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ESTATE AND GIFT TAX AMENDMENTS OF THE REVENUE ACT OF 1948

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I. GENERAL OBJECTIVES OF THESE AMENDMENTS

The estate and gift amendments set out in the Revenue Act of 1948 represent the most drastic changes made in the fundamental concept of the estate and gift tax laws since these two methods of federal tax extraction were first put on the Statute Books—to wit, September 8, 1916, for Federal Estate Tax and June 6, 1932, for the Federal Gift Tax (not considering the abortive attempt at a Gift Tax Law as promulgated in 1924).

As one article in a recent issue of The Tax Magazine states—

> "We asked for it. Now we have it. We wanted reduced taxes; we wanted the privileges of taxpayers in the community property states extended to taxpayers in the common-law states. By virtue of the Revenue Act of 1948, these privileges are now ours, and along with them a whole bunch of headaches."

Because the 1948 Law represents a radical departure from the previous basis for computing estate and gift taxes, and in fact represents a fundamental revision of the tax structure itself, certain of the new provisions are as complicated and as ramified as any enacted in the whole field of federal taxation. This is not surprising, however, when we realize that the Revenue Act of 1948 seeks to establish tax uniformity under two completely diverse systems of law—that is, the community property and the common law systems.

A. Basically, the general purpose of the Revenue Act of 1948 is to effect an equalization of the tax burdens of married couples in the common law and community property states. It is true that the Revenue Act of 1942 attempted to equalize these tax burdens, but it sought to accomplish this by taking away from the taxpayer in the community property states certain basic rights and privileges previously enjoyed by such taxpayers without giving any relief or benefit to taxpayers in the common law states. The Revenue Act of 1948 restores to taxpayers in community property states the rights available to them prior to the 1942 amendments and gives to these taxpayers certain additional rights and privileges. Then the 1948 law proceeds to give equal or substantially equal benefits to taxpayers living in the common-law states.

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It can be said that the basic theory of and the principle motivating and actuating the passage of the Revenue Act of 1948 are as follows:

> "Only one-half of the estate accumulated by a man and his wife shall be taxed at the death of the first spouse to die and the tax on the other half shall be postponed until the death of the survivor."

B. Before proceeding further let me warn that there is a very marked difference between the application of this principle in the community property states and in the common-law states. The law in the community property states specifically provides that property accumulated by husband and wife during coverture is community property and that upon death of one spouse, the survivor automatically becomes entitled to half of such property regardless of provisions of the will of the deceased spouse and in fact regardless of whether or not the deceased spouse died testate or intestate. As a result, generally speaking, the estate of the deceased spouse is automatically exempted under the Revenue Act of 1948 from estate tax on the portion of the community property going to the surviving spouse.

In the common-law states, however, the deceased spouse must, prior to death, take positive steps to see that the surviving spouse gets a share of his or her estate (up to 50% thereof) without the imposition of estate tax on the share so allotted to the surviving spouse.

This means that all wills involving net estates in excess of $60,000.00 should be reviewed and that the vast majority of such wills must be rewritten.

C. Remember that in the proper drafting of a client's will you are rendering a service of very great value to him and by virtue of the provisions of the Revenue Act of 1948, if the will is properly drafted by you, it will be possible to render even greater service. By way of illustration—John Jones has an estate worth $120,000.00 and has a wife and three children. John realizes that his wife will need the bulk of the income from his estate for her life, but wants his children ultimately to reap the benefits of his life work. Under the law existing prior to 1948 John would probably have created a trust, giving his wife a life estate therein with remainder over to his children. Without taking into consideration the comparatively minor adjustments for administration expenses and the like, John's estate would pay a federal estate tax of $9,500.00 or a tax equal to about 8% of the total estate. The wife, at her death, having only a life estate, would pay no estate tax. Under the 1948 Law, John's will can provide for an outright bequest or devise to his wife of $60,000.00 (or a transfer to a trust over which the wife has the power to appoint the corpus thereof to her estate) and then set

up a life estate in trust for the wife of the remaining $60,000.00. In such case, John's estate gets a marital deduction of $60,000.00 which brings his net estate down to $60,000.00 and since the law gives a $60,000.00 exemption John's estate pays no federal tax. Likewise, John's widow at her death, has a life interest in the $60,000.00 trust which is non-taxable, and she has the $60,000.00 specifically devised or bequeathed to her or over whch she has such power of appointment as to make same taxable to her estate at her death. However, she also gets a $60,000.00 exemption and, therefore, pays no federal estate tax. And so proper use of the provisions of the 1948 Revenue Act will result in an estate tax saving of $9,500.00.

D. If John died intestate and his estate consisted of $40,000.00 in real estate and $80,000.00 in personal property, his wife would be entitled under the North Carolina intestate laws to ⅓ of the real estate for life (no part of which would qualify for the marital deduction) and ¼ of the personal property outright—to wit, $20,000.00. This would mean that John's estate would be entitled to a marital deduction of only $20,000.00 and his estate would then be liable for a federal estate tax of $4,800.00. Failure to make a will would, therefore, cost John's estate $4,800.00.

II. Discussion of Estate Tax Amendments

A. *General Discussion.* Stripped of all technicalities and limitations the marital deduction can best be described as follows:

First, determine the gross estate of the decedent—which, of course, will include all properties and interests in properties owned by the decedent at date of death, as well as all gifts held to have been made in contemplation of death.

From the amount ascertained to be the gross estate deduct the following items set out in Section 812(b) of the Internal Revenue Code, to wit—

Funeral expenses; administration expenses; claims against the estate; unpaid mortgages and debts on property included in the gross estate; support given the dependents of decedent. If the decedent was a resident of a community property state, there must also be deducted the value of community property and property converted from community property into separate property (see sub-paragraphs (B) and (C) of Sub-Section (e) (2) of Section 812 IRC).

When these amounts have been deducted from the gross estate the remaining balance is designated as the "Adjusted Gross Estate."

Having determined the so-called "Adjusted Gross Estate," the 1948 Act then provides that an additional deduction—designated as the "Marital Deduction"—can be obtained up to 50% of such adjusted gross

estate. If the decedent's will provides for charitable bequests, the value of such bequests is then deducted. It should be noted that the charitable bequest deduction comes after determination of the marital deduction. And finally, from the net figure left after all deductions above mentioned have been made, there will be deducted the specific estate tax exemption allowed by law. The resultant net figure is the amount that is subject to federal estate tax.

