Denver Law Review

Volume 33 | Issue 3 | Article 3

May 2021

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Recommended Citation
George E. Ray, Outline of Estate and Gift Tax Changes in the Internal Revenue Code of 1954, 33 Dicta 129 (1956).

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# OUTLINE OF ESTATE AND GIFT TAX CHANGES IN THE INTERNAL REVENUE CODE OF 1954

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The broad scope of the Internal Revenue Code of 1954 encompasses a number of significant changes in the estate and gift tax provisions. In this article, the Estate and Gift Tax Committee of the Section of Taxation of the American Bar Association will present a brief outline of these changes for the benefit of the general practitioner who does not specialize in these fields. Unfortunately, even at this writing (some twenty months after adoption of the 1954 Code) the Treasury Department has not issued the estate and gift tax regulations, even in tentative form, so many of the problems inherent in the new statutory language can only be raised and not solved. It is expected that the tentative regulations will be published in the spring of this year.

## I. ESTATE TAX

A. *Basic and Additional Tax Combined.* (Sections 2001 and 2011, new Code; Sections 810 and 935, old Code). As an historical legacy, the estate tax liability for many years was computed in two parts; first, the so-called "tentative tax," which in fact might well have been called the "real" tax; and second, if the net estate exceeded $100,000, then the so-called "basic estate tax" was computed. An amount constituting 80% of this basic estate tax was the maximum credit allowed for death taxes paid to the several states.

Now, this procedure has been simplified by eliminating the necessity for the separate computation of the basic estate tax. The estate tax is computed under Section 2001 and a credit for state death taxes is allowed, based on computations under Section 2011. However, the new method does not change the tax rates, and the credit for state death taxes is still the same amount.

B. *Credit for Tax on Prior Transfers.* (Section 2013, new Code; Section 812(c), old Code). The 1939 Code permitted a deduction for property received from a prior decedent (or by a gift subject to gift tax) within five years of the death of the current decedent. In order to obtain this deduction for previously taxed property, it was necessary that the property be still in the possession of the

current decedent, or that the property in the current decedent's estate could be traced from the former decedent's property. Further, the deduction was reduced if the property was subject to a debt or claim, and subsequent to the adoption of the marital deduction provisions in 1948, no deduction for property previously taxed was allowed on transfers between spouses. Also, the amount of the deduction was independent of the amount of the tax which was paid on the prior transfer.

To eliminate the complications and inequities of the prior law, the new Code adopts a different approach. In lieu of the *deduction* for property previously taxed, a *credit* is permitted for the tax paid on the property in the estate of the prior decedent, provided that this credit may never be larger than if the current decedent had not received the property. The credit is based on the value of the property at the time of the death of the prior decedent.

It is important to note that property transferred between spouses to the extent that no marital deduction is available is now eligible for this credit, and this alleviates to a certain extent qualifying more property for the marital deduction than one-half of the decedent's adjusted gross estate.

A full credit is allowed if both decedents died within a two-year period of time. The credit decreases by 20% every two years thereafter until there is no credit if the decedents die more than ten years apart. For example, if the first decedent died in 1953 and the second decedent dies in 1956, an 80% credit is allowed in the second estate; if, on the other hand, the first decedent had died in 1951, then the credit in the second estate is only 60%.

The credit for gift tax paid on a prior transfer was omitted in the 1954 Code.

C. *Transfers Taking Effect at Death.* (Section 2037, new Code; Section 811(c), old Code). Since the amendments made to Section 811(c) of the 1939 Code by the Technical Changes Act of 1949 (October, 1949), property irrevocably transferred by a decedent during his lifetime was includible in his gross estate as a transfer taking effect at death, if the possession or enjoyment of the property could be obtained by the donee only by surviving the decedent.

*Example:* A transfers property in trust to pay the income to B until A's death, and then to pay the principal to C, if living, otherwise to D. Under the pre-1954 Code law, all of such prop-

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erty was swept into A's gross estate, even though A had no retained or reversionary interest in the property whatsoever, the fact that A's life was a measuring stick being sufficient to attract the tax on the entire property.

