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Milton D. Solomon
member of New York Bar

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THE REVENUE ACT OF 1948: FEDERAL ESTATE AND GIFT TAXATION

*Milton D. Solomon**

I

BACKGROUND

THE community property system has always been a thorn in the side of the federal tax structure.¹ The theory that husband and wife have equal, vested, undivided one-half interests in property held by them as tenants in community, when given effect for federal tax purposes, has resulted, because of our system of graduated rates, in substantial income, estate and gift tax advantages in favor of residents of community property states over their neighbors in non-community property states.² Attempts to change this situation as to federal income taxation proved uniformly unsuccessful.³ However, success was achieved in the field of federal estate and gift taxation by the Revenue Act of 1942. Section 402(b) of the Revenue Act of 1942,⁴ effective October 22, 1942, added a provision to the estate tax law which required that all property held as community property be included in the gross estate of the deceased spouse unless derived from income for services or from the separate property of the surviving spouse, and provided further that in all cases the value of that portion of community property over which the decedent had a testamentary power of disposition was to be included in the decedent's gross estate. Section 453 of the Revenue Act of 1942,⁵ effective January 1, 1943, provided that all gifts of community property were to be considered

* A.B., J.D., University of Michigan; member of New York Bar.

¹ Pedersen, "Application of Federal Income, Estate and Gift Tax Laws to Community Property," 45 MICH. L. REV. 409 (1947).

² S. Rep. 673, Part 1, 77th Cong., 1st sess., p. 9 et seq. (1941); Lang v. Commissioner, 304 U.S. 264, 58 S.Ct. 880 (1938).

³ Pedersen, "Application of Federal Income, Estate and Gift Tax Laws to Community Property," 45 MICH. L. REV. 409 at 410-412 (1947).

⁴ I.R.C., § 811(e)(2).

⁵ I.R.C., § 1000(d).

gifts of the husband, except to the extent that it could be shown that the property donated was derived from amounts received by the wife as compensation for personal services or from her separate property.

The constitutionality of the 1942 estate tax amendments was challenged almost immediately and in *United States v. Rompel*⁶ and *Fernandez v. Wiener*⁷ their constitutionality was sustained.⁸

Criticism continued to be directed at these provisions.⁹ It was pointed out that where a nonearning spouse predeceased an earning spouse in community property states, a tax disadvantage existed when the situation was compared with that existing in non-community property states.¹⁰

With the advent of the Eightieth Congress, the legislative climate changed. Both prior to and after the passage of the Revenue Act of 1942, agitation had been in favor of eliminating the tax advantages that residents of community property states had over residents of non-community property states. The emphasis was changed with the Eightieth Congress. The thought which found expression in the Revenue Act of 1948¹¹ was to remove discrimination between residents of community property states and other states by giving residents of non-community property states the advantage presently existing in favor of community property state residents in the income tax field of splitting income between spouses, and in the estate and gift tax field by restoring residents of community property states to their status prior to the effective date of the changes made by the Revenue Act of 1942, and providing residents of non-community property states with a method whereby spouses could split their property for estate and gift tax purposes.¹²

⁶ 326 U.S. 367, 66 S.Ct. 191 (1945), rehearing den., 327 U.S. 814, 66 S.Ct. 526 (1946).

⁷ 326 U.S. 340, 66 S.Ct. 178 (1945), rehearing den., 327 U.S. 814, 66 S.Ct. 525 (1946).

⁸ See 44 MICH. L. REV. 671 (1946).

⁹ S. Rep. 1013, Part 2, 80th Cong., 2d sess. (1948). INT. REV. BUL. 1948-9-12799, p. 49 at 68.

¹⁰ Pedersen, "Application of Federal Income, Estate and Gift Tax Laws to Community Property," 45 MICH. L. REV. 409 at 433 (1947).

¹¹ The Revenue Act of 1948 [H.R. 4790, May 1, 1948 (Public No. 471)] was passed over Presidential veto on April 2, 1948. The estate tax changes made by the act are effective for estates of decedents dying after December 31, 1947 and the gift tax changes are effective for gifts made after the date of the enactment of the act.

¹² At present there is not much published comment on the Revenue Act of 1948. The most detailed discussion of this act to date is contained in a monograph published by the Practising Law Institute as one of its series dealing with Current Problems in Federal Taxation. The article is entitled "Marital Deductions, Split Income and the

II

THE ESTATE TAX

Section 351(a) of the Revenue Act of 1948 repealed, effective with respect to estates of decedents dying after December 31, 1947, sections 811(d)(5), 811(e)(2) and 811(g)(4) of the Internal Revenue Code.¹³ By this action taxation of community property under the federal estate tax is restored to its position before the enactment of the 1942 amendments—generally, community property is includible in a decedent's gross estate only to the extent of his one-half interest therein.

To provide estates of decedents of non-community property states with substantially¹⁴ the same treatment as residents of community property states, section 361(a) of the Revenue Act of 1948 amends section 812 of the Internal Revenue Code by adding thereto a new subsection, (e), affording to decedents' estates a new deduction from the gross estate, the so-called "marital deduction."

A. The Marital Deduction

The law allows as a deduction in computing the net estate of a citizen or resident of the United States dying after December 31, 1947, "an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate."¹⁵ However, this deduction may not exceed 50 per cent of the decedent's "adjusted gross estate."¹⁶ Since the surviving spouse of a decedent in a community property state owns the untaxed share of the community property outright, the deduction provided for by section 812(e) is meant to apply only to interests in property which are given to a surviving spouse absolutely or in such form as will require their inclusion in the surviving spouse's gross estate.¹⁷

Revenue Act of 1948" by Maurice Alexandre and Bruce H. Greenfield. Other comments of interest are contained in the May and June, 1948 issues of TAXES.