B. The following simple illustration will probably clarify the above:

Let us designate husband and wife as H and W respectively. H has a simple and uncomplicated estate (consisting of real estate, stocks, bonds and cash) having an aggregate value at date of death of $200,000. His funeral expenses total $1,000; executor's fees and other administration expenses total $7,000; claims against estate total $2,000; one piece of real estate included in the gross estate has a $7,000 mortgage against it at H's death; his will provides that his executor is to pay to his invalid mother out of the general estate for her support during the twelve months immediately following his death the sum of $250 per month (total $3,000); and H leaves a bequest of $10,000 to Duke University. H also provides in his will that W is to receive outright so much of his estate as will give to her the full marital deduction allowed under the 1948 law.

The funeral expenses, administration expenses, claims, mortgage and support furnished invalid mother total $20,000. Deduct this amount from $200,000 and the balance is $180,000. This is the amount of the so-called "Adjusted Gross Estate."

Since H's will provides that W is to receive the full marital deduction allowed by law, the amount of the marital deduction in this case would be 50% of $180,000 or $90,000.

We then deduct $90,000 from $180,000 and this leaves a balance of $90,000. From this amount we deduct the charitable bequest to Duke University of $10,000 and the remaining balance is $80,000. Since this balance is less than $100,000 (the specific exemption allowed by the Revenue Act of 1926) there is no basic tax. The specific exemption for the so-called "Additional Estate Tax" is $60,000 and after deducting this we have a net taxable estate of $20,000. The estate tax on $20,000 is $1,600.

If H had failed to take the marital deduction (or had attempted to take same but had failed by falling into one of the many possible pitfalls inherent in the 1948 law), his taxable estate (before deduction of specific exemptions) would be $170,000. The basic tax on $70,000 ($170,000 less exemption of $100,000) would be

$900 and the net additional tax on $110,000 ($170,000 less exemption of $60,000) would be $22,800. Add 20% of $900—to wit, $180 (the net basic tax after deducting the 80% credit for state taxes)—to $22,000 and the result is $22,980.

And so, by taking advantage of the marital deduction H's estate tax is reduced from $22,980 to $1,600—a saving of $21,380.

The above illustration has been greatly simplified. This proposition, in its last analysis, and even without running into the may pitfalls occasioned by or resulting from so-called terminable interests and the like, is not quite as simple as I have made it appear in the foregoing example.

To illustrate points that you, as the draftsman of your client's will, must take into consideration, let us suppose that after deducting funeral and administration expenses, and the like, H's adjusted gross estate amounts to $1,000,000; that his bequest to Duke University is $100,000; and that W has inherited from her father the sum of $250,000. If, under such conditions, we give W a marital deduction of $500,000 (50% of the adjusted gross estate) then H would pay a federal estate tax of $87,700. If H had made no marital deduction provision for W (for example, if he had set up a trust and given her only the income for life, with remainder over to the children) his estate tax would have totaled $238,900. And so, at first blush, it would appear that there was a clear-cut tax saving of $151,200.

But there are many other factors to be taken into consideration in this example.

First: Let us consider the situation that will exist when W dies. She has received $250,000 as an inheritance from her father and $500,000 from H—total $750,000. Assume that after deduction of funeral and administration expenses her adjusted gross estate totals $700,000. Unless she has remarried she has no marital deduction and so $700,000 represents her taxable estate before the specific exemption is deducted. Her federal estate tax on $700,000 will total $192,900. If, however, H had not taken advantage of the marital deduction for the purpose of reducing the burden of estate taxation in his estate and had left $500,000 in trust for W for her life with remainder over to his children, W would not have to pay tax on this $500,000 at her death and would have a gross taxable estate of only $250,000. Assuming other deductions totaled $15,000 W's taxable estate before the specific exemptions would be $235,000 and the federal estate tax on $235,000 would be $41,160.

Accordingly, the combined federal estate tax burden would be as follows:

	If H Claimed Full Marital Deduction	If H Claimed No Marital Deduction
Tax on H	$ 87,700	$238,900
Tax on W	192,900	41,160
	$280,600	$280,060

So that, without taking other items into consideration the combined actual loss in federal estate tax resulting from H claiming the full marital deduction in the illustration given above would be $540.

This loss of $540 would be immediately converted into a still greater combined loss when we consider other items that must be taken into consideration in figuring the estate of a resident of North Carolina.

Second: Under existing North Carolina Inheritance Tax Laws, H will pay full inheritance tax at his death regardless of any marital deduction. But W's situation is different—if H leaves her only a life estate W will not pay inheritance tax on such life estate at her death. Let us further assume that at death of H the age of W was 50 and that at death of both H and W there were two children—both over 21 years of age. We will further assume $15,000 deduction on W for administration expenses, debts, etc., if she has at her death the $250,000 bequest from her father and has only a life estate in $500,000 set up in trust by H. On the other hand we will assume a $30,000 deduction on W for administration expenses, debts, etc., if H gives her $500,000 outright.

On the basis of these facts the state inheritance tax liability would be as follows:

	If H Claims Full Marital Deduction	If H Claims No Marital Deduction
Tax on H	$41,610	$41,650
Tax on W	35,260	7,850
	$76,870	$49,500

It can be seen that if H claims the full marital deduction there will be an over-all loss in state taxes on the two estates of $27,370.

Third: It will be noted above that we increased administration expenses on W as follows:

If her taxable estate is $250,000—$15,000
If her taxable estate is $750,000—$30,000

The use of the marital deduction by H (instead of use of life estate to W) will result in an over-all increase in administration expenses, debts, etc., of $15,000.

If we set up a recapitulation of these adjustments we will arrive at the following results:

	If H Claims Full Marital Deduction	If H Claims No Marital Deduction
H—Federal Tax	$ 87,700	$238,900
W—Federal Tax	192,900	41,160
H—State Tax	41,610	41,650
W—State Tax	35,260	7,850
H—Administration Exp.	30,000	30,000
W—Administration Exp.	30,000	15,000
	$417,470	$374,560

From the above it can be clearly seen that the use of the full marital deduction by H would result in an over-all dimunition in the two estates, by the time they finally get down to the two children, of $42,910. So that, the apparent savings in federal tax to the estate of H—resulting from his claim of the full marital deduction—of $151,200, winds up as an over-all loss to the two estates of $42,910.

