Estate and Gift Tax Equalization—
The Marital Deduction

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"I doubt very much whether there is any Member of the Senate or of the House, or any lawyer, except possibly one who has been devoted to tax legislation for a quarter of a century, who can interpret the meaning of the amendment." Senator O'Mahoney, referring to the estate tax and gift tax provisions of the Revenue Act of 1948.1

Lawyers who have been informed that the Revenue Act of 19482 contains a $250,000,000 "melon" in estate tax and gift tax reduction3 may well be warned by the above quotation that there are difficulties ahead. The fact that these provisions will require review of practically every will, trust or other plan of estate distribution has been well advertised. In the course of such review it will be apparent that the estate tax and gift tax provisions of the new law are complicated and will require careful attention to the detailed rules of the statute.

The estate tax and gift tax sections fill nearly fifty per cent of the pages of the new Revenue Act. These sections amend the Internal Revenue Code by adding some of the most complicated provisions ever to be enacted in any tax law. Critics may well wonder at the reasons for these complications. Complications, however, do not arise from a vacuum. Enlightenment may be obtained from an examination of the basic policy of the new legislation.

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The views expressed in this article are those of the author and do not necessarily reflect the views of the Bureau of Internal Revenue.

1 94 Cong. Rec. 3239 (March 19, 1948).
3 See speech of Senator O'Mahoney, supra note 1. The various tax services have well advertised the tax saving possibilities of the estate and gift tax provisions of the Revenue Act of 1948. The Staff of the Joint Committee on Internal Revenue Taxation estimated that these provisions will reduce the annual revenue from estate and gift taxes by $199,000,000,000. Sen. Rep. No. 1013, 80th Cong., 2nd Sess. 6 (1948). The Treasury Department estimated the revenue loss at $250,000,000 annually. Hearings before Committee on Finance on H. R. 4770, 80th Cong., 2nd Sess. 24 (1948). The total revenue from the Federal estate and gift taxes for the fiscal year ended June 30, 1947 was $779,291,073.70, Ann. Rep. of Sec. of Treas. 308 (1947).
The estate tax and gift tax provisions of the Revenue Act of 1948 are a part of that portion of the Act which is said to be devoted to providing "geographical equalization." The principal provisions of the Act devoted to this purpose are the sections providing "income splitting." These sections are designed to afford equality in the application of the income tax to spouses similarly situated, regardless of the division of income between the spouses under local law. In particular, these provisions afford to spouses in non-community property states and spouses in community property states with separate income the tax advantages of an equal division of income between them which formerly was an automatic privilege only under the community property system.

Equalization of the estate and gift taxes as between residents of community and non-community property states is also the announced objective of the provisions dealing with such taxes. In 1942, Congress

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4 H. R. Rep. No. 1274, 80th Cong., 2nd Sess. 21 (1948); S. Rep. No. 1013, 80th Cong., 2nd Sess. 22 (1948). These committee reports will hereinafter be referred to as the "House Report" and the "Senate Report," respectively. The Supplementary Report of the Finance Committee on H. R. 4790 (S. Rep. No. 1013, supra, Part 2) will be referred to as "Senate Report, Part 2." "Equalization" as here used is a matter of non-discriminatory application of tax rates and exemptions as between married couples. As more income or more property is included in the income or estate tax base the tax increases sharply because of the progressive tax schedules. If the income or property is divided between spouses, the family wealth may be the same but the tax burden will be less by reason of the greater utilization of exemptions and the double use of the lower rates of the progressive tax rate schedule. See The Tax Treatment of Family Income, Division of Tax Research, Treasury Department (June, 1947), Press Service No. S-370.

5 Revenue Act of 1948, Title III, Part I.

6 The "income splitting" plan generally provides not only "geographical equalization" of the burden of income taxes as between spouses in community property and common law states but also equal tax treatment of investment and earned income of spouses in all states. An assignment of earned income is generally unsuccessful as a method of splitting income for tax purposes. Lucas v. Earl (1930) 281 U.S. 111. However, many devices have been developed for dividing property between spouses which have the effect of splitting investment income. See Surrey, Family Income and Federal Taxation (1946) 24 Taxes 980.


8 House Report at 24; Senate Report at 26. But see President Truman's veto message, in which it is said: "... The discovery that it is possible to make very substantial savings in the gift and estate taxes by dividing a family's wealth between husband and wife has brought forth much ingenious argument to the effect that the provisions in this bill are needed to equalize the application of these taxes in community-property and common-law states. In fact, this equalization was in all essential respects achieved by legislation enacted by the Congress in 1942." H. R. Doc. No. 589, 80th Cong., 2nd Sess. 4 (1948).
had enacted legislation with the same announced objective. The 1942 amendments, however, were designed to bring equality by eliminating "the special estate tax privileges enjoyed by virtue of the community property system." The 1942 amendments went in the direction of applying to community property the concepts founded on the common law property system for imposition of the estate and gift taxes. In general, the 1942 amendments required the inclusion of community property in the gross estate on much the same basis as property held as joint tenants, with the taxable portion determined by the extent to which the property was economically attributable to the decedent. An additional test required at least that portion of the community property subject to the decedent's testamentary power of disposition to be included in his or her gross estate.

However, early in 1948 the air was full of tax reduction and "income splitting." "Estate and gift tax equalization" followed the trend.

The first step was to make the 1942 amendments no longer applicable. The tax committees of Congress, however, announced that they would be unwilling merely to repeal the 1942 amendments. Repeal alone would generally reproduce pre-1942 results which were considered far from equalization. Upon repeal, the estate and gift taxation of community property would once again generally be determined by the interest of the decedent or donor in property under the community property laws. This means, in a typical case, that if the husband, who has been the principal family breadwinner, dies, only one-half of the community property is included in his gross estate.

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9 Revenue Act of 1942, adding Int. Rev. Code §§ 811(d) (5), 811(e) (2), 811(g) (4) and 1000(d).
12 This was over the objection of the President (see note 8, supra). Treasury Secretary Snyder urged that fiscal requirements compelled postponement of such tax reduction and that the estate and gift tax provisions were "not required as the counterpart of the proposed income splitting provisions." He cited "new areas of inequality and administrative problems" under the estate and gift tax provisions of the Revenue Bill of 1948; and stated that the 1942 amendments achieved "substantial equality of treatment between common-law and community-property States" with such differences as remain in the impact of the estate and gift taxes, with the 1942 amendments, capable of being narrowed "by relatively simple amendments." Hearings before Committee on Finance on H. R. 4790, 80th Cong., 2nd Sess. 24, 25 (1948).
13 Revenue Act of 1948, §§ 351, 371. See further, notes 16, 17, and 19.
14 House Report at 26; Senate Report at 27.
subject to tax and the other half is held by his widow free of estate and gift tax.

Efforts for repeal of the 1942 amendments were therefore coordinated with efforts to find some method whereby a married person with non-community property could obtain the benefit of disposing of one-half of his property free of estate and gift taxes. Of course, this happy tax-equalization result was desired without the necessity of changing fundamental property law. If the community property laws were to be respected by reinstating the pre-1942 rules for taxation of such property, it can be argued that it is also fair to respect the common law property system. Therefore, “equalization,” estate tax and gift tax-wise, was sought through the operation of specific rules added to the tax system itself.

The system evolved under the Revenue Act of 1948 to accomplish the above objectives is, in general, as follows:

1. Estate tax

Effective with respect to estates of decedents dying after December 31, 1947—

16 See Supplemental Report of Committee on Equalization of Taxes in Community Property and Common Law States, A. B. A., Sec. of Taxation (1947). The legislation proposed in this report was approved by the House of Delegates of the American Bar Association on Sept. 26, 1947 and was introduced in the 80th Congress, 1st Sess. as H. R. 4730 and S. 1777. This draft of legislation will hereinafter be referred to as the “A. B. A. Bill.”

16 One of the purposes of the “equalization” provisions of the Revenue Act of 1948 was to provide tax equalization without the “extreme confusion” which would result if the common law states adopted a “new and strange system of law.” House Report at 23; Senate Report at 24. Congressman Gearhart introduced (by request) H. R. 3842, 80th Cong., 1st Sess., which was designed to provide income, estate and gift tax “equalization” by giving recognition to “marital partnership agreements” which would have the effect of splitting income and property. “Equalization” sought only through special provisions of the federal estate tax law has its pitfalls. State inheritance taxes are still to be reckoned with. In the case of state estate taxes imposed with respect to property included in the gross estate under the federal law, the Revenue Act of 1948 does not reduce the tax base since it provides only a reduction in computing the net estate. The credit (Int. Rev. Code § 813(b)) for state death taxes allowed up to 80 per cent of the federal basic estate tax will be reduced by the reduction in the federal tax.

17 The general statements outlining the statutory plan are subject to the exceptions and limitations contained in special provisions, which are subsequently discussed.

18 It had been urged by some that the 1942 community property provisions be repealed retroactively to the date of enactment of the Revenue Act of 1942, but an amendment by Senator Connally to that effect was defeated. 94 Cong. Rec. 3238 (March 19, 1948). It was not proposed that the legislation giving equal benefits for non-community property be made retroactive to 1942. Hearings before Finance Committee on H. R. 4790, 80th Cong., 2nd Sess. 329 (1948). Apparently the new estate and gift tax “equalization” was made effective on January 1, 1948 in order to coincide with the beginning of income tax equalization under “income splitting.”
(a) The community property estate tax provisions of the Internal Revenue Code added by the Revenue Act of 1942 are repealed.¹⁰

(b) A new deduction is provided for property passing from the decedent to his surviving spouse which makes it possible for a decedent to eliminate one-half of his non-community property from the tax base.²⁰

2. Gift tax

Effective with respect to gifts made after April 2, 1948—²¹

(a) The community property gift tax provisions added by the Revenue Act of 1942 are made inapplicable.²²

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¹⁰ Revenue Act of 1948, § 351. In the case of decedents dying after December 31, 1947, the portion of community property includible in the gross estate is determined under the 1948 law, even in the case of decedents dying in 1948 before April 2, and those who had made transfers of community property while the 1942 amendments were in effect. But if the reinstatement of the pre-1942 community property treatment on January 1, 1948 would cause the inclusion of community property in the gross estate of a spouse who died in 1948 prior to April 2, 1948, where the 1942 amendments did not have that result (as in a case of a transfer of community property economically attributable to the other spouse), the additional tax will not be imposed. Revenue Act of 1948, § 351(c). However, if both spouses died in 1948 before April 2, the surviving spouse's estate tax may be increased by reason of the exclusion (through repeal of the 1942 amendments) from the gross estate of the spouse first to die of the survivor's share of community property and the possible consequent loss in the survivor's estate of the deduction (Int. Rev. Code § 812(c)) for property previously taxed (see section 362(a), Revenue Act of 1948). The repeal of § 811(g)(4), Int. Rev. Code, removes from the law an express provision that "the term 'incidents of ownership' [a test for includibility in the gross estate of insurance proceeds on the decedent's life] includes incidents of ownership possessed by the decedent at his death as manager of the community." But Quaere: Are incidents of ownership as manager of the community still "incidents of ownership" under § 811(g)(2)(B) which is retained in the law? Cf. House Report at 54; Senate Report, Part 2, at 2. Cases under the prior law, where the statute was not as explicit, are conflicting. See 1 Paul, Federal Estate and Gift Taxation, 562, et seq. (1942).

²² Under the gift tax, the rate of tax on net gifts for any calendar year is determined by cumulating the net gifts for all previous calendar years on the rate schedule below the net gifts for the current calendar year. Int. Rev. Code § 1001. In determining the
(b) A new deduction is provided for one-half of the value of any gift of non-community property made to the donor's spouse.\(^\text{23}\)

(c) Gifts made by husband or wife to third parties may be treated as made one-half by each spouse.\(^\text{24}\)

In addition, numerous technical amendments are made to the Internal Revenue Code to give effect in other respects to the policy of the basic amendments.\(^\text{25}\)

The task of giving to decedents with non-community property the estate and gift tax advantages of community property is obviously complicated by the inherent differences between the community property and common law systems. Moreover, as a guiding policy "equalization" is not self operative; it means different things to different people. In the following pages, the problems which arose in connection with "equalization" under the policies of the Revenue Act of 1948 will be explored. In this way the causes for the complications in the estate tax and gift tax provisions may be explained.

I. THE APPROACH TO "GEOGRAPHICAL EQUALIZATION"

The "income splitting" plan provides "equalization" of the income tax as between married couples similarly situated by treating each bracket at which net gifts for 1948 (or any future year) will be taxed, the provisions of § 1000(d) Int. Rev. Code will continue to apply to transfers made after 1942 and before April 3, 1948.

\(^{23}\) Revenue Act of 1948, § 372.

\(^{24}\) Revenue Act of 1948, § 374.

\(^{25}\) See note 201, infra, as to amendments made necessary by the new marital deduction system. The Revenue Act of 1948 (§ 366) also amends § 113(a)(5) Int. Rev. Code, relating to the basis of property, for the "benefit" of surviving spouses in community property states. Under prior law the basis to the surviving spouse of his share of community property was generally unaffected by the death of his spouse. Estate of James F. Waters (1944) 3 T. C. 407; G. C. M. 24292, 1944 Cum. Bull. 162; I. T. 3808, 1946–2 Cum. Bull. 58. Under the new law, the basis of the surviving spouse's share of community property will generally be the value at the date of death of the decedent, if the decedent died after December 31, 1947. This brings the treatment of the survivor's share of community property in line with property acquired by bequest or inheritance (for which a marital deduction may be allowed the estate of the decedent under new § 812(e) Int. Rev. Code). However, the survivor of a joint tenancy or tenancy by the entirety does not get the "benefit" of a new basis. Lang v. Commissioner (1933) 289 U. S. 109. The A. B. A. Bill would have applied the former community property rule to the basis of property for which a marital deduction was obtained. The "benefit" of the new rule may be negative in some cases, for it may result in a basis lower than cost. The new law retroactively provides a basis of cost or value at date of death, whichever is higher, for the surviving spouse's share of community property, if included in determining the value of the decedent's gross estate under the 1942 amendments (prior to January 1, 1948) and an estate tax was payable on his net estate.
ESTATE AND GIFT TAX EQUALIZATION

couple as a unit. The plan is operative only upon the filing of a joint return by husband and wife, and in such return the income of the spouses is combined. There is no division of income between the spouses or any change in property laws as to the ownership of income between them. The benefits of "income splitting" are obtained entirely by the mechanics of computing the tax on the joint return as twice the tax on half of the combined income. Accordingly, the "income splitting" plan provides a universal method for computing the tax of married couples, which, in effect, overrides property laws.

The estate tax and gift tax provisions of the Revenue Act of 1948 are, however, based upon a more restricted approach. There is made available in computing the tax of a spouse with non-community property, the method under the community property system for reducing the tax base, namely, a division of property between the spouses.