Section 2037 contains a second condition which must be met before the tax will apply, namely, that the decedent has at the time of his death a reversionary interest in the property transferred exceeding 5 per cent of the value of the property. In other words, even though the decedent's life is a measuring stick, no tax will result unless there is at least one chance in twenty that the property will revert to the decedent, either under the express terms of the instrument of transfer, or by operation of law.

The value of the decedent's reversionary interest in such cases is determined by the usual methods of valuation, including the use of mortality tables and actuarial principles. Such determination is made, of course, without regard to the fact of the decedent's death.

D. *Annuities.* (Section 2039, new Code; no provision in old Code). Decisions under the 1939 Code created uncertainty as to whether the value of the survivorship rights in a joint and survivor annuity were subject to estate tax on the death of the purchaser of the annuity. The statute now specifically provides that a joint and survivor annuity will be taxed in the gross estate of the deceased annuitant, but only to the extent that the decedent contributed to its cost. Payments made by an employer under a

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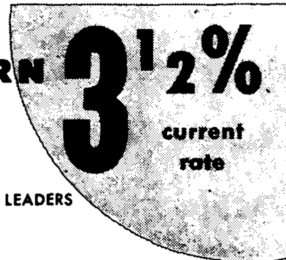


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qualified pension, profit-sharing or retirement plan are not considered as having been made by the decedent, and therefore the portion of the annuity purchased by the employer's contributions in such cases escapes the estate tax.

An income tax deduction is granted (Section 691 of the 1954 Code) to the surviving annuitant who reports the income, such deduction being equal to the estate tax attributable to the income element of the survivorship feature which has accrued since the annuity was purchased.

E. *Proceeds of Life Insurance.* (Section 2042, new Code; Section 811(g), old Code). Since 1941, the old Code provided that the proceeds of insurance on a decedent's life were subject to Federal estate tax on his death if either (1) the proceeds were payable to his executor, or (2) the proceeds were payable to other named beneficiaries, if the decedent either paid the premiums directly or indirectly, or if the decedent possessed the incidents of ownership in the policy at his death.

By far the most important (and controversial) estate tax change is the complete elimination of the premium payment test. Ownership of the policy is now made the sole criterion of taxability. The incidents of ownership in the policy include the right to change beneficiaries, to assign, surrender or borrow on the policy, to receive dividends, etc.

The 5% reversionary interest rule discussed above has now been made applicable to transfers of life insurance policies. The rules for valuing such reversionary interests are similar to those used under Section 2037.

Several interesting questions have arisen with respect to the new law, where the decedent who originally owned the policy has made a gift thereof during his lifetime. These questions have given rise to a great deal of discussion in print and otherwise, and it is generally hoped that the forthcoming Treasury regulations will clarify most of the questionable points.

For example, does the assignor's right to inherit from the assignee, or the assignor's expectancy under the assignee's will constitute a reversionary interest under the 5% rule? Suppose a husband, age 60, makes an outright assignment of an insurance policy to his wife, age 55. Since the chances of the husband's surviving the wife are better than one in twenty, will the fact that the husband is the wife's heir under state law, or that he has a statutory right, such as dower or in lieu of dower, in her estate, or the fact that he may be a beneficiary under her will, be held to be a reversionary interest? Although, generally speaking, a right of inheritance or expectancy is not a "reversionary interest" in the property law, there is some peculiar language in Section 2042, which is susceptible of a contrary interpretation for tax purposes. While most authorities are firmly of the belief that the right of inheritance or expectancy does not constitute a reversionary interest under this Section, the Treasury Department may not take such a favorable view of its regulations, since it may feel, as others do, that the new law has gone too far in

completely eliminating the premium payment test.

The contemplation of death provisions of Section 2035 further complicate and cloud the estate tax results of transfers of life insurance. Where the assignment of the policy occurs within the three-year period immediately prior to the death of the insured, the proceeds are presumed to be included in his estate as a transfer in contemplation of death, and although such presumption is rebuttable, the chances of success are rather slim, in view of the fact that life insurance, by its very nature, is testamentary in character. Where the assignee has paid the premiums subsequent to the transfer of the policy, it would seem that the proceeds of insurance attributable to the premiums paid by him should be excluded from the gross estate even though the transfer was held to be in contemplation of death. Assume that the decedent continues to pay the premiums after the transfer, including the premiums in the three-year period prior to his death. Presumably these premiums within the three-year presumptive period will be included in his estate, and it can be argued that a part, or possibly all, of the proceeds can be brought back into the estate by reason of the payment of these premiums. In other words, it is not advisable for the insured to continue to pay the premiums, so long as the law is in its present uncertain state.

