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Jack W. Burnett

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GENERAL PRINCIPLES OF FEDERAL ESTATE TAX PLANNING*

JACK W. BURNETT**

INTRODUCTION

Many technical articles have been published dealing with our federal estate and gift tax laws and the subject called estate tax planning. The purpose of this article, however, is not to discuss some of the technical areas of this specialized subject but rather to cover the whole area of estate tax planning in a general way realizing that most of the Journal's subscribers are engaged in the general practice of law, many in small communities, and can perhaps profit by a general discussion of this subject.

Lawyers and accountants in Wyoming and Montana and other northern Rocky Mountain states rarely if ever become involved in planning the estates of men of great wealth who have accumulated their fortunes in industrial enterprises or by way of inheriting vast fortunes. Therefore, in the illustrations and discussions herein, the more typical kind of well-to-do Westerner will be considered. Generally, he will be a rancher or farmer whose net worth may run from $200,00 to a million dollars or he may be the owner and operator of a small business, such as a merchant or a contractor, with an equivalent net worth.

METHODS OF EFFECTING ESTATE TAX SAVINGS

The Federal estate tax rates begin at 3% and progressively rise to 77%. Assuming that the Wyoming inheritance tax equals or exceeds the maximum credit allowed for state death taxes, the effective Federal estate tax rate for net estates between $60,000 and $1,000,000 varies between 26.4% and 32.2%. As stated previously, this article will deal mainly with estates in the range from $200,000 to $1,000,000 where the effective tax rate is therefore roughly 30%. To this would be added the Wyoming inheritance tax to determine the overall death tax rate.

Because of this heavy tax burden, it is not surprising that accumulators of wealth and their advisors have sought means to reduce the impact of the tax and it is also not unexpected that Congress itself has seen fit to enact specific statutes which reduce the effectiveness of the estate tax law. First of all, the law allows all debts and expenses of administration to be deducted from the gross value of a decendent's estate and in addition thereto the first $60,000 of the net value is not taxed. Secondly, Congress

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**Law firm of Felt, Felt & Burnett, Billings, Montana; Member of the Montana Bar and the New York Bar; Member, Section of Taxation, American Bar Association; B.S. (Accounting), Wyoming University, 1947; LL.B., Montana University, 1949; LL.M. (Taxation), New York University, 1951; Lecturer at tax institute, Montana University Law School; contributor to legal periodicals.

does not include in the taxable estate any gifts made by a decedent during lifetime unless they are made within 3 years of the date of death and are made in "contemplation of death." However, gifts must be made within certain limits if the donor desires not to incur a gift tax liability, for Congress has also seen fit to tax gifts at progressive rates. Thirdly, Congress has enacted legislation permitting a deduction to be taken for property left to the decendent's spouse. This deduction is called the "marital deduction."

Although various ways exist whereby estate tax savings can be effected such as making a wise choice between valuing the property as of the date of death or on the alternate valuation date, the use of buy-and-sell agreements, family annuity plans, investing in foreign real estate, and other special devices, this article will deal primarily with the two broad methods which exist for estate tax savings: inter-vivos gifts and the use of the marital deduction.

INTER-VIVOS GIFTS

Controlled gifts

Assume that either a prosperous old client or a prospective new client requests your advice as to what steps he might take in order to reduce the amount of death taxes which would otherwise be incurred as a result of his death. You will, of course, have to obtain many facts such as his marital status, wealth, age, health, number of children, and also his general testamentary intent. Assuming he is a married man, you can also discuss the estate tax marital deduction and how it could be used to advantage. But eventually, after acquiring whatever facts you deem to be important, you should get around to the subject of making lifetime gifts because that is the most effective way to reduce death taxes. Your client or prospective client may show little or no interest at all in the idea of giving away his property. This, of course, should be expected as it must be realized that after a lifetime of building up an estate, the idea of now giving it away may seem ridiculous to him. However, he may say that he is willing to make some gifts provided that he deeds or assigns the property subject to retaining its use during his lifetime. On this point you would have to reply that at one time it was possible to avoid Federal estate taxes by giving away property subject to the donor reserving a life estate but this clearly cannot be done under present law.[1] You would also have to advise him that signing deeds to land and assignments of personal property without delivering them to the donee would not effect any tax reduction and the same can be said for revocable trusts or placing property in joint tenancies.[2]

Assume further that the client is not in a position to make outright

1. Section 2036 of the Internal Revenue Code. Hereinafter all section numbers not otherwise designated, will refer to the 1954 Internal Revenue Code.
2. §§ 2035, 2037, 2038, and 2040.

gifts of part of his property at this time. This will be the situation which most often occurs. Busy ranchers and businessmen need all of their assets for working capital and they will usually be unable or unwilling to commence giving away their property to their children and indeed in many cases it would be unwise for you, as their tax or legal advisor, to advise such a course of action.

However, there are alternative courses of action which might be taken. In the case of a rancher it could be suggested that he incorporate the ranch lands and thereafter, over a period of years, give away 49% of the corporate stock. The incorporation would not be subject to the imposition of an income tax so long as the transferor received only stock or securities in exchange for the land.[3] By retaining 51% of the stock, the donor will control the board of directors and the officers of the corporation. He could lease the lands at a fair rental and continue to operate his ranching business as before. The lease should only run for one or two years at a time for if it were a long-term lease, a revenue agent might claim that he had retained a life interest in the land. From an estate tax standpoint, the donor would have given away almost one-half of the value of his land holdings but he still retains control over them. This corporate device is of common usage and has not, to my knowledge, been challenged by the Treasury Department in recent years. It would be difficult for the Treasury Department to obtain any authority contrary to this result because even though a minority shareholder can to some extent be disregarded in corporate affairs, it is nevertheless well established corporate law that he is entitled to his pro-rata share of any dividends declared and paid and to a pro-rata share of the corporation's assets if it is liquidated and, of course, he can exercise his voting rights and also protest corporate action based on fraud or the wasting away of corporate assets. Hence, it is clear that a gift of stock in a corporation controlled by the donor can result in a substantial reduction of his estate, even though it may be that his 51% stock interest would have to be valued at somewhat higher than a share for share basis because of the control feature. This plan of utilizing a corporation in this way has been criticized by some as a "tax loophole" but such criticism is unjustified as any advantage it might offer does not arise because of any oversight in drafting legislation but rather because of the general operation of our corporation laws and the general proposition that every individual can reduce his or her taxable estate by making lifetime gifts. In addition, this plan should not be undertaken lightly or thought of as a golden gate for avoiding estate taxes without actually making a real gift. It should not be thought of as simply a gift of a piece of paper. If you were going to advise that this plan be utilized, you would want to impress upon your client that after the gift he will not able to deal as freely with the corporate assets as before. For example, if he desired to sell the corporate assets the buyer would probably want him to first