¹³ § 811(e)(2) applied to community property generally; § 811(d)(5) applied to community property transferred in contemplation of death and § 811(g)(4) applied to insurance, the premiums for which were paid with community property.

¹⁴ "It is recognized that complete equalization of the estate and gift taxes cannot be achieved because of the inherent differences between community property and noncommunity property. However, the new provisions will result in equality in the important situations." INT. REV. BUL. 1948-9-12799, p. 49 at 69. S. Rep. 1013, Part 2, 80th Cong., 2d sess. (1948).

¹⁵ I.R.C., § 812(e)(1)(A).

¹⁶ "Adjusted gross estate" is defined in I.R.C., § 812(e)(1)(H).

¹⁷ I.R.C., § 812(e)(1)(B), (F) and (G).

1. *The general rule.* An interest in property will qualify for the marital deduction only to the extent that it is includible in determining the value of the decedent's gross estate.¹⁸ Thus, for example, as the Supplementary Report states,¹⁹ if the surviving spouse inherits foreign real estate from the decedent which is not includible in determining the value of the decedent's gross estate,²⁰ no deduction will result from such interest passing to the surviving spouse.

For an interest in property to qualify for the marital deduction, it must pass or have passed from the decedent to his *surviving spouse*²¹ and the status of surviving spouse is determined as of the date of the decedent's death.²²

A further requirement under the general rule is that the interest *must pass or have passed*.²³ Section 812(3) defines the interests in property which shall be considered as passing from the decedent to any person. Such interests are limited to: (1) an interest bequeathed or devised to any person by the decedent; (2) an interest inherited by any person from the decedent; (3) the dower or curtesy interest (or statutory interest in lieu thereof) of any person as surviving spouse of the decedent; (4) an interest transferred to any person by the decedent at any time; (5) an interest which was at the time of the decedent's death held by any person and the decedent in joint ownership with right of survivorship; (6) an interest over which the decedent had a power of appointment exercisable either alone or in conjunction with any person and he appoints or has appointed such interest to any person, or if any person takes such interest in default upon release or nonexercise of such power; and (7) an interest which consists of the proceeds of insurance upon the life of the decedent re-

¹⁸ I.R.C., § 812(e)(1)(A).

¹⁹ The Supplementary Report to Senate Report No. 1013 of the Committee on Finance, INT. REV. BUL. 1948-9-12799, p. 49 at 95. This report discusses in detail the estate and gift tax amendments to the code made by the Revenue Act of 1948 and will be referred to throughout this paper as "Supplementary Report."

²⁰ I.R.C., § 811.

²¹ I.R.C., § 812(e)(1)(A).

²² Supplementary Report, INT. REV. BUL. 1948-9-12799, p. 49 at 99. The report states that a legal separation which has not terminated the marriage as of the date of the decedent's death does not affect the status of surviving spouse. Since status is determined as of the date of the decedent's death, a transfer by the decedent during his lifetime to one who was not married to him at the time of the transfer, but who is married to him at the date of his death, is a transfer to his surviving spouse, and conversely if an interest in property passes from the decedent to a person who was his spouse at the time of the transfer, but is not his spouse at his death, the interest is not considered as passing to the decedent's surviving spouse.

²³ I.R.C., § 812(e)(1)(A).

ceivable by any person. If under (6) and (7), *supra*, it is impossible to ascertain at the time of the decedent's death what persons will receive the interest in the property passing from the decedent, the interest is considered as passing from the decedent to persons other than his surviving spouse.

The Supplementary Report points out that "the definition of an interest passing from the decedent is broad enough to cover all of the interests included in determining the value of the decedent's gross estate under the various subsections of section 811 of the Code."²⁴ However, an interest in property does not pass from the decedent to his surviving spouse within the definition of section 812(e)(3) by reason of a claim against the estate, or any indebtedness, in favor of the surviving spouse for which a deduction is allowed by section 812(b) of the Internal Revenue Code nor does it cover amounts expended in accordance with local law for support of a surviving spouse.

It is pointed out in an interesting paragraph of the Supplementary Report²⁵ that as used in section 812(e) of the Internal Revenue Code the terms "interest" and "property" have separate and distinct meanings. The term "property" is said to be used in a comprehensive sense and includes all objects or rights susceptible of ownership while the term "interest" refers to the quantum of ownership in any person to a particular property.

In deciding what interests pass to the surviving spouse, her actions after the death of the decedent may affect the marital deduction. The Supplementary Report states:

"If the surviving spouse takes under the decedent's will, the interest passing to her is determined from the will. In this connection proper regard should be given to interpretations of the will rendered by a court in a bona fide adversary proceeding. If, as a result of a controversy involving a bequest or devise to the surviving spouse, such spouse assigns or surrenders an interest in property pursuant to a compromise agreement in settlement of such controversy, the amount so assigned or surrendered is not deductible as an interest passing to such spouse. Moreover, any interest received by the surviving spouse under a settlement which does not reflect her rights under the local law does not pass to the surviving spouse from the decedent. However, if the surviving spouse elects to take her share of the decedent's estate under the local law instead of taking an interest under the will, the interest

²⁴ Supplementary Report, INT. REV. BUL. 1948-9-12799, p. 49 at 97.

²⁵ Id. at 97.

she takes under the local law is by the definition in section 812(e)(3) considered as passing from the decedent to the surviving spouse. The failure of a widow to elect to take under the local law is not considered to any extent as a purchase by her of the interest she takes under the will."²⁶

The above is a clear warning against compromise settlements of will contests which do not clearly reflect the rights of the surviving spouse under local law.