A third question arises, again with respect to the revisionary interest rule. The reversionary interest rule comes into play only "if the value of such reversionary interest exceeded 5% of the value of the policy immediately before the death of the decedent." *Query:* What is the value for this purpose of a term policy which has no cash surrender value and only a nominal, if any, cash reserve?

F. *Expenses, Indebtedness and Taxes.* (Section 2053, new Code; Section 812(b), old Code). Funeral and administration expenses, claims against the estate and mortgages were deductible under the 1939 Code, but the deductions were limited to expenses allowable by the local law where the estate was administered. Moreover, such deductions could not exceed the value of the decedent's probate estate—that is, the value of his property subject to creditors' claims. If the assets were in a trust, or if property was held in joint tenancy, then the expenses paid out of such trust assets or joint tenancy property were not deductible to the extent that they exceeded the probate estate.

Section 2053 now provides that these items are deductible without limitation, except that to the extent that these items exceed the probate estate they must be paid within fifteen months from the date of death. For example, if the decedent's estate consists solely of joint tenancy property, all funeral expenses, debts, administration expenses and other claims paid from such property will now constitute an allowable deduction if paid within the fifteen-month period.

Also, the new Code permits the deduction of expenses of administering property included in the gross estate but not in the probate estate, if such expenses are paid within fifty-one months

from the date of death. Examples of this type of expense would be trustee commissions paid with respect to a trust which is included in the gross estate and attorney fees incurred in contesting the inclusion of such trust in the decedent's gross estate.

G. *Marital Deduction.* (Section 2056, new Code; Section 812(e), old Code). The provisions of the 1939 Code with respect to the so-called "marital deduction trust" are familiar to everyone. Under these rules, a transfer of property from one spouse to another in trust qualified for the marital deduction if the surviving spouse had the right to receive all of the income of the trust and, in addition, had a general power of appointment under the entire trust. However, a *legal* life estate coupled with a power to appoint or consume did not qualify for the marital deduction, and several recent decisions (e.g. *Estate of Hoffenberg vs. Commissioner,* 223 Fed. 2d 470 (2d Cir.) affirming 22 T.C. 1185) have held that the receipt of only *part* of the trust income or the power to appoint only *part* of the trust principal also failed to satisfy the statute. Both of these matters have been cleared up by the 1954 Code. Legal life estates have been placed on a parity with trust interests and a part of a trust can now be qualified for marital deduction. Note, however, that these changes were not made retroactive.

H. *Stocks Situated in the United States.* (Section 2104, new Code; Section 862, old Code). The former law provided that shares of stock held by nonresident aliens were subject to estate tax where such stock was either in a domestic corporation or in a foreign corporation and the stock certificates were physically located in the United States. Now, only stock in a domestic corporation will be taxed in the estate of a nonresident alien. This rule conforms to tax conventions entered into by the United States with numerous foreign countries and now makes it possible for banks and other organizations in the United States to serve as depositories for stocks of foreign corporations.

I. *Conclusions.* The changes made by the 1954 Code with respect to the Federal estate tax were substantial, and although not numerous, were, without exception, favorable to the taxpayer. The changes with respect to life insurance will have particularly widespread application to literally millions of taxpayers.

## II. GIFT TAX

A. *Gifts to Minors.* (Section 2503(c), new Code; no provision in old Code). The familiar $3000 annual gift tax exclusion is not applicable to all gifts, but only to those which escape the classification of a "future interest." Prior to the adoption of the 1954 Code there was considerable uncertainty as to the application of the term "future interest" to gifts to minors, and particularly to transfers made in trust for the benefit of minors.

While Congress did not see fit to attack the general problem of "future interests", it did delineate, in Section 2503(c), a certain type of gift which was entitled to the $3000 annual exclusion. This new statute provides that any transfer (whether in trust or otherwise) for the benefit of a minor does not constitute a future interest if the property and the income therefrom may be ex-

pended by or for the benefit of the minor prior to his reaching 21, and, to the extent not expended prior to majority, will pass to the beneficiary when he reaches 21, or, if he dies prior to 21, will pass to his estate, or as he may appoint under a general power of appointment.