3. § 351.

liquidate the corporation or at least the buyer might want to own all the stock. In such latter case, the minority shareholders must be paid for their stock at a price agreeable to them or in the case of a liquidation, the minority shareholders would be entitled to their pro-rata share of the assets of the corporation which they may or may not be willing to sell. For these and other practical reasons, this plan should not be undertaken unless thoroughly understood and approved by the client.

An alternate plan for a rancher would be to incorporate the entire ranch, that is, land, buildings, cattle, machinery, and other assets and thereafter make gifts up to 49% of the stock. Likewise, a merchant, contractor, or other businessman could incorporate his business and thereafter make such gifts. Another possibility would be to transfer the property to the corporation in exchange for common stock and also for preferred stock or debentures and thereafter make gifts of the preferred stock or debentures. If it is desirable to effect a tax-free incorporation, the debentures would have to be long-term obligations.[4]

You must also point out that if the client should ever want to liquidate the corporation, the income tax consequences would be the same as if he sold his stock. That is, the liquidation will be treated as a taxable exchange.[5]

You will have to inform him that such a plan involves extra red tape, in the form of more tax returns and annual reports to file, more paper work in the form of corporate record keeping, all of which will cost something more in the form of general expenses, bookkeeping, accounting and legal fees.

A full outline of the income tax features of the plan would have to be explained to the client. In the case of a land corporation, the donor could lease the land from the corporation and the rental paid would be deductible by him and included in the corporation's gross income. It would have to be a fair rental. The corporation would deduct therefrom such items as taxes and interest and also insurance and depreciation if the land deeded to the corporation included improvements. The donor could be paid a small salary by the corporation, but the remainder of the net income, after paying federal corporation income tax, would be locked up in the corporation except that dividends not to exceed $50 per person could be paid and received by the stockholders tax-free.[6]

The corporation income tax rate is 30% up to $25,000 of net income. Over that sum, the rate jumps to 52%. Since the corporate income would all be rental income, the recently enacted law allowing corporate income to be taxed to the shareholders could not be used.[7]

4. § 351.
5. § 331.
6. § 116.
7. § 1372 (e) (5).

The surplus could be invested in new buildings or remodeling old ones or could be used to purchase equipment, new fences, or additional land. There would be no need to worry about incurring any penalty tax for accumulating surplus so long as it remained under $100,000.[8] Nor would the land corporation be subject to the severe personal holding company tax.[9] However, at least yearly, this matter of being subjected to the personal holding company tax should be checked and any corporate investments which might yield any income other than rentals from stockholders or others should be avoided or at least kept well within the 10% rule of Section 543 (a) (6).

Prior to deeding any land to the corporation, the grantor should usually reserve all of the mineral interests for, should they become valuable, it would be less complicated to deal with them as a personally owned asset rather than as an asset of the corporation.

In summary, you may find that the incorporation of property combined with gifts of 49% of the stock thereof, will be a logical plan to follow in certain cases. It can be used where the donor is unable or unwilling to make gifts in a more outright manner. It does have some potential disadvantages from an income tax standpoint and it does involve some extra red tape and expense. It can be used in cases when the property is in the form of land or other business property. Space prohibits a full discussion of the severe penalty imposed by the Internal Revenue Code on personal holding companies but you must make certain that your client does not fall within the scope of this penalty tax.[10]

Gifts to donor's wife

The discussion above involves primarily gifts to children or members of a younger generation in order to cut down the estate tax burden which might otherwise fall upon the donor's estate or his wife's estate in the event she survived him and inherited his property. However, it may be of more importance to postpone gifts to a younger generation until the estate of the husband and wife have to some extent been equalized. For example, if a husband owns property worth approximately $240,000 and the wife owns nothing and he dies leaving at least half of it to her, an estate tax will have to be computed and paid on some $60,000. However, if during lifetime he had transferred $120,000 to his wife, then no estate tax would have to be incurred by the estate of the first one that died because a marital deduction of $60,000 could be taken and the Code provides for an exemption of $60,000. Generally then, from an estate tax standpoint, the best result is reached by equalizing to some extent the estates of husband and wife either prior to or in conjunction with the undertaking of a gift program to children or others. At least this is true when the husband and

8. §§ 531 through 537.
9. §§ 543 (a) (6) and 543 (a) (7).
10. §§ 541 through 547.

wife are of about the same age or the donee is the younger and either both or at least the donee is enjoying good health. In order to do so, it usually requires the making of yearly gifts from husband to wife, assuming he is the original accumulator of the property and income. This matter of equalization of the estates requires yearly action in common law states such as Wyoming. In community property states, it is more or less done automatically as the spouses are treated as joint owners of income and of certain property.

Your client may be much more interested in this type of gift program than he would be in making gifts to children. He may already think of his wife as a joint owner in fact if not in law. Prior to making such gifts, you will have to check into the nature and amounts of any prior gifts to determine if any part of his lifetime exemption has been used. The donor could use such property in his business by borrowing it from his wife or at least it could be used for credit purposes. A bank or other lending institution will generally require a wife to sign any notes and mortgages and the size of any loan will depend on their combined net worth. Hence gifts to a wife may be completely acceptable whereas gifts to a child or someone else would be out of the question.

Even if no other gifts are practical, your client may be willing to give his life insurance policies to his wife or others. For example, if he dies owning a $50,000 policy, that sum will be includable in his gross estate. However, if he makes a gift of the policy at least three years prior to death, the insurance proceeds would not be taxable, even though he continues to pay the premiums.[11] Any such gift is valued at approximately its cash surrender value for gift tax purposes.