Of course, if the full marital deduction is taken by H his estate (during the life of his wife) will be worth $151,200 more than it would if he claimed no marital deduction. His wife is 50 years old at the death of H and (based on North Carolina tables) has an expectancy of 20.9 years. If we assume that $151,200 could be invested to yield a yearly average after income taxes of 3% (and this would be a very high net yield—Wachovia Bank, in its similar computations, figures a yield of 2%), the annual additional income from H's estate during the life of W would be $4,536 or a total during the 20.9 years of $94,792. This, of course, would depend on whether the 3% net yield could be maintained, whether W spent, lost or threw away part of the principal of the $500,000 available to her outright in order to qualify for the marital deduction, whether W lived 20.9 years or 6 years or 30 years and many other completely unknown factors (such as changes in tax rates, inflation, deflation and the like).

Probably the best rule to follow in use of the marital deduction would be as follows:

Take into consideration (a) the over-all savings to be effected or loss to be sustained; (b) the age, health, personal habits and characteristics of the wife—whether she has a good business head or is flighty, a spendthrift or easily susceptible to the wiles of the gold-brick artist, etc. Put all these factors in the pot and shake them up. If then the net result interferes with a carefully thought out estate plan for the wife and children, use or disregard the marital deduction as the facts obtained from such detailed analysis warrant.

It can, however, be seen from the foregoing illustrations, that the proper drafting of a will under the 1948 law is a major undertaking,

and will necessitate many prayer meetings with yourself and your client and literally hundreds of computations.

C. Conditions for allowance of marital deduction

We have spoken very glibly of the marital deduction and it might be assumed that the ability to claim or not to claim the marital deduction is solely a matter of choice vesting in the taxpayer. Such is not the case.

1. The basic condition for allowance of the marital deduction is that the taxpayer must be married at the time of his death. However, a legal separation which has not terminated the marriage does not affect the status for purposes of the marital deduction. A transfer by the decedent during his lifetime to an individual to whom he was not married at the time of the transfer but to whom he is married at the time of his death and who survives him is considered a transfer by the decedent to his surviving spouse. On the other hand, if an interest in property passes from the decedent to a person who was his spouse but is not married to him at the time of his death, the interest is not considered as passing to the decedent's surviving spouse.

2. The decedent must be at the time of his death a citizen or resident of the United States.

3. The taxpayer must have died after December 31, 1947.

4. An interest in property which has been included in decedent's gross estate for the purpose of determining estate tax liability must pass from decedent to his surviving spouse. Included under this general heading would be an intervivos gift of property when such gift is construed as having been made in contemplation of death. If such intervivos gift is not held to have been made in contemplation of death, its value would not, of course, be included in decedent's gross estate for the purpose of determining his or her estate tax liability and it would, therefore, be automatically excluded as a marital deduction.

D. Interests passing from decedent to his surviving spouse which do not qualify as marital deductions

We have heretofore discussed the general conditions governing allowance or disallowance of the marital deduction. Now we turn to the various limitations on this deduction.

1. Definition of words "interest" and "property"

Before we discuss the specific limitations set out in the 1948 law it might help to call attention to two words that constantly appear in these limitations. These words are "interest" and "property." Cer-

tainly for the purposes of the 1948 Law these two words have very distinct and separate meanings.

The word "property" is used in a comprehensive sense and includes all objects or rights which are susceptible of ownership. The term "interest" refers to the extent of ownership, that is, to the estate or the quality and quantum of ownership by the surviving spouse or other person of particular property. For example, if the surviving spouse is specifically devised an estate for her life in a farm, the "interest" passing to her is the life estate, and the "property" in which such interest exists is the farm. Thus, in the case of a bequest, devise, or transfer of an interest which may be satisfied out of, or with the proceeds of, any property of the decedent's general estate or of a trust, the interest so bequeathed, devised or transferred is an interest in any and all of such property. And, if the decedent's general estate or the trust consists of assets which are themselves interests in property (such as leases), the interest so bequeathed, devised, or transferred is an interest in such property.

The above definitions are taken from the supplementary report of the Senate Finance Committee.

2. The terminable interest rule

a. In general it can be stated that the marital deduction will not be allowed in respect of certain terminable interests passing from the decedent to the surviving spouse. To some extent, however, this general statement is misleading, because the marital deduction is not disallowed in respect of an interest passing from the decedent to the surviving spouse merely because it is terminable. Such interest will be disallowed as a marital deduction only if two conditions exist—to wit:

(1) If an interest in the same property passes, for less than an adequate consideration in money or money's worth, from the decedent to any person other than the surviving spouse or the latter's estate; and

(2) The person acquiring such interest (or such person's heirs or assigns) *may* by any possible circumstance under the bequest, devise or gift, possess or enjoy the property *after* the termination or failure of the interest so passing to the surviving spouse.

A simple illustration of (1) and (2) above would be a devise of a life estate to the surviving spouse with remainder over to the children of the decedent.

On the other hand, the interest of the surviving spouse is not considered a terminable interest merely because her possession or enjoyment may be affected by events not provided for by the terms of the bequest, devise or gift. Thus, if the property in which the surviving spouse has an interest, or all of the interest, is terminable, the interest

of the surviving spouse is a terminable interest but the marital deduction is still allowable. An example of this would be a bequest of a patent by decedent to his surviving spouse.

b. We have, in preceding paragraphs, referred to the phrase—"a terminable interest." The question next to consider is—What is a "terminable interest"?

For the purposes of allowance or disallowance of the marital deduction, a terminable interest is defined as an "interest" passing to the surviving spouse which will fail or terminate (1) upon the lapse of time, or (2) upon the occurrence of an event or contingency, or (3) upon the failure of an event or contingency to occur. It appears to be immaterial whether the interest passing to the surviving spouse is considered as a vested interest subject to divestment or as a contingent interest. A terminable interest is created whether the terms of the instrument or the theory of the application of such terms are conceived as creating a future interest which may fail to ripen or vest or as creating a present interest which may terminate. The Senate Finance Committee says that the occurrence of a contingency includes the ending of a condition—for example, an interest given to the surviving spouse as long as she remains unmarried is a terminable interest, and, furthermore, such interest would not qualify for the marital deduction.