The treatment of community property upon repeal of the 1942 amendments is generally based upon the separate ownership of one-half of the community property by each spouse. As a result, only one-half of the community property is generally includible in the gross estate of the spouse first to die. The other half is considered to be owned outright by the surviving spouse and may be included in her gross estate.

In order to provide similar tax benefits for a decedent with non-community property, the basic policy under the Revenue Act of 1948 is to permit one-half of his non-community estate to pass outright to his surviving spouse free of tax. The benefits under this policy are

26 INT. REV. CODE § 12(d), as amended by Revenue Act of 1948, § 301.

27 House Report at 47; Senate Report at 53. As pointed out in note 6, supra, the income splitting plan is intended for equality of treatment of earned income and investment income, as well as geographical equalization.

28 This comment and those following apply equally to the marital deduction approach under the gift tax. However, the "splitting" of gifts to third parties (INT. REV. CODE § 1000(f)) is the exact counterpart of "income splitting." The simplicity of the "gift splitting" provisions is in sharp contrast to the complications under the marital deduction provisions.

29 Exceptions are community property under the laws of New Mexico, Nevada, and California (acquired and held under the law in effect prior to April 16, 1923), in the case of which upon the wife's death no part of the community property is included in her gross estate. Hernandez v. Becker (C. C. A. 10th 1931) 54 F. (2d) 542. Another exception, in case the husband dies first, is community property held under the law of California prior to the Act of July 29, 1927 which is includible in full in the husband's estate.

30 House Report at 26; Senate Report at 27. See also A. B. A. SUPP. REP., supra note 15 at 2. It should be noted that this basic policy is to permit, rather than to require, one-half of the decedent's property to pass free of tax if transferred to the surviving
derived from separating the interests of the spouses and therefore property laws are necessarily involved. Accordingly the "property splitting" plan embraces problems which are avoided by the "income splitting" plan.31

These problems arise at the very outset in seeking a basic rule for determining the nature of the property rights (passing to the surviving spouse) for which an exemption from the decedent's tax base should be granted. The mechanics for granting such an exemption are not difficult to invent, for a deduction in computing the net estate may be used, as is done in the Revenue Act of 1948, providing what is commonly called the "marital deduction." The fundamental question is: "What kind of property interests passing to a surviving spouse should qualify for a marital deduction?" There are a number of ways in which this question might be answered. The following approaches indicate the difficulties involved.

1. **Allowing a marital deduction for any type of property interest in the gross estate which passes to the decedent's spouse.** Under this approach, the marital deduction would be comparatively simple to determine and would, it can be imagined, be similar to the existing deduction allowed under the estate tax for bequests, devises and transfers to charitable institutions.32 In such case, the marital deduction would be allowed whether the interest in property given by a decedent to his spouse was his entire interest in the property or only a partial interest, or only an interest in trust.

This approach, however, has several fundamental objections, under the present estate tax system, arising from the decedent's power to carve out interests in property for the benefit of his spouse. This power would give the decedent with non-community property the same estate tax advantage, by eliminating from the tax base the interest in property which his surviving spouse takes, as a decedent with an interest in community property, but with the additional advantage of being able to limit the interest of his surviving spouse, which generally cannot be done by a decedent with respect to his spouse's share of community property.33 This is important in that it would spouse. Thus "equalization" is not automatic and in fact the decedent with non-community property will have less "equality" of treatment as he gives less than half of his estate to his surviving spouse.

31 As to an approach which more nearly applies the "income splitting" plan to the estate tax, see the conclusion.

32 § 812(d), INT. REV. CODE.

33 1 De FUNTAX, op. cit. supra note 7 at 555, 564; House Report at 25; Senate Report at 27.
enable a husband to make beneficial dispositions of non-community property, as in trust, for the protection of his wife while having the tax advantages of a community property decedent whose spouse takes an entire interest in the property outright. Even more important, however, is the fact that it would enable a decedent with non-community property to exempt completely one-half of his property from estate tax not only in his estate but also in that of his spouse. This would be accomplished by the familiar life estate-remainder type of disposition, whereby the surviving spouse’s interest would terminate upon her death and not be included in her gross estate.\(^{34}\)

2. Allowing a marital deduction only for dispositions of a fee simple interest in property.\(^{35}\) Under this approach, a marital deduction would be allowed, for example, if a husband who owned a farm in fee simple devised his entire interest to his spouse. This approach is so obviously restricted, however, as to be open to serious objections. Its chief merit lies in the fact that it would avoid the obvious tax avoidance possibilities of the first approach. But, as a matter of fact, it does not insure that the property devised to the decedent’s spouse will be subject to the estate tax upon her death; for example, the proceeds of a sale of a fee simple interest may be consumed during life.

While this approach would provide equalization with the treat-

\(^{34}\) Representatives of community property groups complained that an attempted disposition by will by a husband of the entire community property into a trust with income to his surviving spouse for life and remainder to others would not save the surviving spouse’s estate from tax, for her election (see 1 DE FUNK, op. cit. supra note 7 at 616 et seq.) to take under the husband’s will would constitute a transfer, with income retained for her life, of her share of the community property into the trust, taxable under § 811(c), INT. REV. CODE. Hearings before Finance Committee on H. R. 4790, 80th Cong., 2nd Sess. 327 (1948). Cf. Commissioner v. Masterson (C. C. A. 5th 1942) 127 F. (2d) 252. (Compare: Op. of Atty. Gen. of Texas (Oct. 22, 1941) 4 P-H INH. & TRANSFER TAX SERV. (11th ed.) Tex. ¶ 1007, in which it was held that where the husband’s will disposed of the entire community property and his wife elected to take under the will the entire community property was subject on the husband’s death to the State inheritance tax law, which imposed a tax on property “which shall pass absolutely or in trust by will.”)

The same representatives proposed a plan to give community property decedents the benefit of the life estate device during the period the 1942 amendments were in effect, if such amendments were not retroactively repealed. The plan was to give a life time credit for the surviving spouse’s estate equal to the tax paid by the decedent with respect to the survivor’s share of community property. Hearings, \textit{supra}. This proposal, as a method of equalization, was apparently made on the assumption that every decedent in a common law state left property to his spouse only under a life estate in order to avoid tax on her death.

\(^{35}\) The A. B. A. Bill § 4, used this approach in part by excluding the “value of the interest . . . passing to or vesting in the surviving spouse . . . absolutely and in fee simple.”
ment of community property held in fee simple, it obviously would
provide no equalization at all with community property not so held.
In this respect, with repeal of the 1942 community property amend-
ments, an important area of tax advantage to community property
spouses would remain in the application of the estate tax. Moreover,
the term "fee simple" involves difficulties of definition. There is no
assurance that its application would be uniform under state laws. It is
also not generally applied to the ownership of cash and personal
property, although no apparent reason would seem to exist for dis-
allowing under this approach a marital deduction for an outright bequest of the entire interest in a fund of cash or other personal
property.

Allowing a marital deduction for the value of property which
will be included in the surviving spouse's gross estate. This approach
actually is quite different from an approach based on equalization with
community property. Rather it is based upon a concept of "a tax at
least once every generation." This concept is not a part of the com-
munity property system as applied under the estate tax; for under
such system, ownership of an interest in the community property is
the basis for exclusion of the surviving spouse's interest. However,
this approach can be considered as a means to prevent tax avoidance
and at the same time to bring results not far different from those under
the community property system.

Careful examination of this approach reveals serious defects. It is
first necessary to define the terms of this approach by establishing the
time as of which it will be determined whether the property will be
included in the surviving spouse's gross estate. This might be deter-
mained as if the surviving spouse died immediately after the
decedent. While this would not permit a deduction for a life estate, it would per-
mit a deduction for similar estates the value of which may never be
included in the surviving spouse's estate. Thus, if Mr. Jones be-

30 Cf. Restatement, Property § 14 (1936) under which an estate in fee simple
includes a fee simple absolute and all types of estates in fee simple defeasible, but not
estates in fee simple conditional.

37 Apparently the term "absolutely and in fee simple" was intended to be used in a
broad and not a technical sense under the A. B. A. Bill, so as to cover any outright transfer
As indicated in the main text, however, "absolutely and fee simple" might not have
carried the intended meaning. As to the use of "fee simple" only in connection with
land, see 1 Tiffany, Real Property (3rd ed.) § 27 (1939).


39 This was the rule intended under the A. B. A. Bill (§ 4). See A. B. A. Supp. Rep.,
queathed an estate for ten years to his wife, Mary, with remainder absolutely to their son, John, a marital deduction would be allowed for the value at Mr. Jones' death of the ten year term. However, the ten year term may represent the expected remaining life span of Mary and each year that she continues to live its value declines until, in fact, upon her death, if she survives the term, no part of its value may be included in her gross estate. Another example is a bequest of an estate on a condition subsequent. If the fiction of the surviving spouse's immediate death is applied, such interest might be considered includible in her gross estate; but in fact the event may occur prior to her death which terminates her interest so that nothing will be included in her gross estate.

On the other hand, if the test is made that the value of the property bequeathed or devised to or for the use of the surviving spouse must in all events be included in her gross estate, difficulties of another kind appear. In the first place, such a rule would impose a limitation not applicable with respect to community property. Thus, a lease may be held by husband and wife as community property and only one-half of its value included in the gross estate of the spouse first to die. However, a marital deduction would not be allowed under the approach being discussed for the value of a non-community lease included in a decedent's gross estate where such lease is bequeathed to the decedent's spouse.

More important, however, this approach, despite its apparent simplicity, creates difficult problems of application. Thus, from the viewpoint of the includibility in the legatee's estate, is there any difference between a bequest of $50,000 and a bequest of a life estate which may be sold for cash and has a value of $50,000? As a matter of fact, the includibility in the surviving spouse's estate of a bequest will generally depend upon her use and consumption of it, rather than upon the quality or quantum of her title. Thus, there is more likelihood that a bequest to one's spouse of a life estate which provides income in excess of her needs will result in an estate tax upon her death than will a lesser bequest of cash which may be consumed during her life. A so-called "consumption test" would obviously involve practical difficulties. Moreover, it would depart from equalization in that the

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40 The income from the term to the extent accumulated by the surviving spouse may be included in her gross estate; but the same may be said of the income from a life estate.
41 Such problems arise under existing law on a smaller scale where a trust is created for the benefit of an individual with remainder to charity, and no value may be assigned to the charitable remainder because the extent to which the trust property may be used
ownership of property rather than its possible consumption by the surviving spouse is the basis for the application of the community property rules under the estate tax.

4. Allowing a marital deduction for the interest passing to the surviving spouse from the decedent, but excluding her income interest. This approach is a rationalization of the bases of the previous approaches. Thus, it would allow a marital deduction for any interest in property to the extent of the corpus or capital element of such interest. A marital deduction would be allowed for a fee simple interest in property but not for a mere life estate in such property. The principle of this approach is that, in effect, the corpus or capital interest of the surviving spouse in community property is the property excluded from the decedent’s estate and that only the income interest is consumed by the surviving spouse during her lifetime.

This approach may represent sound theory but it raises difficult practical problems. Thus, under this approach, a bequest of the income of a trust for life presumably would not be deductible but a bequest of an annuity payable out of corpus would be. It is apparent that this approach would lend itself to various devices for payment of an annuity while income was being accumulated. Moreover, from the viewpoint of eventual includibility in the estate of the surviving spouse, it would appear immaterial whether $10,000 a year, for example, was paid out of the income or corpus of a fund.

To avoid such problems, this approach would probably require determination of the extent of the income interest necessary for the support of the surviving spouse. This would involve obvious difficulties and controversies. Moreover, it would not provide equalization for, as previously stated, the ownership of property (which may be only an income interest) is the basis for the application of the community property rules under the estate tax.

5. Allowing a marital deduction for any interest in property other than an interest which must be determined with reference to the surviving spouse’s age. This approach would disallow a marital deduction for a life estate and for any other interest which will terminate at a time determined with reference to the surviving spouse’s death. Thus,


42 See note 41, supra.

43 Cf. § 811(c) Int. Rev. Code under which, if such interest is retained by the transferor, the value of the property so transferred will be included in his gross estate.
a deduction would be disallowed alike for a bequest of income for life and for a bequest of an annuity for life. The purpose of this approach obviously is to disallow a marital deduction for an interest which will not be includible in the surviving spouse's gross estate. It would also disallow a marital deduction in most cases in which the decedent gave his spouse only a partial interest in property; and to that extent would serve the purpose of equalization by limiting the deduction in the case of residents of common law states.

However, this approach also has a serious objection, for the reason that it would allow a deduction for an estate for a term of years but not for a life estate. Is there any difference between a bequest of the income of a trust for life and a bequest of such income for twenty years when twenty years is the expected remaining life of the legatee? There is an obvious difference if the legatee dies within the twenty year term, for only if the bequest is for an estate for twenty years will the value of the unexpended term be included in the legatee's gross estate. However, such value is continuously decreasing from the time of its creation so that at the expiration of twenty years there is no difference from the standpoint of the tax on the legatee's estate between a life estate and a twenty year term. While additional arguments may be made as to the differences between a life estate and a term for years, the fact remains that a statute which drew such a distinction in disallowing a marital deduction for the former but not for the latter would be easily avoided. Furthermore, it would distort estate planning by, in effect, forcing testators to create estates for years, not a common method of disposing of property.

6. Allowing a marital deduction for interests in property other than partial interests created as part of a settlement of property. This approach is based upon equalization with the situation of a decedent in a community property state. A settlement has been described as including "every device known to conveyancers by which the enjoyment of estate under the same deed or will may be had by different persons succeeding to the estate in their order." A decedent with an interest in community property generally cannot make a settlement of the community property between his spouse and other persons, for the surviving spouse has an outright one-half interest in every item of...
Accordingly, as a matter of equalization, a marital deduction should be allowed if an individual gives his spouse a one-half interest in everything he has.

Under this approach, if a decedent's only interest in a particular piece of property is a partial interest, such as a lease, a marital deduction would be allowed if he gives his entire interest (or an undivided half interest) to his spouse. It will be noted that the lease may not be present in the estate of the surviving spouse. However, this is precisely the situation with respect to a lease which is community property. Moreover, as previously stated, the test of includibility in the surviving spouse's estate is not real. The income realized on account of the lease may be retained and included in the gross estate even though the value of the lease is not.

There are two principal problems under this approach. First, in order to be on a comparable basis with community property, all the property of the decedent should be viewed to determine whether a settlement has been made. Thus, if an individual uses part of his property to acquire a limited interest (such as a life estate or an annuity) for the benefit of his surviving spouse and gives the balance of his property to other persons, no marital deduction should be allowed, for, in effect, a settlement has been made. The difficulty in applying this view is the obvious problem of attempting to trace all property acquisitions and dispositions of an individual.

The second problem under this approach is that, being based upon community property concepts, it would not allow a marital deduction for some of the usual common law methods of testamentary dispositions, such as certain annuities and transfers in trust.