Mechanics of gift making

Prior to advising your client to embark upon a gift program, you will want to advise him that the method and manner in which gifts are made are important because of the U. S. gift tax law. You will seldom find a client in Wyoming or Montana who is willing to pay out any cash to Uncle Sam for the privilege of giving his property away! He will expect you to plan his gifts so that no gift tax will ever be incurred.

Under Section 2521 of the Internal Revenue Code, every person is allowed to make gifts up to $30,000 without incurring any gift tax. This once-in-a-lifetime exemption is called the "specific exemption." It is independent of a second relief provision called the "annual exclusion." This latter provision allows every person to give to *each* donee $3,000 *a year* without incurring a gift tax nor using up any part of his specific exemption.[12]

In addition, a gift by a married person can be treated as having been

11. § 2042.
12. § 2503.

made one-half by each spouse.[13] For example, a married person who has not made any prior gifts can give each of his children $6,000 in cash or property and the donor could divide an additional $60,000 among them in the same year and no gift tax would be incurred assuming his wife files a valid consent to such gifts. The $6,000 gifts are treated as if both spouses made gifts of $3,000 each and as such the amount of the gifts only uses up their yearly exclusions. The $60,000 gift is treated as if each spouse made a gift of $30,000 and thereby each spouse would have used up his and her specific exemption. In future years, the donor would have to restrict his gift-making to $6,000 per donee per year in order to avoid paying any gift tax, again assuming the gifts are legally consented to by his wife. If not, or if the donor is a single man, such gifts would have to be limited to $3,000 per donee a year.

Gifts made to a spouse are eligible for the gift tax marital deduction.[14] The effect of this law is that a gift to a spouse is treated as a gift of only one-half of the actual amount given to him or her. Hence a husband could give $6,000 to his wife without using up an part of his specific exemption since only $3,000 would be treated as a gift and the annual exclusion would take care of that amount. In addition, the husband could also give his wife $60,000 in the same year without incurring any gift tax, assuming again that he has not previously used up any part of his lifetime exemption. Only $30,000 of the $60,000 given to her would be treated as a gift and his specific exemption would be totally used up on that gift. In future years, gifts to his wife would have to be limited to $6,000 in order to avoid paying a gift tax.

In connection with the specific exemption, you need not be concerned about whether the subject of the gift is a "present interest" as distinguished from a "future interest." Both types of interests qualify for the exemption. However, in considering whether or not a particular gift will qualify for the annual exclusion, you may be vitally concerned with these concepts for only gifts of "present interests" qualify therefor. If you are advising a donor to deed a parcel of land or transfer certain personal property, perhaps shares of stock in a family corporation, to his wife or children, including minors, you need not be concerned with these concepts as it is clear that such outright gifts qualify as present interests. However, if a gift is being made in some other form, such as placing property in an irrevocable trust, the gift may not qualify for the annual exclusion. An interest in a trust fund for an individual under the age of 21 can qualify as a present interest if the trust meets the requirements set forth in Section 2503 (c). Gifts to minors under Uniform Gifts to Minor's Acts also qualify for the annual exclusion.

Any gifts made three or more years prior to the donor's death are safe

13. § 2513.
14. § 2523.

from the imposition of an estate tax thereon. Any gifts made within three years of death are presumed to be made in "contemplation of death."[15] Gifts so made are includable in the decedent's gross estate under Section 2035 (a). In order to overcome this rebuttable presumption in favor of the Treasury Department, it must be shown or proven that the dominant motive for the gift was a "living motive" as distinguished from a "testamentary motive."

As stated above, you will most often be dealing with a client who is unwilling or unable to step up his gift program to the point where gift taxes would be incurred. He will expect you to keep any gifts within the limits of the annual exclusion and his lifetime exemption. Situations may arise where you will advise that larger gifts be made even though gift taxes will have to be paid. The reason for such advice would be to further reduce the client's estate and in addition the payment of a gift tax itself will further decrease the client's estate. Gift tax rates start at 2¼% and progress up to 56¾%. Relatively speaking, the gift tax rates are three-fourths of the estate tax rates in the same brackets.

A gift resulting in a gift tax can result in substantial estate tax savings even though it be admitted that the gift is made in "contemplation of death." Assume a wealthy individual makes an outright gift of $100,000 shortly prior to his death and that a gift tax liability of $20,000 is thereby incurred. This $20,000 gift tax can be deducted on the estate tax return as a debt of the decedent and if it is assumed that the estate is in the 30% bracket, said debt reduces the estate tax by $6,000. In addition, Congress has seen fit to prevent "double taxation" of property in such cases. That is, if a gift tax liability is incurred on a transfer of property but the property is nevertheless subject to an estate tax, the law provides that the amount of gift tax paid is a full credit against the estate tax liability. Therefore, in the example above, the overall tax bill is reduced by $6,000 by the making of the death-bed gift, assuming that if the gift had not been made the estate tax would be at least $26,000.[16]

This particular point has sometimes been overlooked by both tax advisors and revenue agents and it is suggested that in any case in which you are involved, whether it be in preparing an estate tax return, planning an estate for tax savings, or in litigation over estate taxes either in the courts or before the Treasury Department, that you check this point.

Lastly, in this matter of planning and advising on the size of gifts, be sure to impress upon your client that if the gift is other than cash, it must be reported at its "fair market value." Make it clear that the original cost of property, or its par or book value if corporate stock is involved, may have little or no relation to the valuation that is required to be reported on a gift tax return. A rancher or farmer may have difficulty

15. § 2035 (b).
16. §§ 2012, 2053; Treasury Regulations, § 20.2012-1.

in realizing that a gift of land should not be valued at his cost even though it be only a fraction of what the land is worth and a donor of corporate stock sometimes thinks that any gifts thereof should be made on its par or book value rather than its fair market value. As a precautionary measure, even in cases where it is believed that the property is valued objectively and fairly, you need not try to have the gifts made at exactly the amounts of the yearly exclusions or the lifetime exemption. It may be advisable to leave some slack so that even if a revenue agent is able to show that the property has been undervalued, there will still be no tax due.

The willing giver

Hereinabove, the mechanics of gift planning and how it might operate to reduce a man's estate by making gifts to his wife or children has been briefly discussed. Mainly it has dealt with a donor who is unable or unwilling to make completely free and uncontrolled gifts, at least to anyone other than his wife.