The provisions of the 1948 Law relating to terminable interests state in substance that no marital deduction will be allowed with respect to such interest—

> "(i) If an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to *any person other than such surviving spouse* (or the estate of such spouse)"; and
>
> "(ii) If by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse."

The following example appearing on pages 9 and 10 of the Supplemental Report of the Senate Finance Committee will fully illustrate the above quoted paragraphs from the 1948 Law—to wit:

> "The decedent by his will devised Blackacre to his wife and daughter as joint tenants. Both his wife and daughter have terminable interests in the same property, Blackacre. The daughter *may* (if she survives the wife) possess or enjoy such property after the termination of the wife's interest. Accordingly, no marital deduction is allowed with respect to the interest passing to the surviving spouse. It is immaterial that the daughter *may not* possess or enjoy all of Blackacre in the event of a severance of the joint interest. It is sufficient under Clause (ii) that any part of the property may *(by any possibility)* be possessed or enjoyed

> by the daughter after the termination or failure of the wife's interest. Similarly, if the property were bequeathed in trust for the joint benefit of the wife and daughter with the corpus passing to the survivor, no marital deduction would be allowed. The daughter, by surviving the spouse, may possess or enjoy the property after the termination of the spouse's interest."

3. Interest in unidentified assets:

Subparagraph (C) of Section 812 (e) (1) is a very unintelligible and yet a somewhat innocuous sounding paragraph which reads as follows:

> "Where 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 particular asset or assets with respect to which no deduction would be allowed if such asset or assets passed from the decedent to such spouse, then the value of such interest passing to such spouse shall, for the purposes of subparagraph (A), be reduced by the aggregate value of such particular assets."

It sounds simple but it would be advisable, after you have completed your draft of a client's will, to go back over all provisions made in the will for the surviving spouse and see whether or not the above quoted paragraph has not torn up and practically destroyed your entire estate plan for the surviving spouse.

The following example will probably illustrate the meaning of Subparagraph (C):

> The decedent has an adjusted gross estate of $100,000 and he bequeathed $50,000 to his surviving spouse, figuring that this amount represented the full marital deduction he could claim. During his lifetime decedent had made a gift of real estate to his son but reserved to himself and his estate the income from such real estate for a term of years. In valuing decedent's gross estate at his death the Commissioner assigned a value of $60,000 to the estate reserved by the decedent. Subparagraph (C) above says that the value of the interest passing to the surviving spouse (to wit, $50,000) shall be reduced by the value of any particular asset with respect to which no deduction would be allowed if that particular asset pased from the decedent to the surviving spouse. The estate for a term of years (valued at $60,000) would not itself be allowed as a marital deduction and, accordingly, this item of $60,000 is applied against the $50,000 bequest to the surviving spouse and thereby reduces the marital deduction to zero. And it should be noted that it is immaterial whether or not the surviving spouse actually received the estate for the term of years.

This subparagraph (C) generally applies to situations in which the surviving spouse is a pecuniary or residuary legatee or is a beneficiary of a trust created by decedent during life or by will.

In other words, if any asset in the general estate or trust would not qualify as a marital deduction if it had been considered as the interest passing from the decedent to the surviving spouse, the value of such asset (although it may not actually pass from decedent to surviving spouse) must be applied in reduction of the amount otherwise allowable as a marital deduction with respect to the residuary bequest, pecuniary legacy and the like.

What can be done to prevent such a catastrophe? (1) Try to eliminate such non-deductible assets from the residuary estate where the surviving spouse's interest may be or is to be satisfied from such residuary estate, or (2), if the estate is of sufficient size to justify such procedure, provide in the will for the specific allocation of such non-deductible assets to persons other than the surviving spouse.

E. Exceptions to the terminable interest rule

There are four principal exceptions set out in the 1948 Law to the general rule which disallows the marital deduction in the case of the passing from the decedent to the surviving spouse of a terminable interest.

1. Interests which are to terminate *only* if the surviving spouse should die (a) within six months after the decedent's death, or (b) as the result of a common disaster fatal to the decedent, or (c) in either of such events. The deduction is allowed in such cases *only* if the surviving spouse does not in fact die within the six months' period or as a result of the common disaster.

This rule would not, however, apply in a case where the decedent devised real estate to his wife for life with remainder over to his son. Even though the wife died within the six months' period, the marital deduction would not be allowed.

2. An interest is not to be considered a terminable interest merely because it represents ownership of a bond, note, or similar contractual obligation, the discharge of which would not have the effect of an annuity for life or for a term of years. But a partial interest in such property, such as a life estate, is a terminable interest.

3. Certain life estates in trust coupled with a power of appointment. (Subparagraph F of Section 812 (e) (1)).

This is an important exception to the general rule. Generally speaking, a power of appointment is not an "interest in property." Accordingly, no marital deduction is allowed with respect to a power to appoint given to a surviving spouse, except as provided in the special rules set out in Subparagraph (F) and (G) of Section 812 (e) (1) in cases of certain trust and insurance proceeds where the surviving spouse is given a power of appointment.

It will be noted, however, that there are six separate conditions set out in Subparagraph (F) of Section 812 (e) (1) and all of these conditions must be met before such life estate will be allowed as a marital deduction. These conditions are as follows:

a. The property must be held in trust and the trust must be created by a transfer of property by the decedent during his lifetime or by his direction under his will.

b. The surviving spouse must be entitled for her life to *all* the income from the corpus of the trust.

c. The surviving spouse must be entitled to the income from the corpus of the trust *annually,* or at more frequent intervals.

d. The surviving spouse must have power to appoint the *entire corpus* free of trust, and such power must be exercisable in favor of such surviving spouse, or in favor of her estate (or others).

e. 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.*

f. The power possessed by the surviving spouse to appoint the entire corpus free of trust *must be exercisable alone and in all events.*

We again call attention to the fact that even though a trust meets all the tests of subparagraph (F), the provision of clauses (1) and (11) of subparagraph (B) may result in a disallowance of the marital deduction where the trust corpus consists, in whole or in part, of terminable interests. And, likewise, subparagraph (C) may reduce the marital deduction otherwise allowable under subparagraph (F) in cases where the decedent merely directs the creation of a trust, the corpus of which may consist of a terminable interest in the decedent's general estate.