2. *Disclaimers.* Section 812(e)(4) deals with the effect of disclaimers by the surviving spouse and by other persons. Subparagraph (4)(A) provides that if an interest in property would be deemed to pass to a surviving spouse from the decedent in the absence of a disclaimer by the surviving spouse and in fact she does disclaim such interest, the interest is to be considered as passing to the person or persons entitled to receive the property as a result of the disclaimer. On the other hand, subparagraph (4)(B) provides that if an interest in property would be deemed to pass to a person other than the surviving spouse from the decedent in the absence of a disclaimer by such other person and in fact he does disclaim such interest, with the result that the surviving spouse is entitled to receive such interest, the interest is not to be considered as passing to the surviving spouse.

While at first glance this result might appear to be illogical, it is not necessarily so. If we postulate that the test of what property passed to the surviving spouse is the intention of the decedent, then subparagraph 4(A) is incorrect, and if the test is what property was actually received by the surviving spouse, then subparagraph 4(B) is in error. However, there is no reason for limiting it to one or the other in the case of the surviving spouse. An interest in property will be deemed to pass to her from the decedent (and hence qualify for the marital deduction) not only if she actually receives an interest in property of the decedent, but also only if the decedent intended that she receive an interest in the property.

3. *Life estate or other terminable interest rule.* After establishing the general rule for determining the marital deduction,²⁷ an important limitation of the general rule is set forth.

Subparagraph (B) of section 812(e)(1) provides that no marital deduction will be allowed with respect to any interest in property passing to the surviving spouse where, upon the lapse of time, upon the occurrence of an event or contingency, or upon the failure of an

²⁶ Id. at 98.

²⁷ I.R.C., § 812(e)(1)(A).

event or contingency to occur, the interest passing to the surviving spouse will terminate or fail provided that

“(i) . . . 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 further provided that

“(ii) . . . 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.”

Even if the marital deduction is not disallowed because the conditions of clauses (i) and (ii) are not satisfied, it will be disallowed if an interest which will terminate or fail

“(iii) . . . is to be acquired for the surviving spouse, pursuant to directions of the decedent, by his executor or by the trustee of a trust.”

The concluding sentence of subparagraph (B) is as follows:

“For the purposes of this subparagraph, an interest shall not be considered as an interest which will terminate or fail merely because it is the 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.”

It should be borne in mind that an interest under this subparagraph will not fail to qualify for the marital deduction merely because it is terminable. To be disqualified the conditions of both clause (i) and clause (ii) must be satisfied *or* the conditions of clause (iii) must be satisfied.

a. *Nature of terminable interests.* The Supplementary Report, in discussing the terminable interest rule,²⁸ states that subparagraph (B) is intended to be all-encompassing with respect to various kinds of contingencies and conditions, and includes interests passing to the surviving spouse whether they are considered vested interests subject to divestment or contingent interests and whether the interest passing to the surviving spouse is considered as being a future interest which may fail to ripen or vest or a present interest which may terminate.

In order for an interest to be terminable it is not necessary that the contingency or condition occur or fail to occur, it being sufficient that

²⁸ Supplementary Report, INT. REV. BUL. 1948-9-12799, p. 49 at 100 et seq.

the condition which will cut off the interest of the surviving spouse may occur, and terminable interests include interests which will terminate in all events, for example, a life estate. However, an interest is not considered terminable merely because possession and enjoyment of the interest by a surviving spouse may be cut off by events not covered by the terms of the bequest.²⁹

It is pointed out in the Supplementary Report³⁰ that an interest may be terminable even though such interest is the entire property if the property itself is terminable. Examples of such property are patents, copyrights and annuity contracts.³¹

b. *Clauses (i), (ii) and (iii)*. The provisions of clause (i) apply if an interest in property in which the surviving spouse has a terminable interest passes or has passed for less than an adequate consideration in money or money's worth from the decedent to any person other than the surviving spouse or her estate. The interest which passes to a person other than the surviving spouse need not pass at the same time as the interest which passes to the surviving spouse. Whether local law gives effect to the rule in Shelley's case may be important in determining whether the conditions of clause (i) are satisfied, for in those states where the law is to the effect that heirs take by purchase rather than by descent, the interest received by the heirs is deemed to pass to them for the purpose of clause (i).

Clause (ii) applies only if by reason of the passing of an interest, described in clause (i), a person other than the surviving spouse may possess or enjoy any part of the property after termination or failure of the interest passing to the surviving spouse. The term "possess or enjoy any part of such property" is intended to be broadly construed, and it is immaterial whether the person who may possess or enjoy any part of the property, after the termination of the interest of the surviving spouse, possessed or enjoyed an interest in the property prior to the termination of the surviving spouse's interest.³²

The Supplementary Report gives an example³³ of a terminable

²⁹ A fee simple is not a terminable interest, and an interest in property is not terminable merely because it may be consumed. Supplementary Report, INT. REV. BUL. 1948-9-12799, p. 49 at 100.

³⁰ Supplementary Report, INT. REV. BUL. 1948-9-12799, p. 49 at 100.

³¹ Bonds, notes or similar contractual obligations, the discharge of which would not have the effect of an annuity for life or for a term, would also be examples of such property if they had not been expressly eliminated from the definition of terminable interests by the last sentence of subparagraph (B).

³² Supplementary Report, INT. REV. BUL. 1948-9-12799, p. 49 at 101.

³³ Id. at 103.

interest for which a marital deduction will be allowed even though clause (i) applies, because clause (ii) does not also apply. If a decedent bequeaths all the interest he ever had in a patent to his wife and daughter as tenants in common, the marital deduction is allowed as to the wife's interest in the patent, but if the patent were bequeathed to the wife and daughter for their joint lives and then to the survivor, the marital deduction would not be allowed, for in the latter case clause (ii) applies.

