of original cost and value at creation of the tenancy (the time of the gift).

[79] *Cf.* Estate of Hornor v. Comm'r, 130 F. 2d 649 (3rd Cir. 1942), holding (1) the entire property includible in the husband's estate (he having contributed it all), and (2) the entire gift tax available as a credit, even though the wife had paid part of it, with Sullivan v. Comm'r, 175 F. 2d 657 (9th Cir. 1949), discussed *supra* note 19. See Rudick, *supra* note 78 at 13.

[80] See Special Ruling, dated Oct. 1, 1948, P-H INH. TAX SERV. ¶¶ 26, 856. See Rudick, *supra* note 78 at 23.

succession qualifies for the marital deduction,[81] and proof of contribution may become academic. But if the full marital deduction is taken in the will, the problem remains, because the survivor's benefits may exceed one half of the adjusted gross estate.[82]

Under the 1948 Act, husband and wife have the option to treat absolute ownership like joint ownership for certain tax purposes. Income can be split;[83] a gift of the property can also be split for gift tax purposes.[84] At the same time, the above disadvantages can be avoided, since the property remains in the sole ownership of one of the parties.

Joint tenancies should become of progressively less importance among the patterns of property disposition.

MARITAL DEDUCTION IN WILLS

Under the 1948 Act, a man can leave one half of his estate to his wife tax free.[85] The property need not be given outright; if he wishes to protect her against herself, he can limit her to the income for life, provided she is given unrestricted power to appoint the principal by will.[86] Stated in these simple terms, the enormous benefit to the taxpayer is obvious. However, the gift-horse has been examined by some and alleged demerits found:

1. The assets constituting the marital deduction will be subjected to estate tax at the wife's death.[87] Answer: If the wife's estate is smaller than the husband's, a considerable saving may result from the difference in applicable tax brackets.[88] Regardless of whether or

81 INT. REV. CODE § 812(e)(3)(E); Reg. 105, § 81.47a-(b).

82 *Cf.* note 71 *supra.*

83 See note 25 *supra.*

84 See note 13 *supra.*

85 See note 23 *supra.*

86 INT. REV. CODE § 812(e)(1)(F); Reg. 105, § 81.47a-(c). A trust must be used, however, and the wife must have a general power of appointment; the deduction does not apply if the wife has a *legal* life estate plus a general power of appointment, or, in the case of a trust, if she has less than a general power (even if it is a power taxable at her death), *e.g.,* a power to appoint to "blood relatives" (see note 107 *infra* and related text). There is double taxation in these cases.

87 Either because the assets are owned outright by her, or, where they are placed in trust or consist of insurance proceeds left with the company, because she has a general power of appointment. INT. REV. CODE § 811(a), 811(f).

88 In states whose inheritance taxes are equal to or less than the 80% federal credit (INT. REV. CODE § 813(b)), the marital deduction (either in whole or in part) may not produce a larger over-all tax, even where the wife's estate is almost as large as the husband's. For some startling computations see Mannheimer, *The Marital Deduction for Substantial Estates,* 27 TAXES 13 (1949).

not her estate is smaller than his, postponement of the tax until her death is a great advantage in itself. The husband's will, like every will, is drawn on the theory that he may die the next day. The wife's life expectancy will be at least that shown in the over-conservative mortality tables and she is thus likely to have the use of the tax savings for a considerable period.[89]

2. Absent a marital deduction under State law, double State inheritance taxes will be paid, once at his death and once at hers. Answer: This will not be true in states which merely absorb the Federal credit.[90] In other states, State inheritance tax rates are much lower than the Federal estate tax rates; some states will not tax the wife's power of appointment; others will not tax insurance proceeds payable to designated beneficiaries.[91] The possible savings in, and postponement of, Federal estate tax should outweigh double State taxation.

3. The maximum marital deduction may sometimes be disadvantageous, as where the wife has a substantial estate of her own; in such cases it may be advisable to take an "equalizing" amount, so that both estates will be similar in size. Answer: Although there are situations in which the maximum marital deduction is not advisable,[92] "equalization" is virtually impossible: the value of both husband's and wife's assets is subject to constant variation due to market fluctuation and possible use of capital for living needs and gifts to children.