4. Life insurance proceeds payable in instalments with a power of appointment in the surviving spouse.

The original bill passed in April, 1948, contained phraseology in Subparagraph (G) that was so restrictive, so manifestly unjust and unfair, that an immediate howl went up from insurance companies, trust companies and taxpayers. As a result this subparagraph (G) was amended by Joint Congressional Resolution approved on July 1, 1948.

In substance, Subparagraph (G), as amended July 1, 1948, provides that in the case of an interest in property (passing from the decedent to the surviving spouse) which consists of proceeds under a life insurance, endowment, or annuity contract, such interest will, under certain specific conditions, be allowed as a marital deduction. The conditions governing the allowability of such insurance proceeds as a marital deduction are:

a. Under the terms of the contract such proceeds shall be payable in installments or shall be held by the insurer subject to an agreement to pay interest thereon (irrespective of whether the proceeds, upon the termination of any interest payments, are payable in a lump sum or in annual or more frequent installments).

b. Each such installment or interest payment shall be payable annually or at more frequent intervals, commencing not later than 13 months after the decedent's death.

c. All amounts payable during the life of the surviving spouse shall be payable *only* to such spouse.

d. Such surviving spouse has the power to appoint all amounts payable under such contract (such power of appointment to provide that it may be exercised 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).

e. No power shall vest in any other person to appoint to any person other than the surviving spouse any part of the amounts payable under such contract.

f. Such power in the surviving spouse to appoint, whether exercisable by will or during life, is *exercisable by such spouse alone and in all events.*

It should be noted that in order to qualify for a marital deduction the requirements of Subparagraph (G) of Section 812 (e) (1) must be met by the terms of the insurance contract, *viewed as of the date of the decedent's death.* In other words, it is the status and condition existing at decedent's death which controls and not at the time of taking out the insurance, or at any other time before or after death.

This amendment was made retroactive to apply with respect to estates of decedent's dying after December 31, 1947 (the date adopted for the remainder of the 1948 law dealing with estate tax).

F. Valuation of interest passing to surviving spouse

We now consider briefly certain adjustments which, if not properly handled in the decedent's will, result in reducing the marital deduction. Incidentally, if the decedent dies intestate, these adjustments will automatically result in a reduction in the value of the marital deduction. Accordingly, to be assured of obtaining the full benefits of the marital deduction, the decedent must leave a will and it should be a carefully drawn instrument.

Subparagraph (E) of Section 812 (e) (1) provides that—

> "In determining for the purposes of Subparagraph (A) the value of any interest in property passing to the surviving spouse for which a [marital] deduction is allowed by this subsection—
> (i) there shall be taken into account the effect which a tax

imposed by this chapter [the federal estate tax], or any estate, succession, legacy or inheritance tax, has upon the net value to the surviving spouse of such interest; and

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

The rule set out in clause (i) above is substantially the same as that provided in Section 812 (d) of the Code, relating to bequests, etc., to charity. The rule applies where the burden of a death tax falls upon the surviving spouse or the property in which an interest passes to the surviving spouse.

The rule set out in clause (ii) above can best be illustrated by the following examples set out in the supplemental report of the Senate Finance Committee:

"(1) If the decedent by his will leaves the residue of his estate to his surviving spouse and she pays, or if the estate income is used to pay, claims against the estate so as to increase the residue, such increase in the residue is acquired by purchase and not by bequest. Accordingly, the value of any such additional part of the residue passing to the surviving spouse cannot be included in the amount of the marital deduction.

"(2) If the decedent by his will leaves to his surviving spouse real estate subject to a mortgage (whether or not such mortgage was a personal liability of the decedent) the value of the interest passing to the surviving spouse does not under this section include the mortgage. If, however, the decedent by his will directs the Executor to pay off the mortgage, such payment constitutes an additional interest passing to the surviving spouse.

"(3) If the decedent bequeaths certain property to his surviving spouse subject, however, to her agreement, or a charge on the property for payment of $1,000 to X, the value of the bequest (and, accordingly, the value of the interest passing to the surviving spouse) is the value, reduced by $1,000, of such property."

The deductibility or non-deductibility of such items from the marital deduction can be controlled by the phraseology of the will and there will be no excuse for a slip-up in these items if the will is properly drafted.

G. Technical amendments to the estate tax law

The foregoing revision as to certain deductions for federal estate tax purposes, necessitated amendments to the provisions of Section 812 (c), relating to the deduction for property previously taxed and to

Section 813 (a) (2) (A) relating to the credit for gift tax, in connection with determination of estate tax liability.

Both of these amendments, as well as the unamended portions of the two sections are extremely technical and we will not in this discussion attempt any analysis of such amendments.

It might be noted, however, that the deduction for property previously taxed is disallowed under the 1948 law with respect to property received by a surviving spouse from a spouse dying after December 31, 1947, whether or not a marital deduction was allowed with respect to the property. The marital deduction must, however, be taken into account in computing the amount of the deduction allowable in other cases. Furthermore, the 1948 law, with respect to property previously taxed, provides a special rule with respect to the deduction allowed on account of gifts received within 5 years preceding a decedent's death, where the gift was considered as made one-half by the donor and one-half by the donor's spouse. By way of illustration, a gift from an individual of $50,000 to the decedent will be considered for purposes of Section 812 (c) as a gift of $25,000 from such individual and of $25,000 from his spouse if the gift qualifies for the marital deduction under the provisions of the 1948 amendments to the gift tax law. In such a case, if the husband paid a gift tax with respect to any part of the $25,000 considered as a gift by him but gift tax was not paid with respect to the $25,000 considered as a gift by his spouse (by reason of the $30,000 exemption under the gift tax law), the deduction under Section 812 (c) is allowed only with respect to the $25,000 gift (or property acquired in exchange therefor) from the husband.

With respect to the changes in the so-called "Credit for Gift Taxes" (Section 813 of the Code), the amendments are intended to give effect in computing the credit to the estate and gift tax provisions for a marital deduction under Sections 812 (e) and 1004 (a) (3) of the Code, and to the gift tax provisions for splitting of gifts of spouses to third parties under Section 1000 (f) of the Code.