Clause (iii) disallows the marital deduction regardless of whether clauses (i) and (ii) apply, if pursuant to the decedent's directions terminable interests are to be acquired for the surviving spouse. Thus, if the decedent directs his executor to purchase an annuity contract for the decedent's surviving spouse for a term of years or for life, no marital deduction is allowed for the interest so passing to the surviving spouse.⁸⁴

Whether an interest in property is terminable or whether the conditions of clauses (i) and (ii) are met, is to be determined by viewing the situation as of the date of the decedent's death, while at the same time giving effect to interests which have passed prior to the decedent's death.⁸⁵

The election by an executor to use the optional valuation date in valuing the decedent's gross estate, pursuant to section 811(j) of the code, does not extend to the optional valuation date the time for determining the applicability of subparagraph (B).⁸⁶

4. *Interest in unidentified assets.* Apparently to prevent evasion of the terminable interest rule, section 812(e)(1)(C) provides that if the decedent's estate includes assets with respect to which no marital deduction would be allowed, if they passed to the surviving spouse and the interest passing to the surviving spouse could be satisfied out of such assets, the value of the interest passing to the surviving spouse for the purpose of the marital deduction is to be reduced by the aggregate value of such assets.

Since, in order for this rule to apply, the interest of the surviving spouse must be capable of being satisfied out of assets which would not qualify for the marital deduction, the rule is intended to apply generally to situations in which the surviving spouse is a pecuniary or residuary legatee or is a beneficiary of a trust created by the decedent

⁸⁴ Id. at 104.

⁸⁵ Id. at 102.

⁸⁶ Id. at 102.

during life or by will, or is the heir of an intestate decedent, and the Supplementary Report so states.³⁷

In the determination of the assets out of which the interest passing to the surviving spouse may be satisfied, such assets are determined prior to the payment of any general claims, but without including named property specifically bequeathed or devised.³⁸

5. *Exceptions to the terminable interest rule.* Three exceptions to the terminable interest rule of subparagraph (B) are provided for by subparagraphs (D), (F) and (G) of section 812(e)(1).

a. *Common disaster provision.* Congress took cognizance of the fact that many wills provide common disaster or similar clauses, which in the absence of special statutory exemption would cause the interest passing to a surviving spouse from the decedent to fail to qualify for the marital deduction because of the effect of subparagraph (B). To prevent clauses of this type from having such effect, subparagraph (C) provides that for the purpose of subparagraph (B) an interest passing to the surviving spouse is not to be considered an interest which will terminate or fail on the death of such spouse, if such death occurs within six months of the decedent's death or as a result of a common disaster, which resulted in the death of the decedent and the surviving spouse, and such termination or failure does not in fact occur.

The rule of subparagraph (D) does not make nonterminable interests which are terminable apart from any common disaster provision. Thus, as the Supplementary Report points out,³⁹ subparagraph (D) does not apply to a devise of an ordinary life estate from the decedent to his surviving spouse, for while it is true that under the assumed common disaster provision in the decedent's will his wife's death, within six months following the date of his death, will cause a termination or failure of her interest, it is also true that her death at any time will also cause such termination or failure.

b. *Trust with power of appointment in surviving spouse.* In the opinion of the author, the most important exception to the terminable interest rule, because it will be used frequently in estate planning, is the exception contained in subparagraph (F) of section 811(e)(1). This exception allows the marital deduction for certain trusts where the surviving spouse, by reason of her right to the income and a power of appointment, is the virtual owner of the property.

For an interest in property transferred in trust to qualify for the marital deduction, all of the following conditions must be met:

³⁷ Id. at 104.

³⁸ Id. at 105.

³⁹ Id. at 106.

(1) The trust must be created by a transfer of property by the decedent during his lifetime or by his direction under his will.

(2) Under the terms of the trust the surviving spouse must be entitled for her life to all the income from the corpus of the trust. This requirement refers only to the income from the corpus of the trust as long as it is in existence.⁴⁰

(3) The surviving spouse must be entitled to the income from the corpus of the trust annually or at more frequent intervals.

(4) The surviving spouse must have power to appoint the entire corpus free of trust and this power must be exercisable in favor of her or her estate. If the surviving spouse has the power to appoint the entire corpus either to herself or to her estate, any lesser power which she may have is immaterial. The Supplementary Report states that a "power to appoint" the corpus includes any power which in substance and effect is such a power regardless of nomenclature used in the will or local property law connotations.⁴¹

(5) A power to appoint any part of the corpus in any person other than the surviving spouse must be exercisable only in favor of the surviving spouse.

(6) The power of the surviving spouse to appoint the entire corpus free of trust must be exercisable alone and in all events.

If all of the above conditions are met, the interest in property transferred to the trust will be considered to qualify for the marital deduction. In other words, this interest will be considered as passing to the surviving spouse and no part of the interest so passing will be considered as passing to any other person. However, even if all six requirements are met, the marital deduction will not be allowed if the trust corpus consists of terminable interests and, in addition, subparagraph (C) (unidentified assets rule) may reduce the marital deduction where the decedent simply directs the creation of a trust without specifying the assets which are to constitute its corpus and the decedent's estate contains terminable interests.

c. Life insurance or annuity payments with power of appointment in surviving spouse. Subparagraph (G) of section 812(e)(1), as orig-

⁴⁰ The Supplementary Report, id. at 106, defines income by stating "The term 'income' is used here in the same sense as it is used in section 162 of the Code, relating to income of estates and trusts." This definition is not very helpful and does not, for example, answer the question of whether a discretionary power in a trustee to allocate capital gains between corpus and income will disqualify the trust for the marital deduction. This question and other similar ones may well be answered in the Regulations interpreting the provisions of the Revenue Act of 1948, which Regulations have yet to be promulgated.

⁴¹ Id. at 107.

inally contained in the Revenue Act of 1948, excepted from the terminable interest rule life insurance proceeds payable in installments to the surviving spouse who also possessed a power of appointment. This subparagraph was amended⁴² so as to expand and clarify the provisions of the original subparagraph.