II. THE "SETTLEMENT" CONCEPT AS APPLIED UNDER THE REVENUE ACT OF 1948

The preceding survey indicates that there is no simple rule based upon a division of property between spouses which will provide equalization. The Revenue Act of 1948 appears to use a number of the above approaches—in order to bring "fair" results—which of course adds to the complications.

The marital deduction system provided under the Revenue Act of 1948 is based primarily upon the "settlement" approach, last discussed above. The new statutory provision (subsection (e) of section

47 See notes 33, 34, supra.
812 of the Internal Revenue Code) first provides a general rule allowing a deduction in computing the decedent’s net estate for—

"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."

This general rule is subject to certain limitations provided in the subsequent provisions of section 812(e).

The first limitation on this general rule is commonly called the "terminable interest" rule. The combined effect of the general rule and the terminable interest rule is to give statutory expression to the "settlement" approach. However, this approach is not applied under the statute to the entire wealth of the decedent but is applied instead asset by asset.

The pattern of the settlement approach as thus applied is generally as follows: If the decedent bequeaths or devises his entire interest in a particular piece of property to his surviving spouse the marital deduction will be allowed; however, if he gives, bequeaths, or devises an interest in the same property to his surviving spouse and to another person, then the marital deduction will be allowed only if the interest of the surviving spouse is a share of the entire interest of the decedent in the property.

Since the statutory approach is based upon whether a settlement has been made with respect to the decedent’s interest in a particular piece of property, it is necessary to distinguish between an “interest” (which itself is property) and the underlying property from which such interest is derived. This distinction is not commonly drawn in other fields of law. However, the statutory history of the Revenue Act of 1948 makes it quite clear that life estates, leases and similar estates, which represent only the quality or quantum of ownership,

\[\text{INT. REV. CODE} \text{ § 812(e) (1) (A).} \]

Subparagraph (C) of the same section also provides a special application of the rule.

This general statement will not apply in those exceptional cases, subsequently discussed, where the marital deduction is allowed for a partial interest given to a spouse if it is not a "terminable interest."

\[\text{Senate Report, Part 2 at 4.}\]
are not to be considered as the "property" referred to in section 812(e), but as "interests" in property.\textsuperscript{63}

If the distinction is not drawn between "interest" and "property," then the statute is reduced to a welter of words which have no purpose. Take, for example, a case in which the decedent devises a farm to his wife for life with remainder absolutely to his son. If the life estate is considered as "property" and the remainder interest is considered as "property," then the surviving spouse does not have an interest in the property in which the son has an interest. If this view were taken, the surviving spouse and every other person taking an interest from the decedent would always have all the interests in the "property" (even though such property represented only one interest). Obviously the statute could not have been intended so to operate, and the "property" referred to in the statute must be the underlying property, such as buildings, land, or shares of stock.

Where the decedent himself possessed only an interest in property, the property referred to in the statute would still appear to be the underlying property in which the decedent had an interest.\textsuperscript{54} The decedent's interest itself would not be considered as the "property" referred to in the statute.

The terminable interest rule provides the mechanics for disallowing a deduction when there is a so-called settlement. The rule, in its comprehensive sense, is set forth in subparagraphs (B) and (C) of section 812(e) (1). There are three different aspects of the rule, which will be discussed below.

1. \textit{Transfers, bequests, etc., of specific interests.} Subparagraph (B) of section 812(e) (1) may be generally characterized as setting forth the method of disallowing a deduction where the decedent makes a settlement by a specific bequest of an interest in property which he has.\textsuperscript{55} The statute does not refer to a settlement but describes in definite terms the three following circumstances which have that effect and which, if all three are present, will require disallowance of the marital deduction:

\textsuperscript{53} For a similar distinction between "interests" and "property," see \textit{Green, op. cit. supra} note 46 at 471.

\textsuperscript{54} Senate Report, Part 2 at 4.

\textsuperscript{55} Subparagraph (B) really contains two rules, the first of which (covered by clauses (i) and (ii) of the subparagraph (B)) is discussed in this section of the text, and the second of which (covered by clause (iii)) is discussed under section 3 of this portion of the text.
(a) The interest in property passing to the surviving spouse from the decedent is a terminable interest, and

(b) An interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse), and

(c) By reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after the termination or failure of the interest so passing to the surviving spouse.

The expression "terminable interest" is not actually used in the substantive provisions of the statute; but it is a convenient short hand expression for the following lengthy statutory description of an interest passing to the surviving spouse from the decedent which—

"upon the lapse of time, upon the occurrence of an event or contingency, or upon the failure of an event or contingency to occur"—will terminate or fail.

Common examples of interests in property which meet the above description are life estates, leases, and other estates for years. An interest may also be a terminable interest even though it represents the entire property. Examples are patents, copyrights, and annuity contracts.

The elaborate description in the statute, however, is clearly intended to be all-encompassing with respect to various kinds of conditions and contingencies which may make an interest "terminable." The legislative draftsmen were leaving no room for argument at this point as to whether a contingent interest is a present interest which

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56 If the dower or curtesy interest of a surviving spouse under state law is an interest only for life (and not a fee), it is a terminable interest and a marital deduction will generally be disallowed therefor under § 812(e)(1)(B), Int. Rev. Code. Senate Report, Part 2 at 9. If, however, the surviving spouse elects to take under the will, the marital deduction is determined by the interest acquired thereby. Id. at 11.

57 Senate Report, Part 2 at 7. The principal significance of such property being "terminable" is found in the application of clause (iii) of § 812(e)(1)(B), Int. Rev. Code, discussed under section 3 of this portion of the main text. If a decedent bequeaths his entire interest in a patent to his wife and daughter as tenants in common, the fact that the surviving spouse has a terminable interest is not sufficient reason to disallow the marital deduction. Senate Report, Part 2 at 12. No other facts appearing, the deduction will be allowed since the daughter will not "possess or enjoy" the property after termination of the wife's interest.

58 Senate Report, Part 2 at 7.
may terminate or a future interest which may fail to ripen; regardless of the "niceties of the art of conveyancing," such interests come within this statute.\(^5\) However, every interest in property is not to be considered a terminable interest merely because it may be consumed or destroyed, as by fire or earthquake.\(^6\)

It might be supposed that such concepts as "terminable interest" and "the property in which the spouse's interest is an interest" will make the statute a source of constant conflict. However, the value of the statutory scheme is that it generally makes it unnecessary to pin a label on the interest or property in the theoretically difficult situations. This is not to deny that problems will arise. But, before going too far in determining whether or not the surviving spouse's interest is a terminable interest, the question should be asked: "Does any other person have an interest in the same property?" If no other person has such an interest, a marital deduction may be allowed whether or not the surviving spouse's interest is a terminable interest.\(^0\) This is because the application of the terminable interest rule depends not only upon the existence of a terminable interest but also upon other circumstances arising from an interest in the same property passing from the decedent to a person other than the surviving spouse.\(^2\) For example, assume that Mr. Smith acquired during his lifetime a 99 year renewable lease on a city lot and devised his entire interest under the lease to his surviving spouse. Is such a lease really a terminable interest? Arguments on this point are immaterial because if Mr. Smith did not give any person other than his spouse an interest in the city lot the terminable interest rule does not apply.

Similar questions may be raised and disposed of as to the "property" in which the surviving spouse is given an interest. An example which may be cited is a case in which the decedent owned a farm and devised the mineral rights to his surviving spouse and all other rights in the farm to his son. A question may be raised as to whether the mineral rights themselves represent property or merely an interest in property, i.e., the farm. But regardless of possible differences on this point, the mineral rights are not a terminable interest and hence the marital deduction is allowed.

The last example also illustrates the limitation of the terminable

\(^6\) Senate Report, Part 2 at 7.
\(^0\) Id. at 8.
\(^2\) Under clauses (i) and (ii) of § 812(e)(1)(B), INT. REV. CODE.
interest rule as an application of the settlement concept. That is, the rule applies so as to disallow the marital deduction—where the decedent gives less than a share of his entire interest in property—only where such share is a terminable interest. The division by the decedent of the interests in a farm into mineral rights and all other rights could not be made in the case of community property with respect to the surviving spouse's share. This result may be recognized for what it is—a deviation from the equal division of property principle and equalization.

However, this deviation is not without compensation. It has the very practical result, as previously stated, of avoiding difficult questions as to what is the "property" in which the spouse has an interest. Moreover, in some cases—but not all—the allowance of the marital deduction may be justified where the decedent bequeaths to his surviving spouse a share (which is not a terminable interest) in less than his entire interest, by the fact that the interest may be found in the surviving spouse's gross estate. This, of course, is an application, not of the settlement concept, but of the "tax once every generation" viewpoint. The application of this concept (based on the includibility of the deductible interest in the surviving spouse's estate) is difficult to justify in the case of a wasting asset.

The limitation of the settlement approach to terminable interests also has the effect of allowing a marital deduction for an absolute remainder interest. An example is a case in which the decedent devises a life estate to his mother with remainder absolutely to his spouse. The allowance of the deduction for the remainder interest is probably only incidental to the practical reasons for limiting the rule to terminable interests.

As previously indicated, in the case of a transfer or bequest of an interest in specific property, the determination of whether the interest is terminable is significant only if two other conditions are present. The presence of both of these conditions is necessary for the disallowance of the marital deduction for a terminable interest. The two conditions, as previously quoted from the statute, are generally descriptive of the settling by the decedent in another person of an interest in property which may survive the terminable interest he bequeaths in the same property to his surviving spouse.

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63 Ibid.
64 The interest must pass from the decedent to such other person for less than adequate and full consideration. Int. Rev. Code § 812(e) (1) (B) (i), (ii).
The simplest example of the application of these conditions is a devise of Blackacre to the surviving spouse for life and the remainder absolutely to the decedent's son. The statute does not permit a deduction for the interest passing to the surviving spouse because an interest in Blackacre also passes to the son and by reason of such interest he may possess or enjoy Blackacre after the spouse's death. An important point in the application of the terminable interest rule is that it is not limited to settlements made solely by testamentary transfers. The rule applies even though the interest passing to the person other than the surviving spouse was the result of a gift made during life—including cases of gifts made prior to the advent of the federal gift tax. This may appear to be a harsh result, but there appears to be a sound reason for the rule.

In determining whether an interest in the property has passed to another person, the broad definition of a terminable interest is important. If an interest is considered terminable under the definition (and itself is not the whole property, as in the case of a patent), it follows that some person must have an interest in the same property in addition to the terminable interest (of course, in order to come under the terminable interest rule, the interest must pass from the decedent). The statute (§ 812(e)(3)) expressly provides that where it is not possible at the time of the decedent's death to ascertain the particular person or persons to whom an interest in property may pass, such interest is nevertheless considered as passing from the decedent to persons other than the surviving spouse (except as provided in § 812(e)(1)(F) and (G)). Thus, persons with remote contingent interests (including the unborn and unidentified) and possible appointees or takers in default under a power of appointment created by the decedent (except as provided in § 812(e)(1)(F) and (G)) are considered as taking an interest from the decedent where if they receive possession or enjoyment of property, it will be because of a bequest or devise or exercise or non-exercise of a power by the decedent. Senate Report, Part 2 at 11. If the state law recognizes the surviving spouse as having the entire interest in property, despite terms in a will of limitations over to other persons, then it may be expected that such other persons will not be considered as having an interest in the property. Cf. Senate Report, Part 2 at 8.

In May v. Heiner (1930) 281 U.S. 238, the Supreme Court held that a transfer by A in trust to pay the income to A for life and then to distribute the corpus to B was not a transfer by A "intended to take effect in possession or enjoyment at or after his death" within the meaning of § 401, Rev. Act of 1918 because the remainder interest in the property passed at the time of creation of the trust, not at the time of A's death. The term "possess or enjoy" as used in the INT. REV. CODE § 812(e)(1)(B)(ii) is not intended to be restricted in the May v. Heiner sense. Senate Report, Part 2 at 8. Moreover, the May v. Heiner interpretation is immaterial because the 1948 law is not based upon when "possession or enjoyment" began but upon whether a person "may possess or enjoy any part of the property after the termination of the surviving spouse's interest . . . ."

In applying the terminable interest rule, the situation is viewed at the date of the decedent's death, although effect must be given to prior transfers. In the case of a gift by H in contemplation of death where W's interest is contingent on surviving X, the terminable interest rule does not disallow the deduction if, prior to H's death, X dies survived by W. If, however, X transferred by sale or gift his interest to W and survived
Compare the following two cases. Mr. Green owns the Green Building and devises the entire property to his son, subject, however, to an estate for twenty years in his surviving spouse. Mr. Brown has a lease on the Brown Building, which at the time of his death has an unexpired term of twenty years, and he bequeaths the lease to his surviving spouse. The difference between the cases appears obvious enough—Mr. Green has given his wife only a terminable interest in his entire interest in the property while Mr. Brown has given his wife his entire interest in the property.

But what if the facts are that Mr. Brown at one time owned the Brown Building and made a gift of his entire interest to his son, reserving only a term for years, which is the lease he bequeaths to his wife? In such event, no real difference appears between the cases of Mr. Green and Mr. Brown. Accordingly, upon these facts, the statute disallows the marital deduction for the terminable interest each leaves to his spouse.68 However, it should be noted that if Mr. Brown never had any other interest in the Brown Building than the lease, his bequest to his wife of his entire interest in the lease will qualify for a marital deduction.

To take another example, Mr. Black owns the Black Building which has a fair market value of $500,000. He sells his entire interest for $400,000 in cash, taking back a lease on a part of the building for twenty years, the lease having a value of $100,000. Mr. Black bequeaths the lease to his wife. The statute allows a marital deduction for the value of the lease at the time of Mr. Black's death because he has not made a gift of an interest in the Black Building to any person other than his wife.69 Thus, this case is treated the same as if Mr. Black never had any interest in the Black Building other than the lease.

But the case of Mr. Black also illustrates the limitations of the statutory rule as an application of the settlement principle. The Black Building represented an asset worth $500,000. Assume that Mr. Black bequeathed the residue of his estate, which included the $400,000 cash from the sale of the Black Building, to his son. In such a case, the

68 Senate Report, Part 2 at 9 (Example (1)).
69 Id. at 9-10 (Example (1)).
bequest of the lease to his surviving spouse was as much a settlement of the decedent's interest in the $500,000 asset as it was in the case of Mr. Green or Mr. Brown. For that matter, if Mr. Black never had any interest in the Black Building except a lease which he purchased, the bequest of such a lease while bequeathing the balance of his property to others is also a settlement of his property. However, as previously stated, the statute generally applies the settlement principle only to the particular property from which the interest passing to the surviving spouse is derived.

A more complete application of the settlement principle would require disallowance of the marital deduction for a terminable interest if the decedent gives his surviving spouse a terminable interest while leaving any part of his estate to others. This policy is, in effect, generally applied in the case of terminable interests acquired after the decedent's death, as will be discussed hereafter. But in the case of all other terminable interests in property, the settlement concept is limited to the particular property, presumably because a terminable interest (such as a lease) may be held as community property and one-half of its value excluded from the estate of a spouse under community property rules.