However, you may be called upon to give advice to a client who wants to make gifts in a more outright manner and who has no hesitation about placing property beyond his own control either in the form of outright gifts to his wife and children or by transferring property to irrevocable trusts for their benefit. From an estate and gift tax standpoint, your considerations will be much the same as those outlined above but the form of the gift will be of more importance because you will now be dealing with a gift of cash or land or personal property which can be converted into cash. The donor will be giving up the ownership and control of property to someone else. A great number of factors will go into making the decision of the form of the gift. Such factors as the age of the donees, their health, intelligence, and loyalty will be considerations. Also their desire and ability to fit themselves into the business of the donor could be important.

While inter-vivos trusts date back centuries in England and have been used extensively in lifetime estate planning on our eastern seaboard, their use in Montana and Wyoming has not been extensive. They are viewed somewhat with suspicion but are slowly becoming more popular as the need for the trust device becomes more apparent and its uses and purposes become better understood. While many men and women are today setting up testamentary trusts in their wills, there is still a reluctance to set up irrevocable inter-vivos trusts and it will be many years before the creation and management of such trusts become commonplace in cities and towns in northern Rocky Mountain states. Generally then, when a Wyoming donor is willing to make outright gifts, at least to competent wives, sons and daughters, it will usually be an outright deed or transfer of cash or other property rather than a transfer into a trust for their benefit.

It is possible to skip estate taxes on one or more generations by the use of trusts for the benefit of successive life tenants. For example, a grandfather could create a trust providing for a life income interest for his children and upon their deaths, a life income interest to his grandchildren and upon their deaths the trust could terminate and the corpus could be distributed to his great grandchildren. By so doing, the trust property would not be taxable in the estates of his children or his grandchildren and hence the trust fund would not be depleted by estate taxes on two generations. The reason why no tax would be imposed on the estates of the children and grandchildren is that the estate tax law does not impose a tax on a life estate except in cases where the creator of a life estate is also the life tenant.[17] Of course, in drafting any trust, whether it be an inter-vivos or a testamentary trust, you must make certain that the rule against perpetuities and other related rules are not violated.

THE MARITAL DEDUCTION

Generally speaking, the deduction allowed by the Internal Revenue Code known as the "marital deduction" is not difficult to understand nor to apply in any given case. The discussion to follow will be based on the operation of the marital deduction as it relates to a Wyoming decedent and, of course, Wyoming is one of the common law states.

All lawyers need to know the practical application of the marital deduction. This knowledge is needed every time a new will is written, particularly for any client whose net worth is in the neighborhood of $60,000 or is expected to reach at least that sum. In addition, in giving general office advice, questions involving the marital deduction will arise in various ways, such as the operation of the marital deduction in connection with life insurance policies and any trusts which a client may create.

Other situations exist in which your counsel may be needed. Your advice might be requested as to whether a surviving spouse should take the share of the property left to him or her under the deceased spouse's will or whether to take such share as the Wyoming law allows if an election is filed to take otherwise than under the will. Of course, this involves many considerations not within the scope of this article but such an election could have an important bearing on the amount of the marital deduction in a given case and the marital deduction factor could have an important bearing upon any settlement made by adverse parties. Another example would be the consideration of whether to deduct certain administrative expenses in the estate tax return or in the estate's federal income tax return. Here again, the amount of the marital deduction will be a consideration. Another factor would be the possible use of disclaimers, that is, where a surviving spouse or other heir disclaims all or part of his or her inheritance. Another factor is whether or not to elect to value the assets on the alternate valuation date, since generally the assets are valued for marital deduction purposes as of the same date for valuing the assets for determining the gross estate.

17. §§ 2031, 2033, 2036.

History of the marital deduction

Residents of community property states, prior to 1942, enjoyed a most favorable advantage over residents of common law states insofar as the Federal estate tax law was concerned. Under the laws of those states, generally speaking, both spouses were regarded as owning equal one-half interests in property owned by them. Therefore, upon the husband's death, only one-half of their combined estates was taxable because that was all the property which the decedent owned. Compare this situation with the result in a common law state wherein, upon the husband's death, his entire property was subject to the tax.

Congress attempted to remedy this inequitable situation in the Revenue Act of 1942 by providing that in community property states the entire community property was to be included in the estate of the spouse first to die except that part which could be shown to have been received as compensation for personal services actually rendered by the surviving spouse or derived from his or her separate property. However, in no event could the gross estate be less than the value of the property over which a spouse had a testamentary power of disposition.

The 1942 law was most unpopular in community property states and it proved to be an unwise law in many respects. Its inequities became apparent to Congress and it was repealed in 1948. However, Congress did not want to re-establish the old estate tax advantage that the community property system held over the common law system and so the 1948 Revenue Act provided for a marital deduction in cases where the decedent resided in common law states. This deduction places residents of all states on substantially the same basis so far as Federal estate taxes are concerned. Inequities still exist but in the main the 1948 law has accomplished its purpose of providing for an equal distribution of the tax burden among the various states regardless of local property laws.

The marital deduction—in general

A deduction is allowed from the gross estate of a deceased citizen or resident of the United States for the value of certain property interests included in the decendent's gross estate which pass or have passed from the decedent to his or her surviving spouse.[18]

While Congress was willing to allow a reduction in the amount of estate taxes imposed on the estate of a decedent who left property to his or her surviving spouse, it was not willing to provide for a complete elimination of the tax. Also, the main reason for enacting the marital deduction law was to attempt to equalize the tax burden between residents of community states and common law states. Therefore, Congress provided that the maximum marital deduction could not exceed 50% of the "adjusted gross estate" which can be defined generally as the total gross estate less expenses

18. § 2056.

of administration, payment of debts, and losses incurred during the period the estate is being probated.[19] For example, if a decedent leaves a gross estate of $220,000 and the expenses and debts of the estate amount to $20,000, leaving an "adjusted gross estate" of $200,000, the maximum marital deduction would be $100,000.

The status of a surviving spouse is determined at the date of death. Hence, a transfer to a spouse prior to divorce does not qualify for the marital deduction; whereas a gift to a person whom the donor later marries does qualify. A legal separation is disregarded for the purpose of the marital deduction.