4. The wife must be given absolute control, either during her life or by her will; in either event she may (foolishly perhaps) cut off the objects of his bounty and leave his estate to a gigolo second husband. Answer: This is the one difficult decision the testator must make. Can he trust his wife to prefer their children over her second husband? Generally the answer is in the affirmative, at least where she is given a testamentary power of appointment over the corpus. An adventurer is interested in immediate cash benefits—he is not likely to be content with the hope that his elderly victim will exercise a

[89] See CCH FED. EST. AND GIFT TAX REP. 2486 (1949). In addition, the wife may expend part of her estate for living expenses, or for gifts (taxed at lower rates), with the result that the amount subject to estate tax at her death will be reduced.

[90] Six states (Ala., Ariz., Ark., Fla., Ga. and Miss.) impose death duties expressly designed to absorb the 80% federal credit and no more. See CCH TAX PLANNING FOR HUSBANDS AND WIVES UNDER THE REVENUE ACT OF 1948 ¶ 159 (1948).

[91] For a general discussion of the problem of state death taxes and the marital deduction, see CCH FED. EST. AND GIFT TAX REPORTS 2483.

[92] See TRACHTENBERG, ESTATE PLANNING 26 (Practising Law Inst., 1949); Mannheimer, *op. cit. supra* note 88.

power in his favor; even if she were sufficiently old for him to marry in "contemplation of her death," a will is much too easily changed.

The marital deduction legacy or trust should become a basic pattern in estates of any appreciable size. The tax advantages are just too great to resist.

Where the testator's affairs are complicated by non-testamentary transfers, such as jointly held assets, insurance and living gifts and trusts subject to attack as in contemplation of, or to take effect on, death, some kind of formula is required to make certain that the will provides an absolute legacy or "Marital Deduction Trust" for the wife in a sum equal to the maximum allowable marital deduction.[93] A number of formulas are in use, some in terms of the "adjusted gross estate" as presently defined in the Internal Revenue Code or as finally fixed in the federal estate tax proceeding in the particular estate; some in the terms of the "maximum marital deduction" allowable in the particular estate; some in terms of both.[94] Under all formulas, the wife's non-testamentary benefits which qualify for the marital deduction are to be deducted from her testamentary provisions.[95] There has been some criticism on the score of difficulties that will be encountered in the administration of estates under a formula bequest. But it would seem that they are not greater than those met under wills containing bequests of a percentage of the net estate to charity[96] —it is not until tax audits are completed that the exact amount of the bequests are determined. The difficulties are not insuperable. The tax benefits of the formula are too great to allow such administrative problems to stand in the way of its use.

The 1948 Act completely eliminates, as between husband and wife, the deduction for property previously taxed.[97] If the wife inherits more than the maximum marital deduction, there will be double taxation of the excess over the maximum marital deduction, once in

93 See Trachtenberg, *op. cit. supra* note 92 at 33; Gutkin and Beck, *Will Clauses and the Marital Deduction*, 26 TAXES 1009 (1948).

94 See note 93 *supra*.

95 If the testamentary estate is small in proportion to the non-testamentary estate, however, this use of the formula may result in the will failing to provide for the wife a share sufficient to preclude her from exercising her right of election. Property received by her as a result of the exercise of her right of election, however, qualifies for the marital deduction. U. S. Treas. Reg. 105, § 81.47a(f).

96 Compare, *e.g.*, Rockefeller, *Charts for Computing Estate Tax with Deductible Charitable Remainders*, 27 TAXES 211 (1949), with Powers, *Marital Deduction Formulas where the Interest of the Surviving Spouse is Affected by Taxes*, 27 TAXES 726 (1949).

97 REVENUE ACT OF 1948, § 362(a), (b), amending INT. REV. CODE § 812(c).

his estate and once in hers, even if she dies within five years of his death. For this reason, any portion of the husband's estate above the marital deduction should be set up in trust for the widow; if she is given a power of appointment, it should be a restricted, non-taxable power.[98] If the trustees are given power to advance principal to the widow, the "Marital Deduction Trust" should first be exhausted before the second trust is invaded; since the "Marital Deduction Trust" will be taxed at the widow's death,[99] she will thus invade Uncle Sam's funds before she resorts to her children's funds.