The difference in the application of the settlement principle to particular property and to the decedent's entire estate is best illustrated by the treatment of annuities. Suppose, for example, Mr. Jones purchases during his lifetime a contract to pay an annuity to himself for his life and then to his wife for her life, with refund of any undistributed portion to his wife's estate. Under his will he leaves the balance of his property to his children. Inasmuch as Mr. Jones' entire interest in the annuity contract passes to his wife, and not to any other person, a marital deduction is allowed under the statute for the value of the contract included in determining Mr. Jones' gross estate. Nevertheless, it is apparent that Mr. Jones has made a settlement of his property whereby he has given his wife an interest very similar to a life estate.

70 Id. at 12-13 (Example (2)). But if the refund is payable to the decedent's estate or to persons other than the surviving spouse (or her estate), the marital deduction would be disallowed. A provision for payment of insurance proceeds in a lump sum, or installments, entirely to the surviving spouse (or her estate), is the same as a bequest of a fund of cash. The mode of settlement is immaterial as long as no person other than the surviving spouse (or her estate) has an interest in the proceeds. Id. at 12 (Example (1)). A special rule is provided in § 812(e) (1) (G), Int. Rev. Code in the case of insurance proceeds where the surviving spouse does not have the entire interest.
Annuity contracts, especially under employee pension plans are a common method of providing for old age and for protection of one’s spouse. \(^{71}\) Accordingly, the allowance of a marital deduction for the above type of annuity in which no person other than the surviving spouse has an interest may be justified as a matter of policy. However, this policy runs head-on into the policy of disallowing a marital deduction for a life estate-remainder type of disposition. \(^{72}\) The conflict between these policies is evidence of the difficulties, and a source of complication, in attempting to provide equalization under the estate tax.

2. Transfers, bequests, etc., of an interest in a fund or the general estate. In the previous discussion of the terminable interest rule we have referred only to cases in which decedent makes a specific transfer or bequest to his spouse of an interest in identified property. But what if the decedent makes a pecuniary bequest of $50,000 or bequeaths or devises the residue of his estate to his surviving spouse? What is the property in which the surviving spouse has an interest?

This question is important for three reasons:

(a) The interest passing to the surviving spouse must be an interest in property included in determining the value of the decedent’s gross estate; otherwise the statute does not allow the marital deduction. \(^{73}\) If a decedent bequeaths $50,000 in cash to his surviving spouse and does not have $50,000 in cash (but has other property which may be sold by the executor), is the property in which the surviving spouse is given an interest included in determining the value of the decedent’s gross estate?

(b) The marital deduction is disallowed for a terminable interest in property only if an interest in the same property passes from the decedent to a person other than the surviving spouse. In the case of a gift or bequest of a right to payments out of a fund (such as the right to receive income from a trust), is there a gift or bequest of an interest in property in the fund or merely of a right of action for non-pay-

\(^{71}\) Cf. Int. Rev. Code § 165.

\(^{72}\) The allowance of a marital deduction for an annuity contract may be justified as being the same as the allowance of a marital deduction where the decedent has only a life estate for the life of his wife which he bequeaths to her. However, the latter is very unusual. The purchase out of a fund of an annuity contract for the benefit of the surviving spouse, with the balance of the fund left to surviving children, may be a substitute for a life estate-remainder disposition of the fund.

\(^{73}\) Int. Rev. Code § 812(e)(1)(A).
ment? Take a case in which the decedent creates a trust directing the trustee to pay the income to his surviving spouse for her life and upon her death to terminate the trust and transfer the corpus to his son. The right to the income for life is certainly a terminable interest; but if this right is not considered as an interest in property (in the trust) in which the son has an interest, then the interest so passing to the surviving spouse would qualify under the statute.

(c) In the case of a bequest which may be satisfied out of a fund or the general estate, which includes a terminable interest, it is necessary to determine whether the interest of the surviving spouse is, in whole or in part, the terminable interest. The answer to this question, in turn, depends upon whether the surviving spouse is considered to have an interest in the assets in the fund or general estate, as the case may be. This problem exists in the case of every pecuniary or residuary bequest and in cases of a gift or bequest of an interest under a trust.

Since an answer must be supplied to the question of what is the property in which the spouse has an interest, consideration may be given to the following theories as a basis for reaching proper results:

(A) The conversion theory. One theory which may be advanced is that the doctrine of equitable conversion is applicable. This theory might be applied so as to treat the property in which the surviving spouse has an interest as having the character of the property of the decedent which the executor or administrator converted into such property. Thus, under this theory, in the case of a cash bequest of $50,000, the $50,000 is the property in which the surviving spouse has an interest but it is considered the same as the property of the decedent which the executor used to obtain the $50,000.

The many difficulties which would be encountered under the con-

74 As to the distinction which may be drawn between rights in rem and rights in personam, see Green, op. cit. supra note 46 at 471.
75 The term "general estate" refers to the assets of the decedent's estate other than property specifically bequeathed or subject to specific mortgages or liens. The general estate is intended to be determined prior to payment of general claims. Senate Report, Part 2 at 14. Cf. Shipley's Estate (1940) 337 Pa. 580, 12 A. 2d 347; 1 Underhill, Wills § 405 (1900).
76 The doctrine is applicable usually to convert the character of the beneficial interest in property to be disposed of to the character of the interest acquired by the disposition. 1 Tiffany, Real Property § 298 (3d ed. 1939). The conversion theory referred to in the text is actually a modified application of this doctrine; for under the theory in the text the surviving spouse, viewed as a transferee, is considered to have an interest in property which takes on the character of the property to be transferred by the estate.
version theory justify its rejection. First of all, if the theory was applied to any conversion by the executor of property in the estate the terminable interest rule would be easily avoided and lose its effect. Consider the case in which the decedent leaves to his wife a life estate (which has a value of $50,000) in a farm and the remainder absolutely to his son. A marital deduction would not be allowed for the life estate. But suppose the executor sold property in the estate and gave the spouse, with her consent, $50,000 in lieu of the life estate. On the conversion theory it might be claimed that the surviving spouse's interest is in the $50,000 and hence is deductible.\(^7\)

In order to prevent such easy avoidance of the statute, the conversion theory might be limited to only “authorized conversions” such as those which the decedent directs by his will or which are necessary for the payment of debts.\(^8\) But even in such cases the statute would be at the mercy of an ingenious executor. By disposing in the liquidation of the estate of the nondeductible terminable interests, no such interests would remain in the general estate for transfer to the surviving spouse. Thus, the marital deduction in the case of a residuary bequest would depend upon the “proper” selection of assets by the executor. But it would also be necessary to determine whether the conversion was required and proper. The involvement of the estate tax (and the taxing authorities) in questions of the proper administration of the estate would result in infinite conflicts.

The conversion theory, therefore, does not give a satisfactory answer in cases in which the surviving spouse is given an interest in unidentified assets. Furthermore, it gives no answer at all as to whether in the case of a gift or bequest of an income or an annuity right, the bequest is of an interest in the property in the fund.

(B) The asset theory. Another theory which may be applied is that the interest given or bequeathed is an interest in the property out of which the gift or bequest may be satisfied.\(^9\) For example, if the decedent's will directs the executor to sell his General Motors stock and to pay over the proceeds to the extent of $50,000 to the decedent's

\(^7\) See Senate Report, Part 2 at 11, for a similar example in which it is declared that the marital deduction will not be allowed.

\(^8\) Cf. 1 Tiffany, Real Property 511 in which it is pointed out that the doctrine is generally restricted to conversions necessary to carry out the intention of the testator.

\(^9\) This theory is consistent with the general rule of law that a general legacy may be satisfied out of the general real or personal estate of the testator owned by him at his death. 1 Underhill, op. cit. supra note 75, § 405.
spouse, the spouse's interest is in the General Motors stock. The interest is not a terminable interest, for the form of its satisfaction ($50,000) is not considered a terminable interest.

If the gift or bequest is a charge on a fund or on the general estate, the same theory may also be applied. In such a case, the interest is an interest in each item of property represented by assets in the fund which may be used to satisfy the gift or bequest. Accordingly, for want of a better name, this theory may be called the "asset theory."

The application of the asset theory may be illustrated in the case of a general bequest of $50,000. Under this theory the interest given is an interest in the property represented by assets in the general estate out of which the bequest may be satisfied. To take another example, suppose the decedent transfers in contemplation of death to his wife a life estate in a farm which he owns and upon his prior death the remainder interest falls into the residue of his estate which is devised to his son. In such a case, the son has an interest in the farm by reason of the remainder interest which is included in the residue to which he is entitled. Accordingly, a marital deduction is not allowed for the transfer of the life estate.

The asset theory appears to provide a basis for a consistent application of a marital deduction system. It is the only theory which seems to give a satisfactory answer to the three problems outlined above, where it became necessary to determine the property in which the surviving spouse takes an interest.

The asset theory, rather than the conversion theory, appears to be adopted in the Revenue Act of 1948. Although the asset theory is not directly expressed in the statute as the basis for determining a marital deduction, nevertheless, the Senate Finance Committee Re-

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81 A variation of the asset theory might be called the "fund theory," in which the fund or the general estate, as distinguished from each asset therein, might be considered as the "property" in which the surviving spouse has an interest (when her interest may be satisfied from unidentified assets in the fund or general estate). The fund theory is at variance, however, with the basic approach, heretofore discussed, of determining the marital deduction with reference to interests in particular property. Moreover, the fund theory would permit results not justified under the purpose of the statute. For example, in the case just given in the main text of a transfer of a life estate in a farm, with the remainder falling in the residue to the son, it might be argued under the fund theory that the residue is the property in which the son has an interest and not the farm. This would be contrary to the obvious purpose of the statute. Cf. Senate Report, Part 2 at 8. The fund theory also would have sporadic results. In the case just given, the son probably would be considered, under this theory, to have an interest in Blackacre if the remainder was the only property in the residue, but not otherwise.
port states the theory as an underlying principle of the legislation. Moreover, there are certain provisions which can be explained as part of the statute only if the asset theory is understood as generally applicable.

Subparagraph (C) of section 812(e)(1) of the Code provides a special rule for application of the terminable interest rule where the asset theory would be expected to apply. This special rule is stated to apply in cases in which the assets (included in the decedent's gross estate) out of which, or the proceeds of which, an interest passing to the surviving spouse may be satisfied include a terminable interest which if specifically bequeathed to the surviving spouse would not qualify for a marital deduction. Such cases are those in which a terminable interest is included in the corpus of a trust or in the general estate out of which the interest passing to the surviving spouse (as a beneficiary of a trust or under a pecuniary or residuary bequest) may be satisfied. The statement of these cases in the statutory rule necessarily presupposes that the surviving spouse has an interest in the property represented by assets in the general estate, such assets being those out of which, or the proceeds of which, the interest of the surviving spouse may be satisfied.

In such cases where a terminable interest is included among the assets, the determination of the extent to which the interest of the surviving spouse is a terminable interest would not be clear without a special statutory rule. Some answer might possibly be found by an apportionment formula, or by an order of priority, or even by looking to the actual disposition of the assets by the executor. However, the statute provides a definite rule. The fact that a clarifying rule is prescribed in these cases is convincing evidence that the asset theory was assumed as fundamental law under the plan of the legislation.

The special rule, in effect, allocates nondeductible terminable interests first to the gift or bequest passing to the surviving spouse, where the interest so passing may be satisfied out of such terminable interests and other assets. The rule operates in the following manner. Suppose a husband during his lifetime transfers Blackacre to his son by gift, reserving, however, the income for the period of his life and that of his wife, and by his will creates a trust over assets of his estate, including the term for his surviving spouse's life, with the income of the trust to be paid to her and the corpus on her death to

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82 Senate Report, Part 2 at 4, 8.
83 Id. at 14.
pass to her estate. The statute provides that in such a case the marital
deduction for the interest under the trust passing to the surviving
spouse shall be reduced by the value of the life estate held in trust. This result is merely a logical extension of the rule previously stated
in the case of a specific bequest of a nondeductible terminable interest,
for there can be no question that under subparagraph (B) of section
812(e)(1) no marital deduction would be allowed for the life estate
carved out by the decedent in the case given if it were specifically be-
queathed by him directly to his spouse or as the entire corpus of a
trust for her benefit.

However, the special rule in the statute, by arbitrarily allocating
nondeductible terminable interests to a pecuniary or residuary be-
quest to a spouse, produces some interesting results. Suppose, for ex-
ample, the decedent bequeaths $50,000 to his spouse, and there is in-
cluded in his estate a lease which is not directed by the decedent to
pass to named legatees and which is a nondeductible terminable in-
terest. If the value of the lease is $50,000 or more, the statute will
disallow the marital deduction entirely, and if the value of the lease
is less than $50,000 (and no other nondeductible terminable interests
are included in the general estate) the marital deduction will be re-
duced by its value.

This result may appear to be harsh; but it is merely a consistent
application of the original settlement approach. As previously pointed
out, under that approach a marital deduction is not allowed for a life
estate where the decedent gives the remainder to others, even though
the life estate is reducible to (or is the equivalent of) cash. Given this
basic policy, in order to prevent its avoidance the Congressional plan
would seem to require disallowance of the deduction in the case of a
bequest of cash or other property which may be satisfied out of a
nondeductible terminable interest in the settlement of the estate.

The statute apparently assumes that in the case of a pecuniary
bequest the surviving spouse may accept a terminable interest in lieu
of cash, and hence the marital deduction is reduced by the value of
the nondeductible terminable interest which may be so used. How-

84 Id. at 14 (Example (2)).
85 For a similar example, see Senate Report, Part 2 at 14 (Example (1)). If the sur-
viving spouse is bequeathed both a pecuniary bequest and a residuary bequest, the order
in which the value of a nondeductible terminable interest is applied to reduce the marital
deduction for one and then the other would appear to be immaterial, but it would not
appear appropriate to duplicate the use of the same value of such terminable interest
for this purpose.
however, the statute also provides the same result even if the surviving spouse refuses to take an asset of the estate and requires the executor to sell assets in order to acquire the cash or other property she is to receive. Thus, the marital deduction in such cases is reduced by the value of any nondeductible terminable interests included in the assets which may be sold for this purpose. Apparently the only way to prevent the operation of this rule is by making it impossible for such terminable interests to be used for satisfaction of a bequest to the surviving spouse, as by specifically bequeathing such interests to others or directing their transfer (or payment of their proceeds) to creditors.⁸⁶

3. Directions to acquire a terminable interest. Up to this point, we have been discussing the disallowance of the marital deduction in the case of terminable interests in property which the decedent has. The view has been expressed that in such cases the marital deduction is disallowed because of a settlement which the decedent has made with respect to particular property in which he has an interest.