Section 2056 (a) provides that the marital deduction is allowable in regard to the value of any interest in propery which "passes or has passed" from the decedent to his surviving spouse. The property may pass to the wife in a lifetime transfer, or under the decedent's will, or by intestacy or under laws of dower or statutes in lieu thereof, or it may be an interest in joint tenancy property or insurance proceeds or an interest acquired by the exercise or non-exercise of a power of appointment.[20] An interest passing to the surviving spouse in the form of an executor's fee does not qualify nor does a payment of a claim held by the surviving spouse against the estate.

Section 2056 (b) provides for a rule for determining which interests in property do not qualify for the marital deduction. This is commonly known as the "terminal interest" rule.

Terminal interests

It can be said as a rule of thumb that the theory of allowing a marital deduction in the estate of the first spouse to die is that the property, if not spent or given away by the survivor, will be included in the survivor's taxable estate. This, however, is not a statutory test and situations do exist where the marital deduction is denied in the estate of the first spouse to die but nevertheless the property is subject to tax in the survivor's estate.

To arrive at the general intent of Congress, Section 2056 (b) (1) provides that where an interest passing to the surviving spouse will terminate on the lapse of time or on the occurrence or nonoccurrence of an event or contingency, no deduction shall be allowed (1) *if* an interest in such property passes or has passed to any other person for an inadequate consideration in money's worth *and,* (2) by reason of such passing, such other person or his successors *may* possess or enjoy any part of such property after the termination of the interest passing to the surviving spouse.

Hence, a terminal interest fails to qualify for the marital deduction only if *both* of the above conditions exist.

19. § 2056 (c).
20. § 2056 (e).

A common example of a nondeductible terminal interest would be a provision in a decedent's will leaving his spouse a life income in property with remainder over to others. Such a provision falls within the above two conditions since an interest in the property passed to someone other than the surviving spouse without consideration *and* by reason of such passing the remaindermen will possess or enjoy the property after the life estate has terminated. Other examples of nondeductible terminal interests would be giving the surviving spouse a life income interest in a trust or leaving insurance under policies providing for yearly payments to her with the residue going to others at the time of her death.

Another example would be the purchase of a refund annunity during the decedent's lifetime in which the decedent's spouse held a life income interest with a provision that upon her death a refund should be made to others. However, if the decedent had purchased an annunity for his wife during his lifetime with no refund feature, it could qualify for the marital deduction as there could be no further enjoyment of the annunity by anyone after her death.

Notwithstanding the above rules, Congress has seen fit to allow a marital deduction for certain terminal interests which would otherwise not qualify. Two of these exceptions are contained in Sections 2056 (b) (5) and (6) and they arise out of the basic proposition that a power of appointment is not such an interest in property as will qualify for the marital deduction in its own right.

Life estates with powers of appointment

Although a legal life estate or a life income interest in a trust coupled with a power of appointment would otherwise constitute a nondeductible terminal interest under the above test, Congress has seen fit to allow the marital deduction in certain cases on the general theory that the surviving spouse's interest is so nearly akin to absolute ownership that the deduction should be allowed. Section 2056 (b) (5) provides that if the surviving spouse is entitled for life to all the income from an interest in property payable at least annually with power in the surviving spouse to appoint such interest to herself or to her estate and with no power in any other person to appoint any part of the interest to any other person, a marital deduction shall be allowable. This provision applies only if such power is exercisable by such spouse alone and in all events, either during lifetime or by will.

Under the original marital deduction law contained in Section 812 (e) (1) (F) of the 1939 Internal Revenue Code, this exception applied only to trusts and not to legal life estates and in addition the trust instrument had to provide that the surviving spouse was entitled to *all* of the income of the trust. A right to a specific portion of the income plus a power of appointment over that portion did not qualify.[21]

21. Shedd v. Commissioner, 23 T.C. 41 (1954), aff'd, 237 F.2d 345 (9th Cir. 1956); Hoffenbery Estate v. Commissioner, 22 T.C. 1185 (1954), aff'd, 223 F.2d 470 (2d Cir. 1954).

Legal life estates plus general powers of appointment were held, under the 1939 Code, to be nondeductible terminal interests.[22]

Fortunately, the 1954 Code has enlarged the scope of the marital deduction and it places a legal life estate coupled with a power of appointment on the same basis as a life interest in a trust with a power of appointment. In addition, it is no longer necessary to create two trusts (or two legal life estates) in order to qualify the surviving spouse's interest as a deductible one. It is sufficient that the surviving spouse has a life income interest in a specific portion of the property interest plus the power to appoint that portion.

Life Insurance or annuity payments coupled with power of appointment

A second general exception to the terminal interest rule is contained in IRC Section 2056 (b) (6).

This section provides for the allowance of a marital deduction in case of an interest in property passing from the decedent consisting of proceeds under life insurance, endowment, or annuity contracts, if under the term of the contract such proceeds are payable to the surviving spouse in installments or are held by the insurors subject to an agreement to pay interest thereon and such payments are payable at least annually, commencing not later than 13 months after decedent's death and the surviving spouse has a power to appoint such proceeds in favor of the spouse or to his or her estate and no other person has a power to appoint such proceeds to any person other than the surviving spouse. This rule applies only if such power, whether exercisable by will or during life, is exercisable by such spouse alone and in all events.

Survival for limited period

Another Code provision which allows the marital deduction where an otherwise nondeductible terminal interest is involved in Section 2056 (b) (3). It provides that an interest passing to a surviving spouse shall not be considered as an interest which will terminate if the spouse's death will cause a failure of such interest only if it occurs within a period not exceeding 6 months after decedent's death, or only if it occurs as a result of a common disaster resulting in the death of both parties, and such failure does not in fact occur.

Internal Revenue Code provisions which effect the reduction of the amount of the marital deduction

Section 2056 contains other provisions which must be carefully considered in determining the amount of the marital deduction. To some extent, they represent tax traps which can defeat or partially defeat the real intent of a testator.

22. Meland Estate v. Commissioner, 22 T.C. 966 (1954); Pipe Estate v. Commissioner, 23 T.C. 99 (1954), on appeal, the 2d Court of Appeals apparently considered that a life estate could qualify as a "trust," 241 F.2d 210 (1957).