Subparagraph (G), as amended, allows the marital deduction for an interest in property passing from the decedent consisting of proceeds under a life insurance,⁴³ endowment or annuity contract,⁴⁴ provided that:

(1) Under the terms of the contract the proceeds are payable in installments or are held by the insurer under an agreement to pay interest thereon⁴⁵ or where interest is to be paid for a period and installments of proceeds are to be paid for a period.

(2) The interest payments or installment payments of proceeds are, under the terms of the contract, payable annually or at more frequent intervals until the proceeds are disposed of in accordance with the terms of the contract.

(3) The first payment under the terms of the contract (interest or installment as the case may be) begins not later than thirteen months after the decedent's death.⁴⁶

(4) All amounts payable during the life of the surviving spouse are payable only to such surviving spouse.

(5) To the extent not previously paid to her, the surviving spouse has the power to appoint all amounts payable under the contract to herself or her estate. If she has either of these powers, she may also

⁴² H.J. Res. 429, 80th Cong., 2d sess. (1948), approved by the President on July 1, 1948, to become Public Law 869, 80th Cong., 2d sess.

⁴³ The original provision applied only to life insurance upon the life of the decedent. The amendment made the provision applicable to proceeds under an insurance contract upon the life of another where the insured predeceases the decedent.

⁴⁴ The original provision applied only to life insurance. The amendment extended the provision to annuity and endowment contracts.

⁴⁵ As subparagraph (G) read prior to amendment, it applied by its terms only to "proceeds of insurance." This was thought to exclude from its provisions a settlement option providing for the payment of interest, though the Bureau of Internal Revenue did issue a special ruling (1948 P-H FED. TAX SERV., ¶ 76,265) holding that where proceeds of life insurance are retained by an insurance company, with interest thereon payable to a surviving spouse during her lifetime and the proceeds unqualifiedly payable to her estate on her death, the marital deduction was allowable since no person other than the surviving spouse had an interest in the proceeds. The amendment settled this question by clearly extending the application of subparagraph (G) to interest on insurance proceeds.

⁴⁶ Subparagraph (G) originally provided that the payments must begin within one year after the decedent's death.

have the power to appoint amounts payable under the contract to others.⁴⁷

(6) A power to appoint any part of the amounts payable under the contract in any person other than the surviving spouse is exercisable only in favor of the surviving spouse.⁴⁸

(7) The power of the surviving spouse to appoint amounts payable under the contract is exercisable alone and in all events.

All of the above requirements must be met to qualify the proceeds of the contract for the marital deduction, and whether these requirements are met is to be determined by the terms of the contract viewed as of the date of the decedent's death.

6. *Computation of the adjusted gross estate.* The most important limitation of the marital deduction is that provided for in subparagraph (H) of section 812(e)(1), which limits the marital deduction to 50 per cent of the value of the "adjusted gross estate," which term is defined in section 812(e)(2) and is used only in section 812(e).

Subparagraph (A) of section 812(e)(2) provides the general rule for computation of the adjusted gross estate. It applies except where the decedent and the surviving spouse at any time held property as community property. Under this rule the adjusted gross estate is computed by subtracting from the entire value of the decedent's gross estate the aggregate amount of the deductions allowed by section 812(b). The 812(b) deductions include usual administrative expenses, claims against the estate and losses.

If the value of the decedent's gross estate is \$500,000 and the aggregate amount of deductions allowed under section 812(b) is \$100,000, the decedent's adjusted gross estate is \$400,000, and the aggregate marital deduction is limited to 50 per cent thereof, or \$200,000.

The Supplementary Report states⁴⁹ that the value of the gross estate, referred to in subparagraph (A) of section 812(e)(2), is the

⁴⁷ Under subparagraph (G), as originally enacted, the power to appoint of the surviving spouse was referred to as being exercisable in favor of her estate, with no mention of its exercise in favor of herself. The question arose, therefore, whether a right of commutation in the surviving spouse withdrew the right to receive insurance proceeds from the protection of (G). The Bureau of Internal Revenue, in a special ruling, (1948 P-H FED. TAX SERV., ¶ 76,257) held that it did not, but later withdrew the ruling, stating in a telegram that the bureau was uncertain as to whether the deduction was permitted, and that the question would be considered in the preparation of the Regulations. The change in the statute removes this question from controversy.

⁴⁸ No reference to a power in any other person was made in subparagraph (G) as originally enacted.

⁴⁹ Supplementary Report, INT. REV. BUL. 1948-9-12799, p. 49 at 108.

value at the date of the decedent's death, or if the value of the gross estate is determined under section 811(j) (optional valuation rule), it is the value so determined.

Subparagraphs (B) and (C) of section 812(e) provide a special rule for computing the adjusted gross estate in cases involving community property. Such a special rule is necessary because only half of community property is includible in the decedent's gross estate, and if that half were included in computing the maximum marital deduction allowable, community property would receive a double benefit.

This paper will not analyze the provisions dealing with the computation of the adjusted gross estate where community property is involved, other than to state that the general effect of the special rule is to deny the marital deduction to community property⁵⁰ by causing to be subtracted from the value of the gross estate in computing the adjusted gross estate, the value of community property included in the gross estate and the deductions under 812(b) which are not allocated to such community property.