The statute, however, provides a broader application of the settlement concept in the case of directions by the decedent to his executor or trustee to acquire a terminable interest for his surviving spouse.⁸⁷ In such cases, the use of any part, or all, of the property of the decedent to acquire a terminable interest for the surviving spouse is, in effect, considered a settlement for which a marital deduction generally is not allowed. For example, suppose a decedent's will directs the executor to purchase an annuity for his surviving spouse for her life. The statute disallows the marital deduction for the value of the annuity regardless of the nature or extent of the assets in the estate which may be used for the acquisition.

This rule, however, is relaxed in the case of certain common forms of investment. Thus, the rule does not disallow the marital deduction if the executor or administrator is directed to acquire "a bond, note, or similar contractual obligation, the discharge of which would not have the effect of an annuity for life or a term."⁸⁸ However, the terminable interest rule will still apply⁸⁹ to bonds, notes, etc., if the interest specifically bequeathed, or directed to be acquired, for the surviving spouse is only a partial interest, if an interest in the bond

⁸⁷ Clause (iii) of § 812(e) (1) (B), INT. REV. CODE.
⁸⁸ Last sentence of § 812(e) (1) (B), INT. REV. CODE.
⁸⁹ Under clause (i) and (ii) or clause (iii) of § 812(e) (1) (B), INT. REV. CODE.
or note passes to another person from the decedent by gift or bequest, and if by reason of such interest such other person may possess or enjoy any part of the property after termination of the surviving spouse's interest.

What is a "similar contractual obligation, the discharge of which would not have the effect of an annuity for a life or a term"? The Senate Finance Committee report gives a rather obvious example of a contract which has the effect of an annuity. The case given is one in which the executor is directed to lend money to a trust and acquire its note for the surviving spouse with terms providing for the payment of principal and interest to her in equal installments of a term of years. The statute can hardly be limited to this simple example. Yet its purpose appears to be to allow a marital deduction for ordinary forms of investments, such as bonds or notes, but not for annuities. Presumably the statute will be construed in accordance with this purpose.

The rule disallowing the marital deduction for such terminable interests to be acquired by the executor or trustee again appears to be merely a logical extension of the basic policy. The same result might be reached without a specific statutory provision disallowing the deduction for such after-acquired terminable interests. In the case of a bequest under which the executor is directed to purchase an annuity, the surviving spouse has an interest in the property of the estate which may be used for the acquisition. In determining whether the interest in such property is terminable, the conditions imposed by the decedent must be taken into account. Where the interest is a right to a terminable interest (such as an annuity), the interest itself would appear to be a terminable interest.

The conversion at the direction of the decedent of his surviving spouse's interest into a terminable interest is not generally possible in the case of community property. Basically, therefore, a deduction should be disallowed on grounds of equalization for such terminable interests not possessed by the decedent.

However, this logical extension of the statute results in the following interesting situation: If a decedent purchases (in contemplation of death) an annuity for his wife, a marital deduction is allowed under the estate tax; but if he directs his executor to purchase the annuity, no marital deduction is allowed. How is this distinction justi-

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91 See notes 33, 34, supra.
fied? Perhaps the fact that in a community property state the surviving spouse's share of the property can be converted in the first manner but not in the second is a basis for the distinction. This would appear to be a thin distinction, however. The result illustrates the fundamental fact that there are two policies operating, one which allows the marital deduction for the annuity purchased by the decedent and the other which does not allow the deduction if the annuity is purchased by his executor. Either policy may be justified in its own setting, but when taken together they illustrate the inherent difficulties of "equalization" under the approach in the Revenue Act of 1948.

III. THE PROTECTION OF COMMON LAW METHODS OF DISPOSITION

The apparent conflicts in statutory policy which have been referred to arise from the desire to protect certain ordinary methods of disposing of property, even though such methods conflict with "equalization" under the settlement approach. A prime example, previously given, is of such protection is the allowance of a marital deduction for the interest in certain annuity contracts acquired by the decedent and included in his gross estate.

Another example, also previously mentioned, is an absolute remainder interest which may be bequeathed or devised to the surviving spouse after a bequest of a life estate to another person. However, of more importance, are three other methods customary in common law states for providing limited estates and for which the statute allows a marital deduction.

A. Property Held in Trust for Payment of Income.

One of the usual methods of estate disposition in common law states has been the creation of trusts to pay the income to the surviving spouse for her life. This device usually serves a number of purposes. It provides income for the support of the surviving spouse while at the same time protecting her and the property by placing its management in the hands of a trustee. It also avoids the estate tax on the property held in trust upon the death of the surviving spouse, unless such spouse is given a taxable power of appointment over the trust corpus.

92 See note 71, supra.
93 See p. 241, supra.
94 INT. REV. CODE § 811(f), which requires inclusion in the gross estate of the value of property over which the decedent has a "power of appointment" (as defined in § 811(f)(2)), whether or not the power is exercised, except in the case of a release prior to July 1, 1949 of a power created prior to enactment of the Revenue Act of 1942. PUB. LAW No. 635, 80th Cong., 2nd Sess. (June 12, 1948).
The testamentary creation of such a trust cannot ordinarily be accomplished by the decedent with his spouse's share of community property. Accordingly, a strict application of an "equalization" principle would appear to require rejection of a marital deduction for the interest of the surviving spouse in such a trust. However, the statute allows a marital deduction under carefully restricted circumstances for such trusts.

The two principal requirements are that the surviving spouse must be entitled for her life to all the income from the trust corpus and must have the power, exercisable alone, to appoint the entire corpus to herself or to her estate. The power to appoint is required to be so broad that it will fall into the category of taxable powers of appointment for estate tax and gift tax purposes. Therefore, if the law continues to subject to tax the nonexercise (as well as the exercise) of a power of appointment, the marital deduction in the case of such trusts may be justified on the ground that the property held in trust will be subject to an estate or gift tax in the hands of the surviving spouse.

The allowance of a marital deduction in the case of a trust where there is the required power of appointment illustrates the application of the statute in protecting common forms of disposition. Consider the case of a devise to one's spouse of a legal life estate with power in the spouse to appoint the remainder to her estate. Unless the state law

95 But cf. note 34, supra.

96 Int. Rev. Code § 812(e)(1)(F). The deduction under this provision is based upon the value of the corpus rather than the wife's right to income. Ruling published in C.C.H. Fed. Est. & Gift Tax Rep., 6018. Trusts not coming within § 812(e)(1)(F), are covered by the other rules of § 812(e)(1). This is not to deny a marital deduction for every other transfer in trust. For example, two cases in which a marital deduction may be allowed for bequests in trust are (1) in trust for W for 10 years and then to W, and (2) in trust to W for life and then to her estate. Senate Report, Part 2 at 16. The limitations under § 812(e)(1)(C) are nevertheless applicable; see Senate Report, Part 2 at 14.

97 Other requirements are (1) the trust must be created by a transfer of property by the decedent during his lifetime or by his direction under his will, (2) the income must be payable to the surviving spouse annually or at more frequent intervals, (3) the surviving spouse's power to appoint the corpus free of trust must be exercisable (whether exercisable by will or during life) in all events, and (4) if any person other than the surviving spouse has a power to appoint any part of the corpus, such power must be exercisable only in favor of the surviving spouse. The detailed application of these rules is set forth in Senate Report, Part 2 at 16-17.

98 In fact the power is required to be greater than that described in § 811(f)(2) as a "power of appointment." However, the definition of a "power of appointment" may be changed by future legislation. See, for example, H. R. 3553, 80th Cong., 1st Sess. The Senate Finance Committee has forewarned that "It is not intended that the allowance of the marital deduction with respect to the creation of a power of appointment will preclude such future revision as may be considered advisable." Senate Report at 29.
treats this disposition as giving a fee, no marital deduction is allowed for any part of the value of the property so devised.

The only difference between this case and the one the statute expressly protects is that in the latter the transfer or bequest is in trust. Presumably the reason for the difference in treatment under the statute is that the life estate in trust is the more "common" method of disposition, and the statute saves it for a marital deduction as a worthy exception to the general rule.

B. Life Insurance, Endowments and Annuity Contracts.

The statute also has a special rule saving for a marital deduction certain common methods of settling proceeds of life insurance, endowment and annuity contracts. Under the general rule of the statute, based on the settlement concept, a marital deduction is allowed for the proceeds of life insurance which are payable absolutely to the surviving spouse or her estate. In such cases it is immaterial whether the proceeds are payable in installments or in a lump sum. However, the general rule would not permit a marital deduction where the undistributed proceeds (as in the case of unpaid installments) may, upon the death of the surviving spouse, be paid under the terms of the policy not to her estate, but to other persons. Similarly, the same principles are applicable under the general rule of the statute to endowment and annuity contracts as to other forms of property.

An exception to the general rule was first provided in the Revenue Act of 1948 in the case of life insurance, corresponding generally to the special rule for trusts with powers of appointment. This rule was broadened by an amendment enacted in the closing days of the Eightieth Congress so as to extend this exception, particularly to cover an-
nuity and endowment contracts as well. This exception now permits a marital deduction—

"In the case of an interest in property passing from the decedent consisting of proceeds under a life insurance, endowment, or annuity contract, if under the terms of the contract such proceeds are payable in installments or are held by the insurer subject to an agreement to pay interest thereon (whether the proceeds, upon the termination of any interest payments, are payable in a lump sum or in annual or more frequent installments), and such installment or interest payments are payable annually or at more frequent intervals, commencing not later than thirteen months after the decedent's death, and all amounts payable during the life of the surviving spouse are payable only to such spouse, and such spouse has the power to appoint all amounts payable under such contract (exercisable in favor of such surviving spouse, or of the estate of such surviving spouse, or in favor of either, whether or not in each case the power is exercisable in favor of others), with no power in any other person to appoint to any person other than the surviving spouse any part of the amounts payable under such contract."\textsuperscript{106}

As the result of the recent amendment, the above rule for life insurance, endowment and annuity contracts more closely follows the pattern of the special rule for trusts with powers of appointment.\textsuperscript{107} The principal effect of the amendment in this regard is to make the above rule applicable where the proceeds of the policy are held by the insurance company for payment of interest to the surviving spouse (with the surviving spouse having power to appoint the entire proceeds). Under the Revenue Act of 1948, the special life insurance rule apparently applied if the proceeds were held for payments of installments but not if held for payment of interest only.\textsuperscript{108} The further ex-

\textsuperscript{106} \textit{INT. REV. CODE} § 812(e)(1)(G), as amended by Pub. L. No. 869, 80th Cong., 2nd Sess. (July 1, 1948).

\textsuperscript{107} The life insurance rule, however, does not require that the proceeds of the policy be held by the insurance company as trustee.

\textsuperscript{108} See Senate Report, Part 2 at 18. The effect of the amendments made by Pub. L. No. 868, supra note 106, is best summarized in H. R. Rep. No. 2370, 80th Cong., 2nd Sess., as follows: "The amendment expands the application of this provision [§ 812(e)(1)(G)] in the following respect:

"(1) The present provision applies only where some part of the principal is payable annually or at more frequent intervals. The amendment extends the application of the provision to include cases where the proceeds are held by the insurer subject to an agreement to pay only interest thereon annually or at more frequent intervals, and cases where interest is to be paid for a period and installments of the proceeds are to be paid for a period. In all such cases, however, payments of either or both must be made at least annually until the proceeds are disposed of in accordance with the terms of the contract.

"(2) The amendment requires that the first payment (interest or installment, as
tension of this special rule, however, to endowment and annuity contracts makes more obvious the difference in the treatment of certain less favored forms of estate disposition, especially the legal life estate coupled with a power of appointment.

C. Bequests, etc., Subject to a "Common Disaster Clause."

A frequent device for avoiding disputes between heirs, and for attempting to insure that property bequeathed to one's spouse will be for her use and enjoyment, is a "common disaster clause" in a will or insurance policy. Such clause may have the effect of making a bequest to a surviving spouse a contingent (i.e. terminable) interest. For example, suppose the decedent provides in his will that if his spouse dies as a result of a common disaster with him, the property devised to her shall pass instead to the decedent's sister. In such a case, if in

the case may be) be payable under the terms of the contract not later than 13 months after the decedent's death, instead of within 1 year after his death as under the present provision.

"(3) The present provision applies only to insurance upon the life of the decedent. The amendment makes the provision applicable also to proceeds under an insurance contract upon the life of another where the insured predeceases the decedent.

"(4) The amendment also extends the provision to annuity and endowment contracts.

"(5) Under the present provision and the amendment the surviving spouse must have power to appoint all amounts payable after the decedent's death under such contract (to the extent not previously paid). The amendment clarifies this requirement by providing that a power will qualify under this provision if it is exercisable in favor of the surviving spouse or her estate (or in favor of either, whether or not exercisable in favor of others). The amendment also adds a provision (corresponding to a similar provision under section 811(e)(1)(F) of the code, relating to trusts) requiring that if any person other than the surviving spouse has a power to appoint any part of the amounts payable under the contract, such power must not be exercisable for the benefits of any person other than the surviving spouse.

"In order to qualify for a marital deduction the requirements of section 812(e)(1)(G) must be met by the terms of the contract, viewed as of the date of the decedent's death.

"The amendment is applicable with respect to estates of decedents dying after December 31, 1947."

To the same effect is Sen. Rep. No. 1746, 80th Cong., 2nd Sess.

109 See 16 AM. JUR. 33. State laws and clauses in instruments as to the presumption of survivorship applicable only where it is impossible to determine survivorship (see 16 AM. JUR. 33 et seq.) generally have the purpose above described but do not give rise to a marital deduction problem. In such a case, the interest of a spouse is not terminable merely by reason of such law or clause; for the passing of the interest to her is determined as of the moment of the decedent's death by her survivorship alone. See Senate Report, Part 2 at 16. But the problem raised in the main text does arise under the following type of state law: "When the surviving spouse or other heir at law or legatee dies within three days after the death of the decedent, or within thirty days after the date of death of such decedent if such death resulted from a common accident, the estate of such
fact the surviving spouse is injured in an accident in which the decedent dies, then at the time of the decedent’s death the surviving spouse has a terminable interest. Under the terminable interest rule the marital deduction would be disallowed because of the interest which has passed to the decedent’s sister (even though such interest is only contingent). It may be noted that the decedent in such a case has placed an obstacle to the taking by the surviving spouse of her share of the property which could not be done with respect to the surviving spouse’s share of community property.

However, the statute provides a special rule which permits use of most forms of common disaster clauses with impunity. Despite the contingency created by such clauses, the marital deduction is allowed if in fact the clause does not defeat the interest of the surviving spouse. Thus, even though it is doubtful at the time of the decedent’s death whether the surviving spouse will survive the common accident, the marital deduction will not be disallowed by reason of the common disaster clause as long as the surviving spouse eventually takes the property.