The factual situation concerning one of these provisions does not arise frequently. Section 2056 (b) (2) provides that where the assets out of which an interest passing to the surviving spouse *may* be satisfied include a particular asset with respect to which no deduction would be allowed if such asset passed to the surviving spouse, then the value of the interest actually passing to such spouse is reduced by the value of such particular asset. The 1948 Senate Report contains an example whereby a decedent during lifetime had given certain lands to his son reserving the use of the lands for a term of years which are included in the probate estate and valued at $60,000 in determining the decedent's gross estate. The value of the interest passing to his spouse is thereby reduced by $60,000 even though the surviving spouse does not actually receive this property if under the decedent's will or local law the executor of the estate had the right to satisfy a bequest or devise to the surviving wife with this property. Of course, if such interest were expressly left to someone other than the surviving spouse, it would not cause a reduction in the marital deduction.

Another provision to be considered is contained in Section 2056 (b) (1) (c) and it provides that if the decedent in a will or in a trust directs that a terminal interest be acquired for his or her surviving spouse, the marital deduction shall be denied with respect to the cost for such interest. For example, if a decedent directs his executor to purchase a non-refund annuity payable to his surviving wife for her life, the purchase price of the annuity will not qualify for the marital deduction. However, the ownership of a bond, note or other contractual obligation, the discharge of which would not have the effect of an annuity, is not considered to be a property interest which will terminate or fail.

Another provision which can reduce the amount of the marital deduction is contained in Section 2056 (b) (4) (A). It provides that in determining the value of any interest in property passing to the surviving spouse such interest shall be reduced by the amount of any Federal estate tax and any other death taxes imposed on such interest.

If property subject to a mortgage debt is left to a surviving spouse, the marital deduction is limited to the value of the property less the mortgage debt; likewise, if property is left to a surviving spouse upon condition that said spouse pay a certain sum to someone else, the marital deduction is limited to the value of the property less the liability.[23]

Disclaimers

If an interest in property would pass to a surviving spouse in the absence of a disclaimer by her, it shall not be considered as so passing if she in fact does disclaim such property.

If an interest in property would not pass to a surviving spouse in the absence of a disclaimer by a third person, it shall not be considered as

23. § 2056 (b) (4) (B).

passing to her even if such third person does in fact disclaim such property and she does in fact receive the property.

Illustrations of how the marital deduction effects estate tax planning

The discussion above briefly sets forth the statutory pattern of the marital deduction. The practical operation of the deduction as it effects estate tax planning will now be considered. Certain factual situations will be assumed and suggestions of how these situations might be handled will be made. However, generalizations regarding the application of the marital deduction to estate planning are at best only guideposts. You will, of course, have to consider many other factors than the estate tax in general and the marital deduction in particular before deciding upon the best plan for your client in any given case. The primary purpose in estate planning is to create a plan which meets with the client's intent as to the disposition of his property. Tax factors are secondary considerations although they are very important. Your real job is to attempt to come up with a plan which will accomplish the client's primary intent and also, to the extent possible, effect a tax saving for his estate and his heirs.

(1) In the first illustration, assume that a wealthy Wyoming resident has separated from his wife. Upon arriving at your office, he informs you that he desires to make out his will, leaving everything to his children or other parties and that he wishes to make no provision whatsoever for his wife.

It would be sad news for him, but nevertheless, you would have to advise him that his wife could easily defeat his intentions of disinheriting her by filing an election to take otherwise than under the will. Rights of a surviving spouse in such cases are beyond the scope of this paper, but it is noted that the Wyoming law applies equally in cases where it is the husband who is the survivor. It is further noted that if a surviving spouse does elect to take otherwise than under the will, the property received by him or her can qualify for the marital deduction.[24]

Could you further advise him as to how he might prevent his separated wife from sharing in his estate or at least to reduce her share? Yes, it would be possible if he is willing to give away all or part of his property during his lifetime. This may seem a drastic step as he may not wish to make outright gifts. However, if some strings can be attached to the gifts, he may be in favor of it. You might suggest placing all or part of his property in joint tenancy with his children with rights of survivorship. However, if he survives the other joint tenants, the property will be right back in his name alone. In addition, the donee joint tenants may sell or transfer their interests in the property or it might be attached by their creditors.

24. § 2056(e)(3).

You might also suggest that a transfer be made of part of his property to an irrevocable trust. He could retain a life income interest and provide that upon his death, the trust would terminate and the remainder would go to his children or others. Could he go further and retain the right to amend or revoke the trust? Could he also name himself as the trustee? Could he keep administrative control over the trust property? Such provisions would be asking for litigation for under these circumstances the surviving wife might challenge the trust as being an "illusory" trust. If successful, the trust would fail and the property would become a part of his general probate estate so far as her rights were concerned. There is little or no law on this subject in Wyoming and a general discussion of it is beyond the scope of this article.

(2) In the remaining examples, the more normal situation will be assumed, whereby the client desires to leave all or a substantial share of his property to his wife and if there were no such things as "estate taxes," "marital deductions," and "terminal interests," he would simply leave all of his property to her, probably outright, or in trust coupled with broad powers of appointment and for invasion of the corpus. Throughout the remaining illustrations, it is assumed that the wife does not remarry.

Assume the husband has an estate of a net value of $120,000 and the wife has little or no property in her name. Assume further that the husband earns a respectable salary or has business income in addition to income from his $120,000 of capital. The figure of $120,000 is used since that is the highest net estate which a man can have and still not be subject to the estate tax assuming at least half of it is left to his wife. That is, a marital deduction of $60,000 plus the specific exemption of $60,000 leaves a net taxable estate of zero.

Now in an estate of about this size and where the husband and wife have undoubtedly become accustomed to a certain standard of living based on his earned income plus the income from his capital, you will probably advise that all of this property be left to his wife, probably outright if she is capable of handling it, or in a trust coupled with broad powers of invasion and appointment. You would want to think twice before tying up any of this property beyond the wife's control or use as even if all of it is left to her, her standard of living is going to decrease and it may be necessary for her to spend all of the income plus part or all of the corpus in order to maintain anywhere near the standard of living she enjoyed prior to her husband's death.