Section 812(e)(2)(C) deals with the effect of converting community property into separate property.⁵¹

7. *Valuation of interest passing to the surviving spouse.* The amount of the marital deduction is determined by the value at the date of the decedent's death of the interest in property which passes or has passed to the surviving spouse,⁵² unless the optional valuation rule provided by section 811(j) of the code is used in valuing the gross estate.⁵³

Subparagraph (E)(i) of section 812(e)(1) provides that in valuing any interest passing to the surviving spouse for which a marital deduction is allowed, there must be taken into account the effect which any estate or inheritance taxes will have upon the net value of such interest to the surviving spouse. This provision is substantially the same as that provided in section 812(d) of the code relating to bequests to charity. Where one spouse is desirous of obtaining the maximum marital deduction by passing exactly one-half of his adjusted gross estate to his surviving spouse, it is necessary to provide for payment of

⁵⁰ The marital deduction is not denied to community property where the interests of the spouses are determined under the law of California in effect prior to July 29, 1927. Such property is not split under local law for estate tax purposes, and is consequently entitled to the marital deduction.

⁵¹ For a discussion of the operation of subparagraphs (B) and (C) of § 812(e), see Altman, "New Estate and Gift Taxes—How They Affect Residents in Community Property States," 26 TAXES 407 (1948).

⁵² Supplementary Report, INT. REV. BUL. 1948-9-12779, p. 49 at 98.

⁵³ See, *infra*, for a discussion of § 364 of the Revenue Act of 1948 amending § 811(j) of the code.

estate and inheritance taxes out of the one-half not passing to the surviving spouse, inasmuch as such taxes are not deductible in computing the adjusted gross estate, but are deducted in determining the amount passing to the surviving spouse.

Subparagraph (E)(2) of section 812(e)(1) provides that in determining the value of an interest passing from the decedent to the surviving spouse, encumbrances or obligations are to be taken into account in the same manner as if a gift of the interest was being determined. Thus, if the decedent by will leaves his surviving spouse real estate subject to a mortgage, the value of the interest passing to the surviving spouse does not include the mortgage.⁵⁴

B. *Miscellaneous Estate Tax Amendments*

1. *Property previously taxed.* Section 812(c) of the code has provided that in computing the net estate of the decedent there shall be allowed as a deduction the value of any property included therein which was included in the gross estate of any person who died within five years prior to the death of the decedent, and a similar deduction was allowed for the value of any property received by gift by the decedent within five years prior to his death.⁵⁵

Section 362 of the Revenue Act of 1948 amends section 812(c) to provide that the deduction for previously taxed property is not allowable (A) if the property was received from a prior decedent who died after December 31, 1947 and was at the time of such death the decedent's spouse; (B) if the property was received by gift after the date of the enactment of the Revenue Act of 1948 from a donor who at the time of the gift was the decedent's spouse; and (C) property acquired in exchange for property described in (A) and (B).

The previously taxed property deduction is not allowed, regardless of whether a marital deduction was allowed in computing the net estate of the prior decedent or the net gifts of the donor.⁵⁶

Situations can be envisioned where because of this provision the combined estate tax of both spouses will exceed under the law, as amended, the combined tax under prior law.⁵⁷ This is a reason why a decedent should not leave his surviving spouse more than 50 per cent of his adjusted gross estate.

⁵⁴ Supplementary Report, INT. REV. BUL. 1948-9-12779, p. 49 at 99.

⁵⁵ The provision allowing a deduction for previously taxed property is detailed, and the above statement is simply introductory to the changes made by the Revenue Act of 1948.

⁵⁶ The gift tax marital deduction is discussed, *infra*.

⁵⁷ If, for example, a husband leaves his surviving spouse a \$500,000 estate for which no marital deduction is allowed, and his surviving spouse dies within five years of

The amended section further provides that where under the provisions of section 1000(f) of the code a gift was considered as made one-half by the donor and one-half by his spouse,⁵⁸ one-half of the gift is considered as received by the decedent from each spouse.

Therefore, using the example of the Supplementary Report,⁵⁹ if a gift of \$50,000 is made to the decedent which the donor and his spouse treat, for gift tax purposes, as a gift of \$25,000 from each, the decedent is considered as having received a gift of \$25,000 from each spouse for the purpose of section 812(c), and if one spouse paid a gift tax with respect to the \$25,000 considered as having been a gift from him and the other spouse paid no gift tax with respect to the \$25,000 considered as having been a gift from her (by reason of the \$30,000 gift tax exemption), the deduction under 812(c) is allowed only with respect to the \$25,000 gift with respect to which a gift tax was paid.

Another amendment to section 812(c) provides that the deduction otherwise allowable for property previously taxed, such as property received from a person not the decedent's spouse, is to be reduced by a proportionate part of the amount of the marital deduction allowed under section 812(e) in computing the decedent's net estate. This rule is said to be consistent with the reduction under existing law on account of deductions for claims and bequests to charity.⁶⁰

2. *Optional valuation.* Section 364 of the Revenue Act of 1948 amends section 811(j) of the code (optional method of determining the value of the gross estate) by extending to the valuation of an interest in property for which the marital deduction is allowed the same rule applicable under existing law in determining, under the optional valuation method, the value of any charitable bequest for which a deduction is allowed under section 812(d) of the code.⁶¹

her husband, this entire estate (to the extent not consumed or given away) will again be subject to estate tax, though it would not have been so taxed under prior law.

⁵⁸ The amendment made to § 1000(f) by the Revenue Act of 1948 is discussed, *infra*.

⁵⁹ Supplementary Report, INT. REV. BUL. 1948-9-12779, p. 49 at 111.

⁶⁰ *Ibid*.

⁶¹ Property passing by decedent's will to a charity, which is deductible under § 812(d), is (under the optional valuation method of valuing the gross estate) deductible at its value at the date of decedent's death, subject to adjustment for any difference in value one year after such death, or at the date of its sale or exchange in case it is so sold or exchanged during such one year period, provided that no adjustment may take into account any difference in value due to lapse of time or the occurrence or nonoccurrence of an event or contingency. U.S. TREAS. REGS. 105, § 81.11.