The determination of the estate tax may be delayed in the case of a spouse who lingers on the brink after an accident, but it can be supposed that generally the facts or a presumption will be determinative in a reasonable time of whether the surviving spouse may die as a result of a particular accident.

The statute also gives the benefit of the same treatment to clauses which provide in effect that the surviving spouse’s interest will be vested only if she is alive after a certain limited period (six months, under the statute) after the decedent’s death. Suppose, for example, the decedent’s will creates a trust of the residue of his estate to accumulate the income for six months and then to transfer the trust assets to his spouse if then living, or if not, to his sister absolutely. Such a clause may have the same general purpose as a common disaster clause.
cordingly, the statute allows a marital deduction for the value of such a bequest if in fact the surviving spouse outlives the designated period and takes the property. It should be noted that the deduction in such a case is for the value of the interest included in the decedent's gross estate, without reduction for the effect of the contingency (at the time of the decedent's death) which in fact does not occur.

IV. SPECIAL PROBLEMS IN DETERMINING THE MARITAL DEDUCTION

The determination of concepts and general policy under the marital deduction system do not settle many equally important problems of a more technical nature. These problems are dealt with in varying degrees by the statute.

A. The Transfer Concept.

Under the community property system the surviving spouse generally acquires a share in each item of community property automatically under the state law. Hence the state law, as given effect under the estate tax, provides the method of excluding the surviving spouse's interest from the decedent's estate. In the case of non-community property, however, the interest of the surviving spouse in property of the decedent may be acquired by a number of different ways. However, the purpose of the marital deduction system is to allow the decedent's

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115 Senate Report, Part 2 at 15.

116 Only the principal technical problems are discussed in this section. The phrase "surviving spouse" covers also a multitude of minor problems. The community property system has the effect of "property splitting" only during marriage. The Revenue Act of 1948 goes further by allowing a marital deduction for a transfer (under § 811(c) or (d), Int. Rev. Code) to a person not the transferor's spouse if such person is his surviving spouse at his death. Senate Report, Part 2 at 6. Also in the case of community property, the survivor's share is her separate property and upon remarriage no property splitting results with the new spouse from the community property system, except by a transfer (subject to the gift tax on the one-half of the property) to the community. The marital deduction system goes further, however, by permitting the property which a surviving spouse acquired free of estate tax (by reason of a marital deduction allowed her spouse) to be bequeathed by her to her new spouse free of estate tax (by reason of a marital deduction), and so on as long as the surviving spouse remarries. See speech of Senator O'Mahoney, 94 Cong. Rec. 3239 (March 19, 1948). (The German inheritance tax law of 1922, under which property left to a husband or wife was exempted, met this problem by disallowing the exemption where the difference in their ages was more than 20 years and they had been married for less than 5 years. Joint Committee on Internal Revenue Taxation, Federal and State Death Taxes, 66 (1933).) On the other hand, the community property system permits splitting for estate tax purposes of transfers to third parties which the marital deduction system under the estate tax does not (the gift splitting provisions not being applicable. Senate Report, Part 2 at 34).

117 See note 33, supra.
estate a deduction for the interests in property which the surviving spouse acquires from the decedent only where such interests are included in his gross estate.\textsuperscript{118}

In the previous discussion of concepts and policies, reference was generally made only to bequests and devises of interests in property. Actually these terms are too limited to describe the interests included in the decedent's gross estate which may be acquired by his surviving spouse. Accordingly, the statute introduces a new concept of the "passing" of interests in property from the decedent.

The phrase "passing from the decedent" is defined in the statute\textsuperscript{119} and as so defined is "broad enough to cover all the interests included in determining the value of the decedent's gross estate"\textsuperscript{120} under the transfer concept\textsuperscript{121} of the estate tax.

An interest is considered as passing from the decedent if he transfers,\textsuperscript{122} bequeaths or devises the interest or it is inherited from him.\textsuperscript{123} The dower or curtesy interest of the decedent's surviving spouse (or statutory interest in lieu thereof) is also considered as passing from the decedent to the surviving spouse.\textsuperscript{124} The Senate Finance Committee Report states that the interest of the surviving spouse in pre-1927 California community property (in which the wife had only an "ex-
pectancy") is an interest which is considered as "passing from the decedent" within the definition applicable to the marital deduction.\textsuperscript{125} The interest of a survivor in property held in joint ownership (with the decedent) with right of survivorship is also considered under the statute to pass from the decedent.\textsuperscript{126} This rule applies to joint tenancies and tenancies by the entirety. It does not apply to a surviving spouse's share of community property, since such property is not held with right of survivorship.\textsuperscript{127}

If the decedent had a power to appoint property, then, under the statutory definition,\textsuperscript{128} the person who takes an interest by reason of an exercise, non-exercise, or release of the power is considered to take the interest from the decedent rather than from the creator of the power.\textsuperscript{129}

Proceeds of insurance upon the life of the decedent are considered as passing from the decedent to the person entitled to the proceeds.\textsuperscript{130} This special provision rounds out the definition and prevents the argument that the proceeds pass from the insurance company.

The definition of an interest passing from the decedent to his surviving spouse will exclude certain interests in property which the surviving spouse may take. Thus, the interest of a surviving spouse as a creditor of the estate cannot be the basis of a marital deduction, nor can any payments she may receive in satisfaction of her claim.\textsuperscript{131} Similarly, the interest passing from the decedent is only such interest as he can give, and does not include any of his property which is acquired by


\textsuperscript{126} This rule applies to interests in property includible in the gross estate (by reason of the power) under \$ 811(f). It also applies to interests subject to a non-taxable power, which is significant for the purpose of interests passing to persons other than the surviving spouse under the terminable interest rule. See Senate Report, Part 2 at 9.

\textsuperscript{127} INT. REV. CODE \$ 812(e) (3) (E). Such interest is includible in the gross estate to the extent provided in \$ 811(e), INT. REV. CODE.

\textsuperscript{128} INT. REV. CODE \$ 812(e) (3) (F).

\textsuperscript{129} INT. REV. CODE \$ 812(e) (3) (G). Such proceeds are includible in the decedent's gross estate under \$ 811(g), INT. REV. CODE.

\textsuperscript{130} Senate Report, Part 2 at 3. This prevents deductions for the same item under both \$ 812(b) and \$ 812(e). For example, a surviving spouse's claim against the estate based upon a separation agreement which is deductible under \$ 812(b) (see E. T. 19, 1946-2 CUM. BULL. 166) will not support a marital deduction.
using the estate income or the surviving spouse’s property to pay off creditors.\(^{132}\)

**B. Will Contests, Renunciations, and Disclaimers.**

The statutory definition of “passing from the decedent,” while supplying a rule expressing the transfer concept, is in turn dependent for its application upon practical aspects of inheritances. Problems arise in giving effect to wills and the acts of the heirs and legatees in determining whether an interest in property has passed *from the decedent.*

Will contests are a fruitful source of problems. If a controversy develops as to the interpretation of a will, or as to the right of the surviving spouse or any other person to take a bequest, then the question will arise as to how the interest passing from the decedent is to be determined. Is the determination to be made on the basis of the will, and if so, according to whose interpretation? In this regard, the Senate Finance Committee Report makes only the cautious statement that “proper regard should be given to interpretations of the will rendered by a court in a bona fide adversary proceeding.”\(^{183}\)

If under a settlement of a will contest, the surviving spouse receives a greater share of the estate or a smaller share of the estate than the will if not contested would provide, how is the marital deduction to be determined? It would seem unquestionable that if the surviving spouse takes a smaller interest upon settlement of a controversy than she would otherwise take, the marital deduction can be allowed only for the interest which she actually takes.\(^{134}\) On the other hand, if the surviving spouse takes a greater share under a settlement than the will would otherwise provide, the marital deduction may not be allowed for the entire interest.\(^{135}\) The executor in attempting to obtain

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\(^{132}\) Senate Report, Part 2 at 6. This result is similar to that obtained in determining the property received from a prior decedent for purposes of the deduction (§ 812(c), INT. REV. CODE) for property previously taxed. McCarthy v. Delaney (D. Mass. 1948) 76 F. Supp. 471.

\(^{133}\) Senate Report, Part 2 at 4. A consent decree in a probate court to a particular interpretation of a will which produces tax benefits may be questioned. See generally 1 PAUL, *op. cit. supra* note 19, § 1.11.

\(^{134}\) Senate Report, Part 2 at 4-6. For a similar rule in determining the deduction for charitable bequests where a charitable organization surrenders a part of a bequest as a result of a controversy, see U.S. TREAS. REGS. 105, § 81.44. Heim v. Nee (W. D. Mo. 1937) 40 F. Supp. 594.

\(^{135}\) See Senate Report, Part 2 at 5. As to a curious case in which a deduction for charitable bequests was allowed where the will did not provide such bequests but a compromise settlement included charitable gifts, see Smith v. Commissioner (C.C.A. 1st 1935) 78 F. (2d) 897.
the marital deduction must overcome the hurdle of establishing that
the interest received by the surviving spouse comes from the decedent
and not from other interested parties. If the settlement reflects the
surviving spouse's rights in the decedent's property under the local
law, then there would appear to be no objection to the allowance of
the marital deduction based upon the settlement. However, a settle-
ment which has the effect of increasing the potential marital deduction
(and thereby saving estate taxes) is likely to be scrutinized carefully
for the bona fides of the heirs in "surrendering" any part of their in-
terests. Such a surrender may be a gift from the heirs or the creation
of a secret trust.

If a surviving spouse renounces her rights under a will and elects
to take instead her dower interest under the local law, is the marital
deduction determined from the will or the nature of her dower in-
terest? In such a case the only interest passing to the surviving spouse
would be that under the local law rather than under the will, and the
Senate Finance Committee Report so indicates. The point is im-
portant not only as to the amount of the marital deduction but also as
to whether the deduction will be allowed in case of a terminable in-
terest. Suppose, for example, the decedent's will directs the creation
of a trust for the benefit of the surviving spouse under such terms that
the marital deduction would be allowed; but the surviving spouse
elects to take instead her dower interest which may be only a life
estate in one-half of the decedent's realty. In such a case, the marital
deduction would not be allowed because of the nature of the terminable
interest taken under the local law.

On the other hand, if the local law provides a fee simple interest
as dower, but the widow takes under a will which gives her only a
life estate (with remainder over to others), will a marital deduction
be allowed? It might be argued that the widow received the fee simple
interest and (by surrendering it) purchased the life estate. However,
this argument has been rejected by the courts and in the Committee

Disclaimers by the surviving spouse and other persons of bequests
or devises under a will present a related problem. As to this, how-

138 Senate Report, Part 2 at 5.
137 See for example, 3 N. J. STAT. ANN. § 37-1, -2.
139 Senate Report, Part 2 at 5. Compare note 34, supra.
140 "A disclaimer is a complete and unqualified refusal to accept the rights to which
one is entitled." Senate Report, Part 2 at 5. This definition is the same as that in § 81.44
ever, there is a special statutory provision.\textsuperscript{141} The effect of the statute is, in general, to treat a disclaimer as effective if made by the surviving spouse, but not effective if made by any other person. Thus, if a widow disclaims a bequest from her husband, the interest attempted to be bequeathed to her is considered as passing to the person or persons entitled to receive the interest by reason of the disclaimer.\textsuperscript{142} On the other hand, if another person disclaims a bequest so that the disclaimed interest falls into the residue bequeathed to the surviving spouse, the disclaimed interest is considered as passing from the decedent in accordance with the original bequest.\textsuperscript{143} The interest passes from the decedent to the person who makes the disclaimer and the interest which the surviving spouse takes in such case is, in effect, considered as received from the other legatee and not as passing to the surviving spouse from the decedent.

C. Valuation.

Since the purpose of the marital deduction is to reduce the decedent's estate tax base, the value of the interest passing to the surviving spouse for which a deduction is allowed should be the value used in determining his gross estate. The statute so provides.\textsuperscript{144}

However, the value of property alone may not determine the value

\textsuperscript{141} \textit{Int. Rev. Code} § 812(e)(4).

\textsuperscript{142} But if the interest disclaimed by the surviving spouse falls into the residue which is bequeathed to her the interest will be considered as passing to her from the decedent by reason of the disclaimer. Senate Report, Part 2 at 5. However, this rule does not contravene subparagraph (C) of § 812(e)(1) which may reduce the marital deduction for other nondeductible terminable interests in the residue. See Senate Report, Part 2 at 15.

\textsuperscript{143} This result might have been reached without the special statutory provision. A similar problem existed in the case of disclaimed legacies passing in the residue to charity under the law prior to the Revenue Act of 1942. § 408(a) of this Act amended § 812(d), \textit{Int. Rev. Code} in order specifically to allow the deduction for the property passing to charity if the disclaimer is made before the date the estate tax return is due. \textit{But cf.} Commissioner v. Macaulay, Est. (C. C. A. 2nd 1945) 150 F. (2d) 847.

\textsuperscript{144} \textit{Int. Rev. Code} § 812(e)(1)(A). If the executor elects to use the optional method of valuation under § 811(j), \textit{Int. Rev. Code}, the value of the interest passing to the surviving spouse is determined accordingly. See § 364, Rev. Act of 1948 amending § 811(j). For an example of such valuation of the interest passing to the surviving spouse, see Senate Report, Part 2 at 4.
of the interest passing to the surviving spouse. Account may have to be taken of conditions and obligations to which the right to enjoyment of an interest in property is subject. Actually this is not, in the first instance, a matter of valuation but of determining the interest which the surviving spouse takes from the decedent. Thus, a bequest of Blackacre, which has a value of $100,000 but which is subject to a $60,000 mortgage, is actually a bequest of only a $40,000 interest in property, for that is all the decedent has to give.\textsuperscript{145}

The statute,\textsuperscript{146} however, approaches the problem as one of valuation, following the precedent of the deduction for charitable bequests and a peculiar legislative history under that provision.\textsuperscript{147} This approach is to allow a deduction only for the net value to the surviving spouse of the interest in property which is the subject of the bequest.\textsuperscript{148} There are two aspects of this approach.

The first aspect involves the effect which an estate, succession, legacy or inheritance tax has upon the net value to the surviving spouse of the interest in property which is bequeathed.\textsuperscript{149} For example, if the decedent bequeaths the residue of his estate to his surviving spouse and the federal estate tax is payable out of the residue, the value of the residue passing to the surviving spouse is the residue after payment of the tax. Since the federal estate tax cannot be determined until the marital deduction is known, and vice versa, the determination of mutually dependent unknown quantities is involved. The same mathematical problem will arise, with more or less degrees of complexity,
where the interest passing to the surviving spouse, whether under the residue or a specific bequest, is subject to the burden of the federal or state death tax as a matter of general law or under a state apportionment law. This problem is similar to that existing in the case of bequests to charities but it is more complicated by reason of the 50 per cent limitation on the aggregate of marital deductions and it also will be more frequent in the case of bequests to spouses.

