Denver Law Review

Volume 33 | Issue 2 | Article 4

January 1956

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BASIC ESTATE TAX PLANNING

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Address delivered at 1955 Convention of the Colorado Bar Association.

The object of estate tax planning is to so arrange the transmission of family wealth as it passes from one generation to the next so as to provide for minimum estate and income taxes consistent with the estate owners non-tax objectives.

FIVE BASIC PRINCIPALS:

1. Lifetime Gifts: It is obvious that what is given away now will not be part of the former owner's estate at the time of his death. Nor will the future earnings of the property be his for income tax purposes.

2. The creation of a succession of life estates to avoid a succession of death taxes. If a life use rather than complete ownership is given to the primary donee, there will be nothing to be taxed in his estate upon his death, since nothing passes to his estate. Here is what may happen when this principal is forgotten. A wealthy industrialist gave his wife $300,000 in the stock of company in 1940. He paid a gift tax of $60,000. She died in 1946. The stock came back to him under an old will in which she had dutifully left "my entire estate to my beloved husband." But only after the Government had collected $54,000 in estate taxes. Thus he was back where he started except for the $114,000 that was paid to the United States Treasury. If he had given it to her for her use during life and upon her death to their children, the second tax would have been avoided and the later estate tax on his death would not have had to be paid.

3. Use of trusts to create additional tax entities or second tax pocketbooks. Under our progressive system the total tax on $30,000, for example, is obviously much less if spread among three tax entities than if taxed to a single individual.

4. Use of gift tax privileges, the lifetime exemption, the annual exclusion, the gift tax marital deduction and the gift splitting option. If not used during life these benefits are irrevocably lost since there is no carry-over to the decedent's estate.

5. Use of the estate tax marital deduction when and only to the extent indicated in the particular situation.

It will be the object of this talk to develop these basic principals with some suggestions as to how and when to use them and some warning as to pitfalls to avoid.

TESTMENTARY PLANS

I. THE UNMARRIED ESTATE OWNER:

A specific illustration will show the tax consequences of a bequest of a life estate as contrasted with a bequest of the complete ownership of the property. We will assume a relatively simple situation and the effect of federal taxes only.

Mrs. Brown inherited $115,000 from her husband several years ago. She has a son John, now 30. He works in the local bank, manages her funds for her and will ultimately inherit them. Mrs. Brown wants a simple will, leaving everything to John. John has a home worth $25,000, some $50,000 of life insurance, $15,000 of stocks, bonds and other miscellaneous property. He is married to a lady who has nominal assets but fairly good prospects of inheriting additional property from her family. They have three children. If Mrs. Brown leaves her estate to John, he will after taxes and administration expenses, receive about $100,000. On his later death his taxable estate will amount to $190,000, even if he makes no further increases in his present estate. The federal tax on a gross estate of $190,000, allowing $15,000 for debts and administration expenses, amounts to $24,400. If instead of an estate of $190,000, John's taxable estate is kept at $90,000 by having his mother give him a life interest in her estate, his federal estate taxes will be reduced to about $2,000. This saving of $22,000 may be accomplished by putting his bequest in trust for him rather than giving it to him outright.

Are there objections to gifts in trust that may cause Mrs. Brown to hesitate? Trusts may be associated in her mind with spendthrifts and incompetents. John doesn't need another to do his investing for him. Trusts tie up property too tightly. She wants John to have a free hand in using the funds and of course John would agree with this and, since we ought not let tax considerations outweigh other factors, perhaps John ought to have $25,000 or $35,000 outright but the bulk of the estate may better serve the family purpose if it is in trust. The advantages are at least worth investigating.

Of course a trust is not the same as outright ownership. If it were we could not save the $22,000. But we can give John most of the benefits of ownership without the attendant tax burdens.

1. John may be given the income each year.

And if you study the power of appointment section of the code you will discover that:

2. John may be given the right to withdraw at his whim and pleasure $5,000 of corpus each year.

3. John may be given the right to demand additional amounts of corpus if needed to maintain his accustomed standard of living.

4. The trustee may be given the power to pay capital to John at any time and in any amount that the trustee may in his discretion for any reason deem proper:

5. John may be given the power to direct the trustees to distribute principal to John's wife or children at any time and in any amount that John shall decide.

6. Lastly John may be given the power to dispose of the capital at his death to such persons as he may wish, other than his estate or his creditors.

With all of the above flexible provisions John has most of the benefits of outright ownership without the tax burden. If he had unlimited control through outright ownership, he would use it for his benefit and the benefit of his family. Under the trust it is available for such purposes and to a very considerable extent John's decisions may determine the particular uses to which it may be put. He can have $5,000 a year for any purpose, he can demand more if needed to maintain his usual standard of living; only if he wants sums in excess of $5,000 and beyond his needs, must he persuade the trustee that he ought to be given them.