3. *Basis of surviving spouse's interest in community property.* Section 366 of the Revenue Act of 1948 amends section 113(a)(5) of the code, which deals with the basis for determining gain or loss for income tax purposes for property transmitted at death. Two rules are provided:

Rule number 1 applies where the death of the decedent occurred after December 31, 1947 and states that the basis of the surviving spouse's one-half share of community property is the same as if it had been acquired by bequest or devise from the decedent—value at the date of the decedent's death or at the optional valuation date, as the case may be. This rule was felt to be necessary in order to equalize community property states with non-community property states. Prior to the change, the surviving spouse who inherited all community property from the decedent had a dual basis for income tax purposes. On the half left her by the decedent, the value on the date of death was applied, while on the other half her basis was cost to the community. Now, value at the date of the decedent's death applies to all community property. This rule does not apply unless at least a one-half interest in the community property was included in the decedent's gross estate.

Rule number 2 applies where the decedent died on or before December 31, 1947 and after October 21, 1942 (the date of the enactment of the Revenue Act of 1942). During this period the repealed provisions⁶² of the Revenue Act of 1942 were in effect, so that the entire community might have been included in the decedent's gross estate. Under prior law, even if the surviving spouse's share of the community was included in the decedent's gross estate, the basis of this property to the surviving spouse continued to be cost to the community. The new law provides that if during the period when the 1942 Revenue Act provisions were in effect any portion of the surviving spouse's share of the community property was included in the decedent's gross estate and an estate tax was payable on the estate, the basis of such property shall be its value at the date of the decedent's death if it results in a reduction of tax. If refunds which might result from the provision are otherwise outlawed, claims may be filed within one year from the date of the enactment of the Revenue Act of 1948.

The above discussed provisions are the principal ones in the Revenue Act of 1948 affecting the estate tax.⁶³

⁶² See note 13, *supra*.

⁶³ Revenue Act of 1948, § 363, deals with the credit for gift tax and § 365 of the act deals with the liability of life insurance beneficiaries. These provisions will not be dealt with in this paper.

III THE GIFT TAX

Section 371 of the Revenue Act of 1948 amends section 1000(d) of the code, which deals with gifts of community property, by providing that the provisions of that section are to be applicable only to gifts made after the calendar year 1942 and on or before the date of the enactment of the Revenue Act of 1948. Thus, as to gifts of community property made after April 2, 1948, the rule is the same as existed prior to the enactment of the Revenue Act of 1942. Gifts of community property are considered as being one-half from each spouse.

The Revenue Act of 1948 then proceeds to put residents of non-community property states on an equal footing with community property state residents. This operation covers two main categories of transfers; interspousal gifts and gifts by a husband or wife to a third party.

A: Interspousal Gifts—The Marital Deduction

The 1948 Revenue Act adds a new subsection (3) to section 1004(a) of the code⁶⁴ which allows a marital deduction in the computation of net gifts of residents or citizens of the United States⁶⁵ effective with respect to gifts made after the date of the enactment of the Revenue Act of 1948. The marital deduction is allowed only with respect to a donee who at the time of the gift is the donor's spouse. This gift-tax marital deduction is similar to the estate tax marital deduction under section 812(e) of the code.

1. *The General rule.* Subparagraph (A) of section 1004(a)(3) of the code sets forth the general rule governing the gift-tax marital deduction, and it provides that where a donor transfers an interest in property to a donee, who at the time of the gift is the donor's spouse, the marital deduction is equal to one-half the value of the property transferred. This gift tax marital deduction with respect to any gift is determined without regard to the annual exclusion (\$3,000 under present law) allowed in computing the total amount of gifts to the donee spouse. Thus, if a gift of \$10,000 is made by a donor to his spouse, the marital deduction is \$5,000.⁶⁶

2. *Life estate or other terminable interest.* As with the marital deduction for estate tax purposes, so with the gift-tax marital deduction,

⁶⁴ Revenue Act of 1948, § 372.

⁶⁵ The marital deduction is not allowed in case of gifts by nonresident aliens, but is allowed in the case of a gift by a citizen or resident to his nonresident alien spouse.

⁶⁶ See, *infra*, for a discussion of the limitation on the marital deduction.

a gift of a life estate or other terminable interest may not qualify for the marital deduction. Subparagraph (B) of section 1004(a)(3), which corresponds to the provisions of 812(e)(1)(B), disallows the marital deduction where a terminable interest is transferred to a spouse if (i) the donor retains in himself or has transferred to any person, other than the donee spouse, for less than an adequate consideration, an interest in such property by reason of which the donor or such person (their heirs or assigns) may possess or enjoy any part of such property after the termination of the interest transferred to the donee spouse, or (ii) the donor retains a power to appoint an interest in such property which he may exercise in such a manner that the appointee may possess or enjoy such property after the termination of the interest transferred to the donee spouse and the donor is deemed to have such power, even though it cannot be exercised until after a lapse of time or the occurrence of an event or contingency.

The Supplementary Report points out⁶⁷ that for the purposes of clause (i) an exercise or release at any time by a donor of a power to appoint an interest in property is a transfer by the donor. Thus, where a donor is the sole income beneficiary of a trust over which he has the power to appoint the corpus on its termination, if he releases such power (his spouse not being the taker in default), and transfers his income interest in the trust 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 and it is immaterial whether the power is a taxable power or not.

3. *Unidentified assets.* Subparagraph (C) of section 1004(a)(3) corresponds to subparagraph (C) of section 812(e)(1) and reduces the marital deduction to the extent that the interest transferred to the donee spouse may be satisfied out of assets which would not qualify for the marital deduction. This limitation applies particularly to gifts in trust under which the donee spouse has a remainder interest or a right to the trust income and a power to appoint to herself or her estate.