While this provision represents some improvement over the former law, it has a number of unfortunate features, notably, its requirement for outright distribution to the child at age 21, which requirement will run contrary to the wishes of most donors. Further, there are a number of traps lurking in the statutory language for the unwary draftsman. There is already pressure for amendments to this provision.

Section 2503(b) contains a minor provision intended to eliminate the incongruous results of certain court decisions (notably, *Evans vs. Commissioner,* 198 Fed. 2d 435), which held that although the ordinary gift in trust of the present right to receive income was a present interest qualifying for the annual exclusion, nevertheless, where the trustee had power to pay over trust principal to the income beneficiary, the income interest could not be valued, and therefore the entire gift had to be treated as a future interest.

B. *Revaluation of Gifts for Prior Years.* (Section 2504(c), new Code; no provision in old Code). The gift tax for the current year is often dependent on the value of gifts made in prior years. This new provision insures that the value of a gift as reported in a prior year will be conclusive in determining the tax in a subsequent year, if the statute of limitations has run on the prior year return and a tax was paid in such prior year.

The reason behind this new provision is the feeling that once the value of a gift has been accepted for tax purposes by both the Government and the taxpayer, that value should bind both in determining the tax to be applied to later gifts. Thus the Commissioner is prevented (as was sometimes his wont under the old Code) from reopening the question of the value of prior gifts where the statute of limitations has run. Note, however, that only valuation questions were put to rest by this provision.

C. *Tenancies by the Entirety.* (Section 2515, new Code; no provision in old Code). Formerly, the creation of a joint tenancy or a tenancy by the entirety between a husband and wife could result in a taxable gift from one to the other, and the termination of such tenancy could also result in a taxable gift.

Section 2515 eliminates this trap in part by providing that unless the spouse who furnishes the major part of the consideration elects otherwise (by filing a gift tax return), a transfer of real property in joint tenancy with right of survivorship or in tenancy by the entirety is not a taxable gift between husband and wife. When such tenancy is terminated, however, it will be a gift at that time, to the extent that the proceeds are divided other than in proportion to the original consideration furnished by each spouse.

Transfers of personal propery in joint tenancy or tenancy by

the entirety between spouses and transfers of all types of property where third persons are involved are not within the protection of the statute.

D. *Property Settlements Incident to Divorce.* (Section 2516, new Code; no provision in old Code). Several years ago, the Supreme Court held that transfers of property under divorce property settlements were not taxable gifts if the terms of the settlement were incorporated in the decree of divorce. *Harris vs. Commissioner,* 340 U.S. 106.

Under Section 2516, transfers between a husband and wife which are made as a part of a divorce settlement are relieved of gift tax where the husband and wife enter into a written agreement relative to their marital and property rights, and a divorce occurs within two years thereafter. This is so, whether or not such an agreement is actually approved by the divorce decree.

Under the estate tax law, it has been held (*Commissioner vs. Maresi,* 2d Cir., 156 Fed. 2d 929) that a claim against a decedent's estate arising out of a divorce settlement is allowable as an estate tax deduction only if the terms of the settlement were incorporated in the divorce decree. In this respect, the estate tax treatment differs from that now provided by Section 2516.

E. *Marital Deduction.* (Section 2523, new Code; Section 1004(a) (3), old Code). In order to correlate the gift tax and the estate tax, changes in the gift tax marital deduction were adopted, similar to those discussed in paragraph I-G above.

F. *Nonresident Aliens.* (Section 2501, new Code; Section 1000(a), old Code). Transfers of intangible property by nonresident aliens who are not engaged in business in the United States are now exempted from gift tax, even though such property is physically located in the United States.

The Estate and Gift Tax Committee of the Section of Taxation has been carefully examining these new provisions and has under consideration a number of possible additions and improvements thereto. The Committee would welcome suggestions from practitioners generally for legislative changes which would improve the estate and gift tax laws. Further, the Committee urges all practitioners to study the forthcoming regulations when they are published, and to advise the Treasury Department of their comments and criticisms. In so doing, the members of the Bar can be of material assistance to the Congress and the Treasury Department.

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