The "non-Marital Deduction Trust" is the basic trust designed to pass property to later generations free of second or third estate tax. We now return to this basic trust to consider some common problems of the living and testamentary trust.

POWERS OF APPOINTMENT

Prior to the 1942 Act only property "passing" through "exercise" of a "general" power of appointment was taxable as part of the estate of the donee of the power.[100] The 1942 Act was designed to eliminate these three controversial requirements. Wholly new tests were laid down. However, powers are elusive and difficult to control.[101] The 1942 Act created a new series of problems. As a result, the Congress for the past seven years has held in a state of suspended animation the applicability of the new provisions to powers created before 1942.[102] During this period Bar Associations and the Treasury have continued to study the entire problem with a view to substantial revision of the 1942 provisions.

Nevertheless those provisions are currently applicable to post-

98 See notes 104, 105 *infra* and related text.

99 *Cf.* note 87 *supra*.

100 See U. S. Treas. Reg. 105, § 81.24(a).

101 Over one hundred years ago New York tried to abolish the common law system of powers and to substitute in its place a new statutory system (N. Y. REAL PROP. LAW, Art. 5, § 130-183), but the old system would not die. California adopted the New York system in 1872 and repealed it in 1874. See generally, Dunne, *Powers of Appointment in California*, 13 CALIF. L. REV. 1 (1924).

102 In the case of general powers created on or before October 21, 1942, there is no estate or gift tax if the donee dies before July 1, 1950, without exercising the power, or if he releases it before that date; the release is sufficient if it reduces the power to a non-taxable special power. REVENUE ACT OF 1942, § 403(d), as amended by Pub. L. No. 137, 81st Cong., 2d Sess.; Treas. Reg. 105, § 81.24(b)(3). A power is deemed to have been created on or before October 21, 1942, if the donor's will is dated before then and if he died prior to July 1, 1949. P. L. 635, 80th Cong.; see Letter Ruling of Charles Oliphant, Chief Counsel, dated August 22, 1949, CCH FED. EST. AND GIFT TAX REP. ¶ 8007.

1942 wills and trusts.[103] Under the 1942 Act all powers are taxed as part of the donee's estate, whether or not exercised, unless the powers fall into one of the following tax-exempt classifications: (A) what might be termed the Family Power: a power to appoint among spouses and descendants of the donor or of the donee, spouses of said descendants, and charities; (B) what might be termed the Fiduciary Power: a power to appoint among a "restricted class" (which can be broader than the class specified in "A"), where the donee has no beneficial interest, vested or contingent, in the property.[104] The latter exception is intended mainly to cover powers held by a "disinterested" trustee—one who is neither life beneficiary nor remainderman. Under both (A) and (B) the power, of course, cannot be exercisable in the donee's own favor.[105]

The exempt Family Power (Classification A) is quite broad. It permits a testator to give his son a non-taxable power to appoint to the son's widow, descendants, sons-in-law and daughters-in-law; his mother, brothers, sisters, nephews, nieces, sisters-in-law, brothers-in-law, descendants of nephews and nieces, and charity.[106] What more could be covered by a general power? Friends, grandparents, uncles, aunts, and cousins—unlikely appointees in any event. The Family Power under the statute is a special power in form only—in substance it is the practical equivalent of a general power. Furthermore, the Family Power is not taxed even if exercised, unless the donee, in exercising it, creates another power.[107]

With proper draftsmanship, estate tax on the death of the donee can thus readily be avoided. It is, therefore, natural that the Family Power has become, since 1942, the basic form of power, both in living trusts and in wills.

The Fiduciary Power (Classification B) is addressed more to trustees' powers to distribute principal to trust beneficiaries, than to

103 Treas. Reg. 105, § 81.24(b)(1).

104 INT. REV. CODE § 811(f); Reg. 105, § 81.24(b).

105 The donee and his estate are not included among the beneficiaries listed in Classification A [§ 811(f)(2)(A)]; § 811(f)(2)B specifically requires that the power be not exercisable to any extent for the benefit of the decedent, his estate, his creditors, or the creditors of his estate.