It is, of course, realized that this credit for gift tax does not come up for consideration unless some gift made by decedent during his lifetime has been held to be a gift in contemplation of death and the date of death value of such gift is included in decedent's estate for federal estate tax purposes. In such case, if a gift tax was paid at the time of making the original gift, some credit (on a very limited and restricted basis) is given against decedent's estate tax for the gift tax previously paid. If the property was originally owned by decedent, then, regardless of the gift tax marital deductions at the time of computation of gift tax liability, the entire value (at date of death) of the property is—if gift was in contemplation of death—added to decedent's gross estate;

then under Section 812 (e) (1) (A) the full amount of the value for gift tax purposes is considered as a marital deduction but this is then reduced on the basis of the 50% limitation rule. It may, therefore, happen that the marital deduction will not be of any actual or tangible value in computing his liability for estate tax and that the full value of such gift is subject to estate tax in decedent's estate. Then, to add insult to injury, the decedent's executor must go through a series of complicated and abstruse formulae for the purpose of determining the proper gift tax credit.

Admittedly, the discussion of these technical amendments relating to prior taxed property and the gift tax credit are very inadequate and could not possibly give any real enlightenment on these matters to anyone. At the end of this paper I have added a few more miscellaneous comments as a supplement but even these additional gems of wisdom do not serve to clarify such abstruse and complicated sections of the law. I am afraid you will have to follow my procedure in respect to such sections—that is, pray that they will not come up in any case handled by you, and, if they do, pray for at least a partial understanding of the law after hours of study.

H. Disclaimers

The disclaimer provision relating to the marital deduction for estate tax purposes should receive a brief comment because there is no provision of the Gift Tax Law which corresponds to it.

A disclaimer is a complete and unqualified refusal to accept the rights to which one is entitled. It should be noted, however, that if a person uses such rights for his own purposes (as by receiving a consideration for his or her formal disclaimer) he is not considered as having refused the right to which he was entitled. In other words, there can be no disclaimer after an acceptance of such rights, expressly or impliedly.

Subparagraph (A) of Section 812 (e) (4) provides that if an interest which would otherwise be considered as passing from the decedent to the surviving spouse is disclaimed by her, then such interest shall not be considered as passing to her and the marital deduction represented by such interest will not be allowed. On the other hand, Subparagraph (B) of Section 812 (e) (4) provides that an interest disclaimed by a person other than the surviving spouse will, notwithstanding such disclaimer, be considered for the purpose of allowance or disallowance of the marital deduction, as passing to the person making the disclaimer in the same manner as if the disclaimer had not been made.

An example of the application of the rule under Subparagraph (B) would be as follows:

> A bequest of an interest in property to a person other than the surviving spouse is disclaimed by such person and, as a result, such interest falls into the residue of the estate. The residue was bequeathed by decedent to the surviving spouse. Because of the above rule, such interest will not be considered as passing to the surviving spouse for the purpose of the marital deduction.

An example of the application of the rule under Subparagraph (A) would be as follows:

> If the surviving spouse disclaims a bequest made by the decedent to her and the property falls into the residue passing to persons other than such surviving spouse, no marital deduction is allowed with respect to such bequest or such property because the property is considered as passing from the decedent to the residuary legatees.

In this last example, however, it should be noted that if the surviving spouse had disclaimed the bequest and the bequest had fallen into the residue of the estate and if the surviving spouse was the residuary legatee, the interest disclaimed by her—to wit, the specific bequest—is considered as passing to her from the decedent for the purposes of the marital deduction.

I. Summary

By way of recapitulation and in summary of the foregoing, it might be stated as a general rule that the marital deduction will be allowed as an estate tax deduction provided the property or interest in property passing from the decedent to the surviving spouse will, upon the death of such surviving spouse, be fully subject to estate tax in the estate of such surviving spouse.

It should be specifically noted, however, that the determination of this fact is made at the time of the death of the decedent and is not governed by an subsequent acts of the surviving spouse. In other words, after the property gets into the possession of the surviving spouse she can effect substantial reductions in her ultimate estate tax liability by making gifts to members of her family or she can spend it, throw it away, etc. The important and essential element is that at the death of her husband she can absolutely control the disposition of the property claimed as the marital deduction.

III. Gift Tax Amendments under 1948 Law

A. General Discussion

In addition to the changes made in the basic laws relating to income tax and estate tax deductions, the Revenue Act of 1948 likewise made a very substantial change in certain aspects of the Federal Gift Tax Law. With respect to citizens of the community property states the

1948 law restores to taxpayers certain advantages taken away from them by virtue of the community property amendments included in the 1942 Revenue Act.

The passage of the 1948 Law simply put community property taxpayers back on the pre-1942 50/50 basis as far as community property is concerned. Then the 1948 Law goes on to provide substantially the same benefits to taxpayers living in the common law states. This is accomplished, insofar as the common law states are concerned, by the allowance of a gift tax marital deduction.

1. It should be noted that the marital deduction allowed for gift tax purposes differs from the marital deduction allowed for estate tax purposes in one very important respect. Whereas deductible interests are allowed in full for estate tax purposes, subject, of course, to the overall limitation of 50% of the adjusted gross estate, the gift tax law provides that for purposes of the federal gift tax 50% of the value of *each gift* made after 3:18 P.M. Eastern Standard Time on April 2, 1948 (date of enactment of the Revenue Act of 1948) to a donee who is the spouse of the donor at the time of the gift is allowed as a marital deduction.

It should be specifically noted that the deduction is allowed only with respect to a gift made after 3:18 P.M. E.S.T. on April 2, 1948—this differs from both the estate and income tax provisions which cover the status of taxpayers from and after December 31, 1947. Furthermore, the marital deduction is specifically limited to a gift to a donee who *at the time of the gift* is the spouse of the donor. This means that a marital deduction would not be allowed in the case of a gift to an individual who was not the donor's spouse at the moment of such gift even though such individual was or became the donor's spouse at some other time during the calendar year in which the gift was made, or at any other time.

2. It should be noted that Section 1000 (f) (1) (A) provides certain specific limitations with respect to the marital status. These are as follows:

a. At the time of the gift each spouse must be a citizen or resident of the United States.

b. As stated above, the two individuals must be married to each other at the time of the gift.

c. Neither spouse shall remarry during the remainder of the calendar year in which such gift is made.