The second aspect of the “net value” approach is applied in cases in which the interest (or property in which the surviving spouse has an interest) is incumbered, or where the surviving spouse incurs an obligation imposed by the decedent with respect to the passing of the interest to her. The statute expressly provides that in such cases the incumbrance or obligation shall be taken into account in the same manner as if a gift of the interest in property to the spouse were being determined. The rationale of this provision appears to be that the concept of a gift (under the gift tax law) should be applied to determine the value of the interest the surviving spouse takes. Thus, if a gift is made of property with a value of $5,000 to X, with X, however, agreeing to pay $1,000 to Y, the gift to X is clearly only $4,000. The same concept would appear to be applicable for purposes of the estate tax marital deduction. It should be noted, however, that if a condition is imposed so that the interest of the surviving spouse will terminate or fail in the event of her non-performance, then the interest may be a terminable interest and the marital deduction disallowed under the terminable interest rule.

V. COMPUTATION OF THE ESTATE TAX MARITAL DEDUCTION: THE FIFTY PER CENT LIMITATION

Once the hurdle is passed of determining that a marital deduction is allowable for an interest in property passing to the surviving spouse, the additional hurdle of the overall 50 per cent limitation on the aggregate amount of the marital deductions must be met. This limitation is an amount—which the aggregate amount of marital deductions cannot exceed—equal to 50 per cent of the “adjusted gross estate.” The

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151 See 1 UNDEmumL, op. cit. supra note 75, § 398 as to the effect of charges on legacies.
152 See note 148, supra.
154 INT. REV. CODE § 812(e)(1)(E).
"adjusted gross estate" is a new, defined term in the law and is discussed hereinafter.

The purpose of the 50 per cent limitation is to establish mathematical equalization with the estate tax treatment of community property. A system which sought equalization with the usual case where the entire wealth of a married couple was community property would presumably permit marital deductions up to 50 per cent of the combined wealth of the spouses at the death of the first to die. Practical considerations, however, weigh against valuation of the surviving spouse's "estate" at that time. The Revenue Act of 1948 adopts the less exact method of determining the 50 per cent limitation upon the basis of the decedent's estate.

In using the 50 per cent limitation as a device for equalization, the pattern to be followed is the manner in which the community property system is applied. In computing the net estate of a decedent who has only an interest in community property, there is generally deducted, in the case of community debts, only his share of such debts. Other deductions provided under the estate tax law—the $60,000 exemption, the deduction for property previously taxed, and the deduction for charitable bequests—come out of the decedent's share of the community property and do not serve to reduce his surviving spouse's share. Accordingly, in order to bring equivalent results in the case of non-community property, the 50 per cent limitation should be based upon such property included in the decedent's gross estate reduced only by the deductible claims against such property.

The "adjusted gross estate" is computed in the manner just described. That is, it is generally the value of the gross estate minus the deductions under section 812(b) of the Code for claims against the estate, etc. However, in the case of community property there are two important special aspects of the "adjusted gross estate" computation. The first is that the adjusted gross is computed only on a separate

155 INT. REV. CODE § 812(e) (2).
156 A. B. A. SUPP. REP., supra note 15 at 3.
158 INT. REV. CODE § 812(b).
159 The A. B. A. Bill would have had this result. The 50 per cent limitation was determined from the net estate computed only without the $60,000 exemption.
160 INT. REV. CODE § 812(e) (2)(A).
property basis, both as to the gross estate and as to the deductions under section 812(b).

The statute requires that the decedent’s share of community property, which is included in his gross estate, be subtracted in determining the adjusted gross estate. The statute also provides, in effect, that only that part of the deductions under section 812(b) (for claims against the estate, etc.) which are allocated to separate property in the gross estate are also to be further subtracted from the gross estate in arriving at the adjusted gross estate. This latter allocation of deductions is provided by a formula which avoids determinations under state law as to whether debts are community or separate charges. In other words, the statute arbitrarily allocates a proportionate part of each debt to the separate property in the ratio that the separate property bears to the entire gross estate. Where the community debts can be identified and the amount thereof is less than the statute allocates, in effect, to community property, the statute will have the effect of providing a larger adjusted gross estate than if such debts were actually allocated to the community property and only the balance of the debts subtracted in determining the adjusted gross estate; but the opposite is the case where the community debts are greater than the amount allocated under the statutory formula. But the statutory formula has the advantage of being a simple rule which is easy to apply. Despite the nature of the statutory formula it is probably just as realistic—and less productive of conflicts—than a rule which would attempt to allocate debts on the basis of state law.

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161 Intr. Rev. Code § 812(e) (2) (B). The community property referred to is the decedent’s share of community property held at death and included in his gross estate under § 811(a); his share of community property transferred during life and included in his gross estate under § 811(c) or (d); and insurance proceeds on his life to the extent purchased with community funds. However, this does not include (1) property held as community property with a spouse other than the decedent’s surviving spouse (as at the time of a transfer during life), and (2) community property held under the California law in effect prior to the Act of July 29, 1927 (adding Cal. Civ. Code § 161(a)) which is includible in full in the husband’s estate. See note 125, supra.

162 This will approximate the result in the case of a wholly non-community property estate where only the § 812(b) deductions (separate debts, etc.) are subtracted from the gross estate (separate property) in determining the adjusted gross estate.

163 As to the confusion in determining community and separate debts, see 1 De Funiak, op. cit. supra note 7, § 161, et seq.

164 While an allocation on the basis of state law might be made as to debts, there is generally no basis under state law for apportioning administrative expenses, funeral expenses, etc. (which are deductible under § 812(b)) between community property and separate property. Cf. Blair v. Stewart (C. C. A. 5th 1931) 49 F. (2d) 257. The statutory formula represents an application of the practical rule of apportioning debts to a dece-
ESTATE AND GIFT TAX EQUALIZATION

The computation of the adjusted gross estate, however, is not without its complexities. These arise principally in the necessity for treating as community property certain separate property acquired by conversion of community property. The reason for such treatment appears clear enough. Suppose a man and wife have only community property. If he leaves his share to his spouse, no marital deduction will be allowed. If the parties partition the property so that each takes one-half as separate property, should a marital deduction be allowed if the husband devises such separate property to his widow? Since there is no gift tax imposed in the case of such partition, allowance of the marital deduction would permit a tax advantage through a nontaxable change in form of ownership, which would not be allowed for a bequest to a spouse of the decedent's share of community property.

The statute addresses itself to this problem by a rule applicable generally in cases in which during the calendar year 1942 or after April 2, 1948 community property was converted into separate property of the decedent and his spouse. In such cases, the separate property so acquired by the decedent, and property acquired in exchange therefor, is treated as community property which is to be subtracted from the gross estate in determining the adjusted gross estate.

The statutory rule is not limited to partitions of community property into the divided separate property of each spouse. It applies as well to a conversion of community property into another form of co-ownership, such as a tenancy in common, tenancy by the entirety or


\[\text{107}\] The application of the rule to 1942 conversions of community property is apparently based upon the assumption that community property was partitioned then to forestall the tax disadvantages of the 1942 amendments, which were applicable to gifts made after December 31, 1942. See Altman, New Estate and Gift Taxes (May 1948) 26 Taxes 407, 408. The application of the rule to conversions after April 2, 1948 is based upon the effective date of the gift tax provisions of the 1948 Act.

\[\text{108}\] By one exchange or a series of exchanges. See Senate Report, Part 2 at 20. The rule does not apply to separate property acquired by conversions of pre-1927 California community property (see note 161, supra) since a gift tax would be paid upon the partition of such property. Cf. Gillis v. Welch (C. C. A. 9th 1935) 80 F. (2d) 165. However, the rule does apply to community property received by the spouses from a third party (on which gift tax or estate tax might have been paid). Senate Report, Part 2 at 21.
joint tenancy. It also applies to any unequal division of the interests of the spouses in community property, but in such cases, the separate property so acquired is considered as community property only to the extent that it represents a true partition, that is, an equal division of property between the spouses. If the decedent receives a greater share of the property than his spouse takes in the conversion, only the portion of property which is equal to the share taken by his spouse is considered as “community property.” If a wife surrenders her entire interest in property held by them as community property, to her husband so that he holds the entire property as separate property, no part of such property will, under the statute, be considered as community property.

The statute imposes a burden of tracing the gross estate with respect to any separate property of a decedent included in his gross estate, if the decedent and his surviving spouse had any community property in 1942 or after April 2, 1948. There appears no way to avoid the necessity for this rule—and its complexities—under the basic policy of “equalization” of the Revenue Act of 1948.

The second community property aspect of the adjusted gross estate computation is that a marital deduction may in some cases be allowed for a bequest from the decedent’s share of community property. It might be supposed that since the community property law automatically provides a 50-50 split of property, no marital deduction would be allowed for a bequest of the decedent’s interest in community property. This should—and will—be the result where the decedent has only a share of community property, for otherwise (upon a bequest of his entire interest to his spouse) 75 per cent of the property would be held by his surviving spouse free of estate and gift taxes as compared with only 50 per cent received free of such taxes in the case of non-community property (with a marital deduction allowed). However, what if the decedent’s gross estate includes separate property (not considered as “community property” under the rule previously dis-

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169 Senate Report, Part 2 at 20.
170 Int. Rev. Code § 812(e) (2) (C) (ii). The portion of the separate property acquired in the conversion which is considered as community property is a percentage of such separate property (and not a dollar amount) and accordingly the same ratio is applicable in determining the portion of property acquired in an exchange which is to be considered as community property. Senate Report, Part 2 at 21.
171 Senate Report, Part 2 at 21.
172 This burden presumably will be lighter than that under the 1942 amendments because it begins more or less currently and is also accompanied by tax reduction (return to the pre-1942 treatment of community property).
cussed), as well as an interest in community property? While it may still be argued that a marital deduction should not be allowed for a bequest of his interest in community property, application of such an argument would necessitate "earmarking dollars." For example, suppose a decedent has $100,000 in stock which is separate property and holds with his spouse $200,000 of real estate outright as community property. Assume he bequeaths $50,000 to her. From which property is the bequest to be considered made? The statute avoids this problem by permitting a marital deduction to be taken (where otherwise allowed) whether the bequest is of community or non-community property; but the 50 per cent limitation is computed upon the basis of an adjusted gross estate determined only with reference to separate property. Accordingly, if the decedent has only community property, his adjusted gross estate—and consequently any marital deduction—is zero.

VI. THE GIFT TAX: MARITAL DEDUCTIONS AND SPLITTING OF GIFTS

The gift tax, like the estate tax, is concerned with transfers of property. In purpose and design it is generally supplemental to the estate tax, and is intended generally to achieve a unified scheme of taxation of transfers whether made during life or at death. Accordingly, the fundamental problems of "equalization" under the estate tax carry over to the gift tax on interspouse transfers.

A. The Gift Tax Marital Deduction.

The community property laws are generally recognized for tax purposes, as creating a division of property between the spouses. Community property, upon being derived from property or earned, may be considered by virtue of the state law as owned one-half by each spouse, and no gift tax is then imposed. If a gift is made by one spouse of his interest in community property to the other spouse, then, under the community property law as given effect once again by the Revenue Act of 1948, a gift is considered made only to the extent of

174 Ibid.
175 See 2 PAUL, op. cit. supra note 19, § 15.04 as to the need for further integration and correlation of the estate, gift, and income taxes. See FEDERAL ESTATE AND GIFT TAXES (1947), a joint study prepared by an Advisory Committee to the Treasury Department and others.
176 See note 7, supra.
one-half of the property; for that is all the donor would be considered as able to give.

In seeking to provide a similar pattern of gift taxation for non-community property, the fundamental problem (as under the estate tax) is whether “equalization” is to be determined with reference to the decedent’s dispositions of all of his property or of separate items of property. Thus, it may well be said that equalization cannot be attained except by a complete exemption from the gift tax of the gifts by a husband to his wife until there is an equal division of property between them; but, thereafter, any interspouse gifts should be fully taxable. On the other hand, if “equalization” is to be determined with reference to each item of property, then the community property theory of equal ownership by the spouses may be applied and the donor considered as making a gift of only one-half of the property (the other half passing tax free). It should be noted under this second approach, however, that if a husband in a common law state desires his wife to own half of the property (as she would in a community property state), then, upon his gift of half the property to her, one-half thereof (25 per cent of the property) would be subject to the gift tax. This may be contrasted with the automatic tax-free division of community property between spouses by virtue of the community property law.178

The Revenue Act of 1948 adopts the second approach to gift tax equalization. Thus, under the statute a marital deduction is allowed for each gift (which meets the statutory tests) made after April 2,
1948 to the donor’s spouse.\(^{179}\) The deduction is 50 per cent of the value of the gift.\(^{180}\)

It may be noted that the method of computation of the gift tax marital deduction is different from that under the estate tax. Under the gift tax the deduction is an amount equal to one-half of a gift to the spouse.\(^{181}\) Under the estate tax the deduction for each interest in property passing to the surviving spouse is the entire value of the interest, but the total amount of such deductions is subject to the 50 per cent limitation (based on the adjusted gross estate). The significance of this difference is that, while a gift tax may be imposed, in effect, as to half of a particular item of property given to a spouse during life, no estate tax may be imposed as to such property if transferred under the decedent’s will to his surviving spouse (as long as the value of the property does not exceed 50 per cent of the adjusted gross estate).\(^{182}\)

The gift tax statute does not generally permit a marital deduction for a gift of a donor’s interest in community property to his spouse.\(^{183}\) This is because the spouses have already enjoyed, in effect, a marital deduction by virtue of the tax-free division of the property by operation of the community property law. In order to give consistent application to this rule, the gift tax disallows the marital deduction for gifts of separate property acquired (as determined under rules similar to the corresponding estate tax provision) by conversions of community property.

\(^{179}\) \textsc{Int. Rev. Code} \S 1004(a) (3). The deduction is allowed only in computing net gifts of a donor who is a citizen or resident of the United States, although the donee—spouse need not be a citizen or resident. The donee must be the donor’s spouse at the time of the gift. \textit{Senate Report, Part 2} at 30.

\(^{180}\) \textsc{Int. Rev. Code} \S 1004(a) (3)(A).

\(^{181}\) The marital deduction is computed so as to bring the same mathematical results as a gift of the donor’s interest in community property. The deduction is computed before the annual exclusion ($3,000) for gifts (other than gifts of future interests in property) made to any person by the donor (\S 1003(b)(3), \textsc{Int. Rev. Code}), subject, however, to the limitation that the total marital deductions for any calendar year shall not exceed the total amount of gifts to the donor’s spouse (for which the deduction is allowed) after the annual exclusion (\textsc{Int. Rev. Code} \S 1004(c)). For example, if the only gift in 1949 by a husband to his wife is $5,000, an exclusion of $3,000 is allowed and a marital deduction of $2,000 is allowed. If he makes two gifts of $5,000 to his wife, one exclusion of $3,000 is allowed and the aggregate amount of marital deductions allowed is $5,000. \textit{Senate Report, Part 2} at 30.