Income Tax Savings:

The use of the trust technique offers opportunities for the creation of additional tax entities. Since the estate will be for the ultimate benefit of the children, the fund may be divided into as many shares as there are children, in this case at least three, each share to be held as a separate and distinct trust but to be administered as a unit. This is largely a matter of phraseology. It is possible to give $50,000 in trust to pay one-third of the income to each child or to give the trustee $50,000 to be divided into 3 funds, each fund to be held for the benefit of a particular child. If this latter technique is used you have three tax entities among which to spread the income. Since capital gains are almost always taxable to the trustee, it is far better tax-wise to spread the gain among three taxpayers and thereby keep it in lower brackets.

In the particular case we are considering there may be other advantages in having the trusts. While Mrs. Brown wants the income to be paid to John it is too bad to force it upon him and thereby make it taxable to him at his top tax brackets. When he gets it, what is left after taxes, is going to be used for his children. Would it not therefore be better to direct the trustee to pay the income in his discretion to either John or to any one or more of the children of John? Now if the trustee, with an eye to the ultimate use and to the tax consequences, pays or applies $1,500 to each of the three children, each will have a $600 exemption and the balance of $900 will be taxed at the beginning rate rather than at John's top bracket. These trusts are known as sprinkle or spraying trusts and offer tremendous income tax savings.

The trustee ought also be given authority in its discretion to accumulate income or to use it for the purchase of life insurance on the lives of John and members of his family. Any income so used or accumulated will be taxable to the trusts and may therefore be kept in the lowest bracket.

A solution of the problem presented might well be to have John remove his insurance from his taxable estate by transferring it to an irrevocable trust for his children. Mrs. Brown's will would then create three trusts, with power in the trustees to pay into John's trust sufficient income to meet the annual premiums. It could then spray the excess income to John's children to take advantage of their $600 exemptions or could accumulate it. Under such a plan the premiums would be paid with funds taxed at only 16% after the dividend credit rather than at John's top bracket. All of the income could be kept within the first tax bracket. Further such a plan would not only preserve but would somewhat increase the estate tax savings on John's death, even if he were given $25,000 or $35,000 outright.

It should be noted that 5% of income would be taxable to John because of his 5% withdrawal privilege.

II. THE MARRIED ESTATE OWNER:

The Marital Deduction—what it is:

Pre-1942 status of community property. Under the law of community property, one-half of all the wealth acquired by the activities of either spouse during the marriage automatically belongs to the other. Thus a successful Californian or Texan who amassed $200,000 from his business operations during his married life would own one-half, the other half by operation of law belongs to his wife. During life he is the manager of the fund but on death he has a power of disposal by will over only his share. This local property rule, recognized for federal tax purposes, resulted prior to 1942 in shocking tax inequality. Thus our Texan with $200,000 paid an estate tax on only $100,000 or a tax of $4,800. A Coloradan similarly situated, because at least theoretically he had the disposal by will of the entire $200,000 paid an estate tax of $32,700. A tax differential in favor of the Texan of $27,900.

The 1942 Legislation. In 1942 Congress attempted to eliminate this estate tax discrimination by providing that all community property economically attributable to a spouse was to be included as part of his or her taxable estate. But it soon became apparent that this approach discriminated against the Texan. Since most families commingled their separate and community property, or at least failed to keep adequate books earmarking individual assets, it was frequently impossible to determine at death whether a particular asset was separately owned or community owned. And the civil law had a strong presumption which the tax law incorporated that all assets were presumed to be community. The result was that very considerable taxes were incurred solely because inadequate records had been kept. Further the effort to equalize the burden actually gave the Coloradan an unfair advantage in that he could so devise his property as to avoid any tax on his wife's death. The Texan, however, whose estate (to stay with our example) was now being measured at $200,000 could arrange for the avoidance of this second tax only with respect to $100,000. The other $100,000 being owned outright by the wife was taxed at her death. Thus the Texans were paying taxes on both deaths whereas Coloradans need only pay taxes on any one death.

1948 Legislation. In 1948 Congress again attempted to place all citizens on an equal basis, this time by a diametrically opposite approach to that adopted in 1942. The purpose of the earlier amendment was to extend to spouses everywhere the tax burdens imposed in the common law states; the objective of the 1948 Act was to grant generally the tax advantage of the community property states.

The legislation provided that property passing at death from one spouse to the other should be free of death taxes up to 50% of the decedent's adjust gross estate, i.e., the net estate after debts and administration expenses but before any deduction for taxes. Thus, the Coloradan with $200,000 who left his wife at least $100,000 could deduct this bequest (up to $100,000) and he therefore would have the same net taxable estate as the Texan.