If the husband's estate were planned with only one thought in mind—the impact of Federal estate taxes—then only one-half of the $120,000 would be left outright or in some manner closely akin thereto and his wife could be given a life income interest with perhaps a special power of appointment over the other half. In such case, the wife's taxable estate would total only $60,000 and hence no federal estate tax would be imposed thereon since it would not exceed the $60,000 specific exemption allowed to all estates. Whereas, if the full $120,000 is left to her and has not been used or given away during her life, there would be a Federal estate tax of approximately $9,000 to be paid by her estate assuming the property had not depreciated in value. Nevertheless, the chances are that the wife's well-being will outweigh this potential estate tax liability and therefore all of the property will be left to her. Since she may very well spend at least $60,000 of this $120,000 during her lifetime, there would still be no estate tax imposed on her estate.

It is noted that under the 1939 Code, a deduction was allowed for previously taxed property if an estate included property which within 5 years had been taxed in a prior estate. However, this deduction was not allowable where the two estates involved were those of a husband and his wife.

The 1954 Code provides for a credit against the estate tax for tax paid in the prior estate and the 1954 law is applicable to estates of a husband and his wife. This credit is a 100% credit if the deaths occur within 2 years of each other; 80% if the deaths occur within 3 or 4 years; 60% if within 5 or 6 years; 40% if within 7 or 8 years; 20% if within 9 or 10 years. No credit is allowed for the previously taxed property if the transferor died more than 10 years before the decedent whose estate tax is being computed.[25]

(3) Assume in this illustration that the husband's net estate equals $500,000 and the wife's net estate equals $60,000. Further, assume that the parties are both in their late sixties and in good health. Assume that the husband's property valued at $500,000 is made up of a ranch valued at $250,000 and investments worth $250,000.

In this type of situation, we get into the area where it is worthwhile advising the client of the potential estate tax savings which are available if his general intent of leaving everything to his wife is altered so that only one-half of his estate will pass to her under conditions which will result in its taxability in her estate and qualify for the marital deduction in his estate.

By leaving at least one-half of his estate to her, the federal estate tax imposed on his estate will be in the neighborhood of $30,000. Assume that state inheritance taxes would amount to about the same figure and assume probate expenses of $15,000. Assume that the will is drawn so that this sum of $75,000 is paid out of the investment property which would reduce that property to some $175,000.

Now if the wife is given the ranch outright, her estate will total

25. § 2013.

$310,000 consisting of the $250,000 ranch plus her own property of $60,000. If she is also given the investment property of $175,000, her estate will total $485,000. If she died leaving a net estate of $310,000, the federal estate tax would amount to approximately $62,000. However, if she died leaving an estate of $485,000, the tax would be some $112,000 or an increase of $50,000 assuming her death occurs at least 10 years after the date of her husband's death. Therefore, a potential saving of some $50,000 in estate taxes is possible if the investment property is not left to her in such a way as to be taxable in her estate.

Hence, it would probably be recommended that the investment property should not be left to the wife in such a way that it will be taxed in her estate. You might recommend that these properties be placed in a trust, perhaps with a bank or trust company as trustee, and that the wife be given a life income interest in the trust with a special power to appoint the corpus either during life or in her will or both. You might also recommend that the trustee be given the discretionary power to invade the corpus for the wife's benefit if needed for her reasonable support and maintenance. Under such circumstances, the wife will have a substantial interest in the property, she will be able to maintain family control, but no part of such property will be includable in her gross estate.[26]

You would have to draft the special power so that in no event can the wife exercise it for her own benefit or for the benefit of her estate or her creditors or the creditors of her estate. Otherwise, the power can be drafted so she can give the property to anyone she desires to benefit.

In this example, the maximum marital deduction has been availed of in the husband's estate and, on the figures assumed, just exactly that amount of property passed to his wife. This plan, therefore, accomplishes the greatest potential tax saving. That is, the maximum marital deduction is taken in the husband's estate and the wife's estate is not increased by any amount in excess thereof. If a larger share were left to the wife, it would cause an overall increase in estate taxes since it would increase her estate without any deduction for such excess being allowed in her husband's estate. At least this is true if she survives by at least two years or if she does not give away or consume such property during her lifetime or if it does not substantially depreciate in value.

Therefore, on factual situations similar to those above, you will want to discuss with your client the drawing of a will whereunder his wife will receive close to or perhaps exactly one-half of his property which will be included in his adjusted gross estate, the other half to go to others or to his wife in such a way that it won't be taxed in her estate. Now the goal is one-half of his adjusted gross estate and not one-half of his probate estate. That is, we are dealing with a fictitious estate, one that may include

26. § 2041.

insurance which has already been paid to living beneficiaries, joint tenancy property, and even property which the decedent did not own at the time of his death but which may be included in his taxable estate as a gift in contemplation of death or as property in which he retained a life income or retained control over during his lifetime.

How do you draw a will to arrive at just the right amount equal to the maximum marital deduction?

On the assumed facts, it would not be a difficult matter. The will would include (1) a provision that all state and federal death taxes and administration expenses would be paid out of the residuary estate, (2) a devise of the ranch and a bequest of the cattle and personal property located thereon to his wife, or, in the alternative, this property could be placed in a trust for her benefit for life coupled with a general power of appointment exercisable by her during life or in her will, (3) a residuary clause whereunder the investment property would go to others or perhaps be placed in a trust with a life income interest in the wife coupled with a special power of appointment over the trust corpus exercisable either during life or in her will.

Further assume that the husband owns $50,000 of life insurance and his wife is the named beneficiary thereof; that he maintains a joint bank account with right of survivorship with his wife and that it contains anywhere from a few hundred dollars to several thousand dollars at any given time; and that he has some speculative oil properties which are held in joint tenancy with his wife or with others which may become very valuable.

Under these conditions or upon similar facts, it will be a more difficult task to arrive at just the right amount to give to the wife under his will to qualify for the maximum marital deduction. It is noted that in some cases she may already receive more than the amount of the maximum marital deduction by way of insurance proceeds and joint tenancy property.

Another example would be when your client doesn't want you to know his exact holdings or the form in which they are held.