\(^{182}\) As to credit for gift tax where the value of the gift is also included in the donor’s gross estate, see note 201, \textit{infra}.

\(^{183}\) \textsc{Int. Rev. Code} \S 1004(a)(3)(F). An exception to the general rule is pre-1927 California community property, a gift of which is considered entirely that of the husband. See note 168, \textit{supra}.
The gift tax law also applies the settlement concept in determining whether a marital deduction is allowable for a gift to a spouse of an interest in a particular property. The law is patterned after the corresponding estate tax provisions with respect to terminable interests and gifts in trust. In only two respects is there an important difference in the interests in property for which the estate tax and gift tax marital deductions are allowed.

In applying the terminable interest rule under the gift tax, the interest retained by the donor must be taken into account. Thus, if a husband gives his wife a life estate, and retains the remainder interest, no marital deduction is allowed for the gift of the life estate. The rationale of this rule is the same as the settlement concept under the estate tax; that is, the donor has given his spouse a terminable interest which is not coextensive with his interest in the property—a limitation which a husband cannot impose on his wife's share of community property. The same principle is applicable whether the donor retains what is technically an interest in property or only a power to appoint an interest in the property.

Gifts of property in co-ownership also present a special problem for the marital deduction system. Where a husband transfers by gift an interest in his property to his wife as joint tenant or as tenant by the entirety, he, in effect, retains a survivorship interest. Ordinarily this would necessitate disallowance of the marital deduction for the gift under the terminable interest rule. Here again the statute departs from the settlement concept to permit a marital deduction for one-half of the value of the donor's gift to his spouse as sole joint tenant with him or as tenant by the entirety. This result may be justified on the ground that such gifts result in the creation of estates similar to com-

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184 INT. REV. CODE § 1004(a)(3)(B) and (C).
186 INT. REV. CODE § 1004(a)(3)(B)(i). The statute applies in cases in which the donor "immediately after the transfer to the donee-spoise has a power to appoint an interest" in the property. Thus, it applies where the donor actually retains a power or in effect retains a power by receiving back a power from the donee-spoise. The statutory rule applies whether or not the power is a taxable power of appointment for gift tax purposes and whether or not the exercise or release of the power is taxable. Senate Report, Part 2 at 31.
187 INT. REV. CODE § 1004(a)(3)(D). Note that this rule applies only where the husband and wife are the co-owners; a transfer into a joint tenancy of husband, wife, and another person or persons runs afoul of the terminable interest rule. However, a gift to a spouse as tenant in common (with or without others) in the entire property does not come under the terminable interest rule.
commum property.\textsuperscript{188} The donor's gift to his wife as sole joint tenant or as tenant by the entirety may also be included in his gross estate.\textsuperscript{189}

B. Splitting of Gifts to Third Parties

Up to this time we have been discussing equalization in the application of the estate tax and gift tax to interspouse transfers. What of equalization in the case of husband or wife gifts to third parties?

By virtue of the effect given to the community property system, a gift of community property to a person outside the husband-wife unit is treated as a gift by each spouse of his interest; that is, if each has a "vested" interest each makes half the gift.\textsuperscript{190} There is generally no advantage in a husband dividing his non-community property with his wife in order that each may make half the gift to a third party, for the gift to the wife will first be subject to a gift tax. Accordingly, equalization in the gift tax treatment of gifts to third parties must proceed upon the basis of a tax-free division of the subject of the gift between the spouses.

The statute provides this equalization by a fiction.\textsuperscript{191} It affords spouses with non-community property the opportunity to treat any gift to a third party as if made one-half by each spouse. The statute requires no actual transfer of property between the spouses.\textsuperscript{192}

The method for giving effect to this remarkable fiction is an annual election which, if made, must be made by both spouses and is then applicable to all gifts to third parties made in that year.\textsuperscript{193} The election

\textsuperscript{188} In this regard such transfers into co-ownership are entitled to special treatment on the theory of "equalization" but even so not all the benefits of the treatment of community property are obtained. See note 178, supra.

\textsuperscript{189} Under § 811(e), INT. REV. CODE. The A. B. A. Bill (§ 5) would have included only one-half of the value of the joint tenancy or tenancy by the entirety in the gross estate of either spouse and also allowed a marital deduction therefor. This would permit property inherited or received as a gift as joint tenants to be subject to tax on only 25 per cent upon the death of one spouse as compared with 50 per cent of community property subject to tax upon the death of a spouse.

\textsuperscript{190} Marian Lintner Park (1939) P-H 8, B.T.A. MEM. DEC. ¶ 39,401. A different rule applies in the case of pre-1927 California community property. See note 161, supra.

\textsuperscript{191} INT. REV. CODE § 1000(f).

\textsuperscript{192} This treatment parallels the "income splitting" plan, except that a "joint gift tax return" is not provided. The A.B.A. Bill (§ 6) permitted such a joint return for gifts to third parties in addition to the separate return for other gifts. Difficulties under such a hybrid system apparently made the statutory treatment preferable.

\textsuperscript{193} INT. REV. CODE § 1000 (f)(1)(B). The election is to be made by filing a consent in the manner to be prescribed by Treasury Regulations. The time for filing the election is prescribed in the statute, (INT. REV. CODE § 1000(f)(2) and (3), but may be required to be made on the gift tax return. Senate Report, Part 2 at 34. However, the
so to split such gifts for one year has the effect of treating such gifts as if actually made one-half by each spouse (for gift tax purposes). In cumulating the gifts of either spouse for the purpose of computing the gift tax for a future year, previous gifts for which the election was made are treated as so split between the spouses whether or not an election is made for a subsequent year.\(^\text{104}\)

The election, however, is only for gift tax purposes, except as the fiction of splitting the gifts is expressly given effect elsewhere.\(^\text{105}\) The election has no effect generally on the estate tax transfer concept. For example, a husband may transfer property in trust with the income to be paid to himself and his wife for their joint lives and then to the survivor, with the trust to terminate upon the death of the survivor and the corpus to be paid over to a son. The husband and wife may make a proper election to treat the gift to the son as made one-half by each. This will split the gift for gift tax purposes. However, for the purpose of determining the husband's gross estate, the entire transfer will be considered made by the husband\(^\text{106}\) and no part of the transfer will be considered made by the wife.

The splitting of gifts applies only to gifts to third parties and not to gifts from one spouse to another.\(^\text{107}\) However, if the election is made to split any gift to a third party made during a year it applies to all

\(^{104}\) Senate Report, Part 2 at 33.

\(^{105}\) Senate Report, Part 2 at 34. The Revenue Act of 1948 amends § 812(c), relating to the deduction for property previously taxed, so that a gift to a decedent which was split for gift tax purposes will be treated as if each half was a separate gift from each spouse in determining whether gift tax was paid. This will have the effect, for example, of not allowing a deduction in a decedent's estate for half the gift where the portion considered a gift by the donor's spouse was within the exemption or exclusion applicable in the case of such spouse. This follows the pattern of treatment of community property gifts. § 813(a)(2) of the Code is also amended to determine the gift tax (for which credit against the estate tax is allowed) with respect to a split gift. The credit is allowed for the entire tax paid on both halves; but in the case of a split gift of jointly owned property, the tax on the portion included in the decedent's gross estate is determined with reference to the gift tax paid as if he made a gift of half of such portion and as if his spouse made a gift of half of such portion. See Senate Report, Part 2 at 26, 27 and 34.


\(^{107}\) The 'splitting' privilege does not apply to a gift of an interest in property if the donor creates in his spouse a taxable power of appointment over such interest. Thus, a gift by \(H\) of property in trust, with the income to be paid to \(W\) for life, and with \(W\) having a general power to appoint the corpus and, in default of appointment to \(X\), no part of the gift can be split between \(H\) and \(W\). Presumably the exercise or release by the wife of the power will be a gift to a third party which can be split by the spouses. Senate Report, Part 2 at 33.
other gifts to third parties made in such year, including gifts of an interest in community property and gifts of other property held in co-ownership by the spouses.

It may appear at first that there is no significance in the splitting of jointly owned property. Thus, if a $100,000 gift of community property is made by Mr. and Mrs. Green to their son, Larry, each has made a gift of $50,000. Mr. Green's gift is the same amount whether he is considered as giving his half interest ($50,000) in the $100,000 property or whether by reason of an election he is considered as making a gift of one-half ($25,000) of his half interest (and Mrs. Green is considered as giving the other half of his half) and as making a gift of one-half ($25,000) of Mrs. Green's half interest (she also making a gift of one-half of her half-interest). But there are important indirect effects of the latter treatment which the statute requires. First of all, it treats community and non-community property alike so that in the case of spouses making the election it is unnecessary to determine whether a gift was from separate or community property. Secondly, it has important consequences in determining the credit against the estate tax for gift taxes paid. Finally, the liability for tax will be different if a gift of property is split by reason of an election rather than by operation of the community property law (without the election).

Under the statute in the event of a valid election to split gifts made in a calendar year to third parties, each of the spouses assumes joint and several liability for the entire gift tax of the spouses for such year. Thus, if both spouses have made taxable gifts, the tax liability of one for that year may be greater by reason of the "splitting," even though the aggregate gift taxes of both spouses is less than it would otherwise have been. This rule of joint and several liability appears necessary to protect the revenues because the donor to whom in fiction one-half of the gifts are ascribed may have no property. However, where gifts are split solely by operation of the community property system such additional liability is not required. While joint and several liability is generally not a real burden to taxpayers, the necessity for it under the gift-splitting plan is evidence of another problem in attempting to provide equalization.

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198 See note 191, supra.
199 Int. Rev. Code § 1000(f) (4).
200 Joint and several liability is also a burden under the "income splitting" plan since a joint return is required under the plan. See Int. Rev. Code § 51(b)(1).
VII. CONCLUSION

In the foregoing analysis, the basic reasons for most of the complications under the estate tax and gift tax provisions of the Revenue Act of 1948 have been examined. There are many additional complications on a more technical level which will bear further study. As the basic plan has developed in statutory form the complications have been extended with snowball effect—and possibly the end of such complications is not yet in sight.

It is fair to say that these complications are compelled by the basic policy upon which the law was written. The basic policy seeks to preserve the separateness of property interests of spouses which the tax

201 § 362 of the Revenue Act of 1948 amends § 812(c), Int. Rev. Code with the principal effect of disallowing the deduction allowed under the prior law in the estate of a surviving spouse for property received within 5 years prior to her death by gift or from the estate of a deceased spouse. The deduction is disallowed if the first deceased spouse died after December 31, 1947. Where a marital deduction is allowed the estate of the first spouse, the disallowance of the § 812(c) deduction has the effect of shifting the deduction from the second estate to the first estate, with equivalent results as long as the surviving spouse takes only half the property. This may be planned. See Hearings before Finance Committee on H. R. 4790, 80th Cong., 2nd Sess. 303 (1948). However, the disallowance of the § 812(c) deduction is not dependent on the allowance of a marital deduction in the estate of the prior decedent. The deduction is also disallowed for the decedent's share of community property received by the survivor. If the deduction for property previously taxed were to be continued for property received from a spouse, presumably a statutory formula would be needed to determine, with due regard to the marital deduction, that portion of the property which bore estate tax in the prior estate; this would add complications to an already highly complicated statutory provision.

§ 363 of the Act amends § 813(a)(2) of the Code principally so as to give effect to the marital deduction and splitting of gifts in computing the credit against the estate tax for the gift tax paid.

§ 364 of the Act amends § 811(j) of the Code so as to apply the optional method of valuation in determining marital deductions under the estate tax.

§ 365 of the Act amends § 826(c) and (b) of the Code to limit the right of an executor to collect the tax under the federal apportionment rule from a surviving spouse, who received proceeds of life insurance or property subject to the decedent's taxable power of appointment, to the tax attributable to such proceeds or property not excluded from the tax base via the marital deduction route.

§ 373 of the Act amends § 1004(c) of the Code to limit the total gift tax marital deductions for a calendar year to the total amount included in gifts (after the $3,000 exclusion) for which marital deductions are allowed.

See also notes 19, 25 and 195. These technical amendments are discussed in Senate Report, Part 2 at 21-29, and 32.

202 The A. B. A. Bill also contained amendments to Int. Rev. Code § 811(e), relating to joint interests, (see note 189, supra), and took a different approach to the basic problem. (See note 201, supra.) Amendment of the marital deduction provisions has already begun. See Pub. L. No. 869, 80th Cong., 2nd Sess. (July 1, 1948) amending § 812 (E) (I)(G), Int. Rev. Code.
system has recognized under the community property law and the common law, and at the same time to find a method for equal tax treatment of married couples living under the two different systems of property law. The difficulties which arise—as reflected in the statute—are traceable to the resulting necessity for distinguishing between forms of ownership of property of the spouses so as to balance the tax advantages under one property system for certain types of ownership with the tax advantages under the other system for other types of ownership. As a result the taxpayer, or his counsel, who seeks the benefits of "equalization" must walk a tightrope.

The dilemma which results from this form of "equalization" is best illustrated, in the case of the common law states, by the problem of the treatment of life estates and annuities. In order that the common law states will not have an advantage over the community property states, a marital deduction is not allowed for the customary common law disposition of property into a life estate for the decedent's spouse with remainder over to children. On the other hand, "equalization" permits in most cases a marital deduction for the value of a contract acquired by the decedent (and included in his gross estate) for payment of an annuity to his surviving spouse for her life. Yet the distinction drawn between a life estate and a purchased life annuity has no real significance, for either device may be used for the same purpose of giving a life estate and minimizing estate taxes upon the death of the life tenant.

The problems which this form of "equalization" creates in connection with community property are exemplified in the rules for tracing separate property back to community property. These rules are required under the "equalization" approach in the Revenue Act of 1948 in order that a change from community to separate ownership of property by spouses will not result in an additional tax advantage (not enjoyed by spouses with non-community property) upon a gift or bequest of such former community property from one spouse to another.

The maze of complications inherent in the approach to "equalization" of estate and gift taxes under the Revenue Act of 1948 suggests the necessity for further study of legislative solutions to the equalization problem. This is a project which must be left for future development. But certain considerations may be pointed out.

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203 The complications are not so important for themselves as for the effect upon equalization. The reliance upon property rights under local law results in gaps in equali-
The success of the "income splitting" plan as a method of equalization results from its universal application without regard to distinctions derived from varying property laws as to the ownership of income between the spouses. The estate tax plan under the Revenue Act of 1948, however, does not follow the "income splitting" plan of treating the husband and wife as a unit. Instead the estate tax plan is based upon their separateness and the division of property between them.

A new approach may be made to the problem of equalization under the estate and gift taxes by following the "income splitting" plan. Mechanics would have to be developed to provide a substitute for the joint return under the "income splitting" plan. But in the basic concept of treating husband and wife as a unit lies the hope for ending the complications inherent under the Revenue Act of 1948 in the treatment of interspouse transfers.