106 He could also include adopted and illegitimate children, and former spouses! Reg. 105, § 81.24(b)(2).

107 INT. REV. CODE § 811(f)(2), Reg. 105, § 81.27(b)(2). The value of any of the principal made subject to the new power is taxable. This exception may constitute a trap for the unwary; *e.g.*, if the donee of a special power exercises it by creating a trust for his widow for life and gives her a general power of appointment, then even though the corpus will be taxable in the wife's estate it will also be taxed in the donee's estate.

traditional powers of appointment.[108] It has had the effect of limiting the functions of trustees who are members of the family. By statutory implication and Treasury Regulation, a trustee's power to advance principal to himself as life beneficiary is a taxable power.[109] Similarly, a power in a trustee who is also a remainderman (vested or contingent) to advance principal to the life beneficiary is a taxable power if the life beneficiary is not one of the persons described in Classification A.[110] For example, where the settlor conveys property to his son to hold in trust to pay income to the settlor's mother for life with remainder to the son, a power in the son as trustee to pay principal to the life beneficiary is a taxable power; gift tax would be imposed against the son upon any payment of principal to his grandmother.[111]

The entire concept of this second exempt classification has been attacked.[112] It may in the not too distant future be relegated to limbo. In estate planning since 1942, it has been a nuisance to the draftsman rather than a hindrance to the client. It merely requires that the "interested" trustee be barred from voting on the exercise of powers to distribute principal where either he or some one outside Classification (A) is the beneficiary. True, it has often become necessary to name a "disinterested" co-trustee where a discretionary power to distribute principal is desired. But considering that the essential purpose of a trust (beyond saving estate tax on the death of the beneficiary) is protection of the beneficiary, this is a salutary feature. By reason of personal interest, neither life beneficiary nor remainderman seems properly qualified to exercise such a power to invade principal.

DURATION OF TRUSTS

If only taxes were considered, a trust should run as long as the law will allow, *i.e.*, for as long as the local Rule against Perpetuities permits. After the initial gift or estate tax is paid on the creation of the living or testamentary trust, the family will pay no further tax until the death of those who take the remainder when the trust terminates.[113] The interim needs of the family group can be covered by

108 See PAUL, FED. ESTATE AND GIFT TAXATION § 9.34 (Supp. 1946).

109 Reg. 105, § 81.27(b)(1); see telegraphed ruling by S. D. Bliss, Deputy Comm'r, dated Oct. 26, 1944, P-H INH. TAX SERV. ¶ 23.776-D.

110 This is implicit in the statute; the Regulations provide, *e.g.*, that a power of revocation or termination exercisable by the life beneficiary with the trustee's consent, does not make the property taxable to the trustee *if* he is disinterested. Reg. 105, § 81.24(b)(1).

111 INT. REV. CODE § 1000(c), Reg. 108, § 86.2(b).

112 See, *e.g.*, Looker, *Estate and Gift Taxation of Trustees' Powers to Distribute Principal*, 45 COL. L. REV. 52 (1945).

a discretionary power in a disinterested trustee to advance principal. These might be called dynastic trusts.

The "Marital Deduction Trust" has two features: the wife cannot be deprived of her right to the income during her life and she must have the power to terminate the trust at her death. It is thus a one-life trust. Although the testator can provide for continuance of the trust (for children, etc.) after her death, this provision can operate only in default of appointment by the wife. Of course the wife can create the dynastic trust in her will.[114] Query: to what extent will wives exercise their powers of appointment and alter the patterns suggested (in default of appointment) by their husbands; to what extent will the testamentary views of females differ from those of males—are they likely to favor more protection for their descendants?

These are important questions. It has been estimated that 60% of the wealth of the United States is owned by women.[115] This matriarchal trend is strongly encouraged by the marital deduction. Even where the "Marital Deduction Trust" (rather than outright bequest) is used, the wife's unrestricted power of appointment can be a source of great personal power. The takers in default of appointment can be cut off by a stroke of mother's testamentary pen.