It is under such circumstances that the possible use of some kind of formula clause must be considered. Much has been written on this topic, and arguments pro and con have been advanced.[27]

One type of formula clause gives the surviving spouse a dollar amount measured by one-half of the value of the adjusted gross estate. Another clause gives the surviving spouse a fractional share of the decedent's probate estate measured by one-half of the adjusted gross estate.

27. See *Proceedings of Probate and Trust Law Divisions,* 77th Annual Meeting American Bar Association (1954), at pp. 98 and 117; New York University, 15th Annual Tax Institute, p. 909.

An objection to the clause calling for a dollar amount is if the assets of the estate appreciate in value prior to the actual distribution, the surviving spouse will not in fact receive one-half of the decedent's estate. On the other hand, if the assets depreciate in value, the surviving spouse will receive more than one-half of the decedent's property. Further, if assets which have appreciated in value during the period of probate are used to satisfy the gift to the surviving spouse, a taxable gain for income tax purposes will be incurred by the estate.[28]

The above objections are not applicable to the fractional share clause which is therefore considered to be the more useful clause.

Other objections to the use of either type of formula clause are: their wording is cumbersome; they leave the amount of the marital gift uncertain, and they may create problems of construction making it necessary for probate courts to deal with problems not within their usual scope. It is said that such clauses can cause conflicts between a surviving spouse and other beneficiaries.

An added objection is that the distribution of the estate can be unduly delayed where the clause states that the values as finally determined for estate tax purposes are controlling.

Some writers have suggested the possibility that these clauses may run afoul of the rule against perpetuities and the rule against incorporation into a will of unattested matter by a reference thereto. However, the general concensus of opinion is that these rules are not violated.

The principal argument for the use of formula clauses is that, as a practical matter, they do work and thereby accomplish substantial tax savings. They should, of course, be used with caution and only in cases where you are striving to pass to the surviving spouse just exactly an amount equal to the maximum marital deduction. If a particular client's property interests and the form in which they are held are not difficult to ascertain and are not likely to change a great deal, it is possible to draft his will in such a way that no reference need be made to the language of the Internal Revenue Code and still the result will be exactly or nearly the same as under a formula clause without the disadvantage of such a clause.

Now return to the example whereunder the husband's estate was assumed to be $500,00 and the wife's $60,000. In drawing her will, from an estate tax standpoint, do you advise leaving her property to her husband? Generally, no, as her property won't be subject to tax as her net estate does not exceed the specific exemption of $60,000. Perhaps it would be advisable for her to leave it in trust with a life income to her husband coupled with a special power of appointment. This will give him sufficient control over it and also family control will be maintained but it

28. Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940).

would not result in its taxability in his estate. Hence, as a general proposition, the only time that the use of the marital deduction is not advisable is in cases of substantially disproportionate estates in which case it may be wise to forego the use of the marital deduction in the smaller estate, but even in these cases, all of the relevant factors will have to be considered before definitely deciding to forego its use. For example, if the husband's net estate is $500,000 and the wife's is $120,000 and the wife dies first, the tax on her estate will be zero if she leaves $60,000 to her husband. If she leaves him nothing outright or in such a way to qualify for the marital deduction, the tax on her estate would be $9,340. However, if she leaves him $60,000 there would be no tax imposed on her estate but the potential tax on this amount in his estate would be some 28% thereof or about $16,800. The potential overall tax cost of taking the marital deduction in the wife's estate would therefore be $7,460. However, the husband may use or give such property away so it is not simply a matter of arithmetic. Also the tax money of $9,340 can be invested and earn more money. An important consideration would be the age and health of the husband. If the husband is quite old and in poor health, you might advise against the use of the marital deduction in the wife's will on facts similar to these.

(4) As a final example, assume that a husband and wife are in their 70's. They are retired and both in poor health. They intend that ultimately their property shall go to their children. Over a great many years, a considerable estate was built up and it now consists of stocks and bonds and real estate. By use of inter-vivos gifts and other equalizing factors, both the husband and wife have net taxable estates of about $350,000.

In this type of situation, do you recommend that their wills be drawn in such a way that the maximum marital deduction will be utilized?

If not, each estate will be subject to an estate tax of approximately $73,300, or a total estate tax bill for both estates of about $146,600.

If the husband dies first and leaves one-half of his property to his wife, the tax on his estate would be approximately $24,400. Her estate of $350,000 would be increased by $175,000 so it would total $525,000. The estate tax would be some $123,500 on this amount. Hence, the combined tax bill of about $147,900 is only about $1,600 more than if no marital deduction were taken in the first estate. So even on these facts, you will probably advise leaving property to the surviving spouse up to the amount of the maximum marital deduction. There is always the chance that the surviving spouse will live on for many years and will use or give away substantial amounts of his or her property. Of equal or greater importance, the surviving spouse will have available the funds which would otherwise have been paid to Uncle Sam as estate taxes. In the example above, this would be the difference between $73,300 and $24,400, or $48,900. A few months' earnings on this sum would more than outweigh the potential overall increase in taxes.

In general then, when dealing with two estates of about equal size, advantage is taken of the lower tax in the first spouse's estate even though running some risk of a higher joint overall tax bill by so doing. That is, just enough property is left to the survivor to qualify for and equal the maximum marital deduction but no additional property is left to the survivor in such form as to require that it be included in the survivor's gross estate.

CONCLUSION

As previously stated, the purpose of this article has been to present a general picture of estate tax planning. The discussions and particularly the illustrations are not intended as setting forth any flat rules or as the best possible plans to follow in any particular case. In any given situation, you will have to analyze the estate and gift tax laws at greater depth than they are discussed herein and the income tax consequences must also be carefully considered. This subject and all of its ramifications and refinements can become quite complicated. Therefore, this article can serve, at best, only as an introduction to more serious study.

As a tax advisor, your job involves primarily the making of recommendations which will lead to the conservation of the client's estate and to assist it making it possible for his wife and children to continue in the decedent's business, assuming that is their desire, whereas the alternative might be a forced sale of the business in order to pay federal and state death taxes or at least require that it be heavily mortgaged. Your responsibility is to understand the basic law of corporations, partnerships, trusts, wills, property and taxation and the practical application thereof for the best possible advantage for your client and to advise him of the legitimate tax saving methods which are available under our federal estate and gift tax laws.