3. As stated above, Section 1004 (a) (3) provides that the marital deduction is allowed with respect to each gift to a spouse and it is determined without regard to the $3,000 annual exclusion. For example,

if, after the enactment of the 1948 law, a husband makes a gift to his wife of $10,000, he is allowed a marital deduction of $5,000 (50% of the value of the gift). This leaves him $5,000 balance and from this amount he deducts his $3,000 annual exclusion. Assuming he had previously exhausted his $30,000 specific exemption, the husband would pay gift tax on the $2,000 balance.

4. Section 1004 (C) has the effect of limiting the marital deduction with respect to gifts to a spouse in any calendar year to the amount of such gifts included for the purposes of computing net gifts.

By way of illustration, if the only gift by a donor to his spouse during a calendar year is $5,000, an exclusion of $3,000 is allowed—so that the amount included in net gifts is $2,000. A marital deduction is allowed in the amount of $2,500 by Section 1004 (a) (3) but is limited by Section 1004 (c) to $2,000. This latter section applies only to the total deduction allowed under any one paragraph of Section 1004 in computing net gifts. The operation of this subsection is illustrated by the following example appearing on page 32 of the supplemental report of the Senate Finance Committee:

> "A donor transferred $4,000 by gift to his spouse in January, 1949, and $4,000 by gift to her in July, 1949, and made no other gifts to her during the year. The marital deductions allowed under Section 1004 (a) (3) in such a case without regard to Section 1004 (c) total $4,000 (that is, two deductions of $2,000 each). Since only one $3,000 annual exclusion is allowed for the gifts to the donee spouse, the extent to which the two gifts (total $8,000) are included in the amount of gifts for the purpose of determining net gifts is $5,000. Accordingly, since the total marital deductions ($4,000) do not exceed $5,000, the marital deductions are allowed in full."

B. Qualifications and limitations on gifts from one spouse to the other

1. Life estate or other terminable interest

Subparagraph (B) of Section 1004 (a) (3) contains substantially the same provisions with respect to terminable interests under the gift tax law as are contained in subparagraph (B) of section 812 (e) (1) under the estate tax law.

a. In fact, the marital deduction is disallowed with respect to gifts of terminable interests on the same two conditions as are applicable to terminable interests for estate tax purposes. That is to say, the marital deduction is disallowed with respect to the transfer of such an interest if—(1) An interest in the same property passes, for less than a full and adequate consideration in money or money's worth, from the donor to any person other than the donor's spouse; and (2) The person acquir-

ing such interest (or his heirs or assigns) may, by any possible circumstances under such gift, possess or enjoy the property after the termination or failure of the interest so passing to the donee spouse.

b. In addition, the marital deduction is disallowed with respect to terminable interests if the donor retains in himself an interest in the property in which a terminable interest is given to the spouse, and the donor (or his heirs or assigns) *may* posses or enjoy any part of such property *after* the termination or failure of the interest transferred to the donee spouse, or if the donor retains a power to appoint the property so that the appointee may enjoy the property after the termination or failure of the interest of the donee spouse.

The rule as to retention of power to appoint is applicable, for example, in a case in which the donor was the sole beneficiary of the income from a trust and had the power to appoint the corpus of the trust upon its termination. If the donor releases his power to appoint (his spouse not being the taker in default of appointment) and assigned his entire income interest to his spouse, the marital deduction is not allowed with respect to the gift to the spouse. The release of the power is considered a transfer by the donor to the taker in default. It is immaterial whether the power so released is a power of appointment within the definition in Section 1000 (c) of the Code or whether such release was for the gift tax purposes (other than as set out in Clause (i) of subparagraph (B)) considered a transfer, or whether the power was released any time before or at the same time as the gift to the spouse. A release of a power includes the failure to exercise a power to the extent such failure has the effect of terminating the power. (See page 31 supplemental report of Senate Finance Committee.)

By way of illustration of the above, if the donor is entitled to the income of a trust for ten years with power to appoint the corpus after such period, a gift of the income interest to his spouse does not qualify for the marital deduction.

2. Unidentified assets

Except for difference in phraseology the provsions of the gift tax law as to reduction in value of interest transferred in the case of unidentified assets (subparagraph C of Section 1004 (a) (3)) are substantially the same as are the like provisions of subparagraph C of Section 812 (e) (1) under the estate tax law.

Likewise, the provisions set out and contained in subparagraph (E) of Section 1004 (a) (3) relating to the allowability of the marital deduction in the case of a trust with power of appointment vesting in the donee spouse, as an exeception to the terminable interest rule, corresponds with similar provisions under the estate tax law, set out in subparagraph (F) of Section 812 (e) (1).

3. Gift of community property not allowed as marital deduction

Subparagraph F of Section 1004 (a) (3) disallows the marital deduction in the case of gifts of the donor's interest in community property. As a backhanded slap at those taxpayers in community property states who converted community property into separate property prior to the effective date of the 1942 Amendments, Clause (iii) of subparagraph F provides that if during the calendar year 1942 or at any time after the passage of the 1948 Law property formerly held as community property was by the donor and the donee spouse converted into separate property, such separate property shall for the purposes of Clause (i) be considered as being held as community property—thereby disallowing the marital deduction.

C. Gifts of husband or wife to third parties

Because of the fact that the income tax provisions of the 1948 Law permit a husband and wife to split the marital income, and the further fact that the estate tax provisions permit the non-taxable division of the estate of the first spouse to die through the medium of the marital deduction, a gift from husband to wife or from wife to husband now becomes relatively unimportant taxwise. The major saving to be hereafter attained will be in gifts by husband or wife to their children or to others.

1. The 1948 Law has given substantial relief in respect to such gifts by providing that, subject to certain specific conditions, such gifts may be considered as made one-half by the actual donor and one-half by his or her spouse. This, of course, could mean, and in the great majority of cases will mean, a very substantial saving in gift tax. For example, suppose H has used up his specific gift tax exemption of $30,000 and his wife has not used any part of her exemption. H, following strictly the conditions set out in the 1948 law, makes a gift valued at $72,000 to his two children. Prior to the 1948 law he could get two annual $3,000 exclusions from this gift and would then pay gift tax on the balance of $66,000. Under the 1948 law, however, the gift will (subject to the conditions hereinafter set forth) be considered made one-half by him and one-half by his wife—that is $36,000 by each. His wife will use her $30,000 specific exemption and two annual $3,000 exclusions—total $36,000—and will, therefore, pay no tax on her $36,000 gift. H will get two annual $3,000 exclusions and will pay gift tax on $30,000. The saving in tax is clearly apparent.