The "non-Marital Deduction Trust" for a widow is far different. Here the testator can provide that her rights be cut off on remarriage or on the children's attaining majority, etc. If a testamentary power of appointment is given the widow, it will be a non-taxable Classification (A) power. The "non-Marital Deduction Trust" is designed to give the widow additional income. In large estates, this piling up of income for the widow is unwise from an income tax standpoint: it would be wiser to invade the principal of the "Marital Deduction Trust," because such withdrawals would not be taxable income[116] and

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[113] Rudick, *supra* note 6 at 35.

[114] Assuming, that is, the validity, under local law, of an appointment in trust. See RESTATEMENT, PROPERTY §§ 356(e), 358(e) (1940); RESTATEMENT, TRUSTS §§ 17(d), 21 (1935). Where an appointment in trust can be made, maximum duration may not be available, since in the United States the perpetuities period, in the case of any testamentary power, is computed from the date of the creation of the power, rather than the date of its exercise; the contrary rule applies, however, if a general power is exercisable during the wife's lifetime. RESTATEMENT, PROPERTY §§ 392, 373(c) (1940); Leach, *Perpetuities in a Nutshell*, 51 HARV. L. REV. 638, 653.

[115] See *What's Happening to U.S. Wealth and Women*, NEW YORK TIMES MAGAZINE SECTION (April 11, 1948).

[116] Generally, distributions are taxable to the trust beneficiary to the extent of the trust income for the year; excess distributions, made out of principal, are not taxable income to the beneficiary. INT. REV. CODE § 162(d)(1); Reg. 11. § 162.2.

would reduce the amount of principal subject to estate tax at the widow's death. In large estates, therefore, where the wife is given a full marital deduction legacy or trust, it should be expected that the (taxable) balance of the estate would go directly to the children, outright or in trust.

Where do and when should trusts for children and grandchildren terminate? Trusts for minority are quasi-guardianships. The separation of legal control from beneficial ownership is unavoidable during infancy. But beyond majority, should trusts end, in whole or in part, at 25, 35, 45—or not until death of the first generation—or not until the law requires the end of the trust? The testator's problem is most difficult, particularly where his children are still young. Consciously or not, his purpose is that his children become well-adjusted, good citizens; he wants his wealth to pass in a way calculated best to encourage this end; he may not think in terms of society's good, but it may well follow from the individual good of his children. He may ask his lawyer what other people do, or what the lawyer would do if it were his will. His inquiry is really: what is the right thing to do; what disposition of his property will best promote the proper development of the personalities and characters of his children.

Property law furnishes the dispositive tools. The tax laws, as we have seen, furnish motivating forces that drive the testator towards certain general dispositive patterns. But within the framework thus laid out, the details, as to which the testator desires guidance, rest on considerations outside the law. The conscientious lawyer will look elsewhere for answers.

But psychology presents a science still in ferment. Conflicting theories battle for the ascendency: heredity v. environment; validity v. invalidity of psychoanalysis; the method of free association v. quantitative (statistical) psychology; Freud v. Jung v. Adler; etc.[117]

Thus, if we accept the theory that the personality is largely formed in the first five or six years of life,[118] money would appear to play virtually no part and the most important decision might be the choice of the guardian of the person of the infant children. Indeed, the designation of a psychiatrist as co-guardian or as adviser to the guardian might well be considered. Given the proper emotional development, infancy will be followed by sound maturity, and the particular time

[117] See MURPHY, HISTORICAL INTRODUCTION TO MODERN PSYCHOLOGY, preface, c. 28 (1949).

[118] See ABRAHAM, CONTRIBUTIONS TO THE THEORY OF ANAL CHARACTER, INTERNATIONAL ANALYTICAL LIBRARY NO. 13, 370 (1927).

at which the trust falls in will be of little import. The tax advantages of the long-term trust may then be decisive.