4. *Exceptions to the terminable interest rule.* Two exceptions to the terminable interest rule are provided for by subparagraphs (D) and (E) of section 1004(a)(3).

a. *Joint interests.* Subparagraph (D) takes out of the terminable interest rule of subparagraph (B) an interest transferred to the donee spouse by the donor spouse as sole joint tenant with the donor or as a tenant by the entirety. Here the only interest retained by the donor

⁶⁷ Supplementary Report, INT. REV. BUL. 1948-9-12799, p.49 at 117.

is the possibility that he may survive the donee or that there may occur a severance of the tenancy. Subparagraph (D) states that these two interests in the donor are not to be considered for the purposes of subparagraph (B) as retained interests by the donor.

b. *Trust with power of appointment in the donee spouse.* Subparagraph (E) of section 1004(a)(3) contains an exception to the terminable interest rule applicable to certain gifts in trust where the donee spouse is given a power of appointment. This provision is substantially the same as section 812(e)(1)(F), which deals with trusts with a power of appointment in the surviving spouse.

5. *Community property.* Subparagraph (F) of section 1004(a)(3) disallows the marital deduction where a donor transfers his interest in community property or his interest in certain separate property, which for the purposes of this section are treated as community property. The rules in this subparagraph, which govern the determination of what separate property is to be treated as community property, are similar to the provisions of section 812(e)(2)(B) and (C) with respect to the estate tax marital deduction.

6. *Limitation on the marital deduction.* As stated above, the marital deduction allowed under the general rule [section 1004(a)(3)(A)] is an amount equal to one-half the value of the gift to the donor's spouse. Section 373 of the Revenue Act of 1948 amends section 1004(c) of the code, which deals with the extent of deductions allowed in computing net gifts, by limiting, in effect, the marital deduction with respect to gifts to a spouse in any calendar year to the amount of such gifts used in computing net gifts. The operation of this limitation is best shown by an example:

If the donor gives his spouse just one gift during the calendar year of \$5,000, the amount included in his net gifts is \$2,000 (\$5,000, less the \$3,000 exclusion). Therefore, though a marital deduction of \$2,500 is allowed by section 1004(a)(3), it is limited by 1004(c) to \$2,000.

B. *Gift by Husband or Wife to Third Party*

Section 374 of the Revenue Act of 1948 amends section 1000 of the code by adding thereto a new subsection (f) which permits "splitting" between spouses of gifts made to third persons.

Subparagraph (A) of section 1000(f)(1) states the general rule, which is to the effect that a gift made after the date of the enactment of the Revenue Act of 1948 by one person to any person other than his spouse shall, for the purpose of the gift tax, be considered as made

one-half by the donor and one-half by his spouse. This provision shall apply only if at the time of the gift each spouse is a citizen or resident of the United States.

An individual is considered as the spouse of another individual, for the purpose of this rule, only if he is married to such individual at the time of the gift and does not remarry during the remainder of the calendar year.

The rule is expressly made inapplicable with respect to a gift by a spouse of an interest in property if he creates in his spouse such a power of appointment, as is defined in section 1000(c) of the code, over such interest.

Subparagraph (B) provides that the splitting of gifts to third parties between both spouses is not mandatory, but is permitted only if both spouses have signified their consent to such treatment in the case of all gifts made during the calendar year by either while married to the other.

The consent which is signified is effective to split the gifts of a spouse only for the purpose of the gift tax, except as expressly provided elsewhere.⁶⁸

Paragraphs (2) and (3) of section 1000(f) provide rules relating to the time and manner of signifying consent and revocation of the consent. The consent is to be signified in such manner as is provided by the commissioner with the approval of the Secretary of the Treasury. The consent may be signified at any time after the close of the calendar year in which the gift was made, subject to the general limitation that the consent may not be signified after the fifteenth day of March following the close of the year in which the gift was made. However, if before such fifteenth day no gift tax return was filed by either spouse, the consent may not be signified after a return for the year in which the gift was made is filed by either spouse. In addition, the consent may not be signified after a notice of deficiency with respect to the gift tax for the year in which the gift was made has been sent to either spouse.

Provision is made for the revocation of a consent previously signified in a manner to be provided under regulations prescribed by the commissioner with the approval of the secretary, subject to the limitations that the right to revoke such consent with respect to a calendar year should not exist after the fifteenth day of March following the close of such year, if the consent was signified on or before such fifteenth

⁶⁸ Id. at 119.

day, and if the consent was not signified until after such fifteenth day no right to revoke shall exist.

Paragraph (4) of section 1000(f) provides that if a consent is signified; the spouses shall be jointly and severally liable for the gift tax with respect to the calendar year for which the consent is signified.

IV

CONCLUSION

Estate tax planners would do well to study carefully the provisions of the Revenue Act of 1948. Substantial savings may be obtained by judicious planning but the savings in many instances when the taxes on the estates of both spouses are considered will not in the opinion of the writer be as large as has been generally assumed. Furthermore, it should be obvious that it will not always be advisable for a spouse to take advantage of the maximum marital deduction, for if both spouses own substantial amounts of property, the optimum tax benefit will be obtained by equalizing the size of their respective estates. Perhaps the greatest saving will be obtained by *inter-vivos* gifts to third parties where the spouses elect to treat the gift for gift tax purposes as made one-half by each.

In will drafting, greater flexibility is possible than heretofore. A husband can leave roughly 50 per cent of his property outright to his wife, knowing that, at most, his property will be subject to only one estate tax in his generation, or a husband wishing to spare his spouse from the burdens and risks of managing property may set up a trust qualifying for the marital deduction in which his wife is given a life interest with a full testamentary power of appointment.

The Revenue Act of 1948 does not simplify the federal estate and gift tax laws. The need for a careful revision of our federal tax laws has been obvious for a long time. This cannot be accomplished by piecemeal changes of the type enacted in 1948. It is to be hoped that in the near future Congress will revise our federal tax system to integrate the federal income, estate and gift taxes.