2. Conditions to be met

To qualify for such a privilege, however, certain specific conditions must be met:

a. The gift must be made after 3:18 P.M., E.S.T., April 2, 1948 (time of enactment of Revenue Act of 1948).

b. Each spouse must be a citizen or resident of the United States at the time of the Gift.

c. The spouses must be married at the time of the gift and must not remarry during the remainder of the calendar year in which the gift is made.

(The above three conditions are set out in Subparagraph (A) of Section 1004 (f) (1).)

d. Both spouses must signify their consent that all gifts to third parties made during that calendar year by either while married to the other will be considered as joint gifts.

3. The time for giving such consent is set out in Subparagraphs (A) and (B) of Section 1000 (f) (2). In all probability the new gift tax return forms will have a space provided for such consents. The statute very specifically provides that the consent must be given before or at the time a gift tax return is filed for the year of the gift by either spouse. It should be very carefully noted that if application for extension is made for one spouse, it will be safer to ask that extension be granted both spouses. Clause (ii) of Subparagraph B provides that no consent can be signified after a notice of deficiency in gift tax for such year has been sent to either spouse. I presume this means that if no gift tax return is filed and later on the Commissioner finds a return should have been filed—if the spouses can get in their consents before the deficiency notice is mailed, such consents will be accepted. In cases of doubt, therefore, it will be advisable to be very careful both to file gift tax returns and to likewise file the required consents.

4. Section 1004 (f) (3) provides for revocation of this consent by either spouse provided such revocation is made on or before March 15th of the year following year of the gift. In other words, if a taxable gift to a third party is made in 1948, a gift tax return is due to be filed on or before March 15, 1949. If the return is filed on February 15, 1949, and the prescribed consent is likewise filed at that time the husband and wife can split the gift fifty-fifty as provided in Section 1000 (f) (1) (A). Later on, one spouse desires to revoke such consent. If such revocation is made not later than March 15th it will be accepted. It should be noted, however, that if a thirty day extension is granted for filing the gift tax return, the consent can be filed but the privilege of revocation is denied.

5. One of the primary purposes of such consent is set out in Section 1000 (f) (4)—which reads as follows:

"If the consent required by paragraph (1) (B) is signified with respect to a gift made in any calendar year the liability with

> respect to the entire tax imposed by this chapter of each spouse for such year shall be joint and several."

This provision applies with respect to gifts made between the spouses as well as gifts to third parties. It also applies to gifts of community property and property held in other forms of co-ownership.

6. While Section 1000 (f) (4) provides that the tax liability shall be joint and several, the Senate Finance Committee (pages 34-35 of the Supplemental Report) gives the following comforting assurance:

> "It is not contemplated under this provision that where one spouse pays the entire tax liability of both spouses any gift tax will result by reason of payment of the liability of the other spouse."

IV. Supplemental Data

A. Previously taxed property

There have been, and continue to be, limitations on the deduction for previously taxed property—it is allowed only where an estate or gift tax has been paid and must be reduced by its share of general claims, etc.

The 1948 Act amended Section 812 (c) to provide that the deduction is *not allowable* with respect to property acquired from a prior decedent who died *after* December 31, 1947, and *was, at the time of such death, the decedent's spouse.* In addition, the amended section *denies the deduction* with respect to property received by *gift from the donee's spouse* after the date of enactment of the Revenue Act of 1948. Neither does it allow the deduction with respect to property acquired in exchange for property acquired from a spouse by gift or from a prior deceased spouse.

The deduction is disallowed regardless of whether a marital deduction was allowed in computing the net estate of the prior decedent or the net gift of the donor.

B. Credit for gift taxes

The law prior to the 1948 Act provided that where a gift tax had been paid upon property included in the gross estate of the donor upon the death of the donor, a credit was allowed against the estate tax for the gift tax paid upon the property, limited to an amount which bore the same *ratio* to the net estate taxes (before such credit), as the value of the gift property included in the gross estate at the time of the gift or at the time of death, whichever was lower, bore to the value of the entire gross estate. (Sections 813 (a) (2) and 936 (b).)

The 1948 law amends the above provisions by requiring the reduction of the entire gross estate by the aggregate of charitable, etc., do-

nations allowed as deductions from the gross estate, and the marital deduction

The 1948 law also provides that in applying the aforesaid ratio, the value at the time of the gift or at the time of death, whichever is lower, shall be reduced by (1) the gift tax exclusion allowable in the year of the gift; (2) the estate tax marital deduction allowed with respect to such gift (adjusted in the manner set out in the 1948 Act), and (3) by the charitable deduction, first reduced by the appropriate gift tax exclusion determined in (1).

For the purposes of the credit for gift tax the law prior to passage of the 1948 Act provided that the gift tax paid on any property was the same proportion of the total gift tax paid for the year of the gift *as the value of the property* bore to the total amount of net gifts (before deduction of the specific exemption) for that year. The 1948 Act changed the words "the value of the property" to a new phrase—to wit, "the amount of such gift," and provided a new rule for the purpose of determining the amount of the gift. In substance the 1948 Act provides that the amount of the gift (for which gift tax credit against estate tax is allowed) is the amount that was included with respect to the gift in determining the total amount of gifts made during the year, reduced by the charitable deduction and the gift tax marital deduction allowed.

Where the decedent was the donor of the gift, but the gift was considered as made one-half by his spouse under the provisions of the 1948 Act, *the amount of gift tax paid, for the purpose of the credit against estate tax, includes* the amount paid with respect to *each half of the gift,* each half being reduced by the annual exclusion allowable for the year of such gift.

C. Joint ownership of decedent and surviving spouse

According to the Supplemental Report of the Senate Finance Committee where property is held at the time of the prior decedent's death in joint ownership with right of survivorship, the interest of the surviving spouse is considered *received from the prior decedent to the extent* of the part of such property included in determining the value of the prior decedent's gross estate.

Furthermore, if property is given by a third party to a husband and wife as joint tenants and upon the death of the husband one-half of such property is included in determining the value of his gross estate, then one-half of such property is received by the surviving spouse from the husband and one-half is received from the donor.