But if environmental factors in later as well as in early years play their part,[119] the terms of the trust may have significance. Should a daughter be protected against the possible improvidence of the man she may some day marry; should a son be free to make his mistakes, even if it means the loss of his inheritance; should a partial "nest-egg" or "gutter" trust be kept inviolate for son, daughter or even grandchildren to give them a sense of basic security; should principal payments be at all times controlled by the discretion of the trustees; if a son is given no capital, is all incentive destroyed—does he necessarily become a "remittance man," a useless playboy?

Psychology might well consider these and similar questions. It might well devote attention to the effect of money on personality.[120]

Sociology or economics or both might consider the long term effects of long term trusts and the matriarchal trend. Trustees (even where not limited to legal bonds) normally invest in well seasoned issues of well seasoned corporations. So do properly advised widows. Neither trustees nor widows are a source of risk capital.

CONCLUSION

We have examined the major patterns resulting from the impact of estate and gift taxes. We have found that they encourage living gifts, long term trusts and a matriarchal trend. We have also seen that there are counteracting non-tax considerations, such as fear of loss of parental control and of King Lear's fate when living gifts are considered; fear of the evils of the Dead Hand when long term trusts are planned; fear of the second husband when marital deduction is considered; fear of divorce or financial difficulties when gifts to a wife are considered or when she builds up the insurance estate in her own right.

The negative effect of a tax law may be of greater importance than its positive effect. A statute imposing a tax on transaction *X* may produce no revenue, but merely a shift to transaction *Y*. For example, an accessions tax, integrating taxes on living and testamentary gifts,

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119 See SCHWESINGER, HEREDITY AND ENVIRONMENT 418 (1933); BAKER AND TRAPHAGEN, DIAGNOSIS AND TREATMENT OF BEHAVIOR-PROBLEM CHILDREN (1935); THORNDYKE, HUMAN NATURE AND THE SOCIAL ORDER cc. 11, 12 (1942); TIFFIN, KNIGHT AND ASHER, PSYCHOLOGY OF NORMAL PEOPLE 72 (1946).

120 *Cf.* LASSWELL, POWER AND PERSONALITY (1948); THORNDYKE, *op. cit. supra* note 119 at c. 19.

would discourage living gifts; a tax on the termination of life estates would discourage trusts; a tax on life insurance on the death of the insured, regardless of ownership or payment of premiums, would discourage ownership of the policies by the wife. In each such case the natural reluctance of the donor or testator (described above) would be supported by the tax law.

But is this reluctance socially sound? Should the tax laws respect it, or, as at present, counter-balance it?

The answer to this question should not depend on what people actually do under the present law, *i.e.*, on what percentage of taxpayers overcome their reluctance and follow the presently encouraged patterns, or what percentage yield to the non-tax considerations and fail to follow these patterns. A quantitative analysis of the patterns currently used will not necessarily disclose whether these patterns are socially desirable.[121]

The assistance of the social sciences should be sought. A scientific appraisal of the social utility of current patterns and trends in property disposition should be made. Following such an appraisal, tax legislators should consider whether changes in the tax laws can be employed to foster the good and discourage the unwise patterns.

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The differences between common law and community property rules and their effect on federal estate and gift tax law frequently may require diverse inter vivos and testamentary property dispositions.

Mr. Looker has examined the legal, practical, and tax motivations surrounding property dispositions occurring in states where common law property concepts govern. In the following article, Mr. Nossaman completes the picture by considering such motivations in a community property setting. (ED. NOTE.)

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[121] The Treasury has most recently used such statistical arguments in support of its proposal to integrate the estate and gift taxes and to impose some kind of tax on termination of life estates. See STATEMENTS OF SECRETARY SNYDER ON ESTATE AND GIFT TAXES before the Committee on Ways and Means, House of Representatives, February 3, 1950, and accompanying analysis of 1945 Estate Tax Returns (and these decedents' prior Gift Tax Returns). According to this analysis, the volume of living gifts was relatively small, even in large estates; in estates of $500,000 or more approximately 45% of the assets was bequeathed in trust, and 55% outright; of the testamentary trusts, 12% of the assets was left in trust for less than one generation, 59% for one but less than two generations; and 29% for two generations or more. These data, of course, antedate the Marital Deduction and are subject to the comments at Note 9 *supra*, and related text.