The Marital Deduction. When to use it:

In many cases it will obviously be desirable to provide for the marital deduction in the will of one spouse and not in the will of the other. This will be true wherever one spouse has the bulk of the family wealth. Thus if husband has $300,000 and wife has $200,000, it will be availed of in his will and not in hers. In these cases care should be exercised to include in husband's will a simultaneous death clause—not a common disaster clause and not a time clause but a simultaneous death clause. The law is clear that the wife must survive in order for the husband's estate to be entitled to the marital deduction. The regulations make it clear that if there is no evidence as to the survivorship then the local law or a presumption supplied by the Will will govern. The clause should read "if the order of deaths cannot be established by proof, it shall be presumed the wife survived." The presence of this provision in the Will assures the marital deduction if both spouses happen to die in a common accident or event and there is no proof that one in fact survived the other. Absent such a provision the marital deduction will be lost since under Simultaneous Death

Act, law in 45 states, the husband would be deemed to have survived for purposes of the distribution of his estate.

There will be other cases where its use is less clear. The wife may have nominal assets but prospects of inheriting a substantial estate from her father—how much and in what form Papa won't tell and, of course, son-in-law is hesitant to ask. If all is to go to her in trust, you would want to use it, if it is to go to her outright, use of the deduction could prove very costly.

There are other situations where each of the spouses has substantial wealth. Thus if each has $300,000, use of the deduction in the estate of first dying spouse will have the difference between $17,500 and $59,100 or $41,600, but will increase the tax on estate of second dying spouse from $59,000 to $102.000, an increase of $43,000, and incur $22,500 of extra Colorado taxes.

It is a good rule that wherever doubt exists to provide for the maximum marital deduction with a provision in the will that the surviving spouse may disclaim in whole or in part. This delays the decision as long as possible and has the following advantages:

1. The wife may decide when all the facts are known how much of the marital deduction to use, by making a partial disclaimer.

2. The wife may enjoy for her life the use of the money retained through deferring the tax.

3. The wife may make gifts to the children after her husband's death and to the extent these come within her exclusion and lifetime exemption the funds will escape tax on both deaths.

In these cases where the deduction is provided for because it is anticipated that the wife will have an opportunity to renounce or to make gifts a different type of survivorship clause should be used. Since it is possible that they may die in a common accident or that the wife may die within a relatively short time after her husband and before she has had an opportunity to disclaim or make the suggested gifts, a clause may be inserted in the will providing that the wife's bequest shall not become effective unless she survives her husband by six months. Here the time clause rather than the simultaneous death clause should be used.

Common disaster clauses, i.e., in the event my wife and I perish in a common disaster or as a result of a common peril, etc., are dangerous in that they may cause litigation, may leave titles unsettled for years and can result in the property being subjected to tax in both estates since the regulations provide that if on a final audit of the return it is still possible that the surviving spouse's interest may fail because her later death may be traceable back to a common accident, the deduction will be disallowed.

H and W are in a motor accident. H is killed. W, badly crippled and bedridden, lives on for years, without ever fully recovering. When, if ever, during W's life can her executor safely pay over the bequest. How can he ever be sure that her later death when it occurs may not have been proximately caused by the accident. There may be a fire in which she burns to death because she can't walk or subsequent negligent medical treatment such as the careless attachment of artificial legs may result in a fatal fall. Perhaps the executor will risk such possibilities, but query if the Revenue Agent, with any knowledge of the tort law of proximate causation, will or may overlook the risks.

QUALIFYING GIFTS FOR THE MARITAL DEDUCTION:

Not every bequest to a spouse will qualify for the marital deduction. Generally speaking the wife must be given the fee to the property or its tax equivalent. A life estate to the wife, an estate during widowhood, a power on the part of anyone else to consume the property will disqualify the bequest.

Under existing law the wife must be given:

1. Absolute ownership.

2. A life estate with remainder to her estate. Just what this gives her is doubtful since there are few cases on the subject. Lawyers did not in the past and do not now create such estates.

3. A life estate with a general power of appointment. This type of qualifying gift is new and under the 1954 Code. It is designed to take care of the practice in many jurisdictions of leaving the estate to the wife for life with power to consume. If you use this device be careful to follow the statute. Give her a life estate with "a general power to appoint by deed or by Will." Don't give her a right "to sell or dispose of" or "a right to consume" or use any of the other traditional clauses. If you depart from the statute, you may be asking for trouble.

4. A bequest in trust under which the wife is given (a) the income for life and (b) a general power of appointment by deed or by will.

In practice the marital gift will either be outright or in trust.

FORMULA CLAUSES:

A bequest of the entire estate outright to the wife will, as we have noted, assure the marital deduction. The trouble with it is that it qualifies too much property. Thus in a $200,000 estate the husband would thereby obtain a $100,000 marital deduction which with the $60,000 exemption would leave a taxable estate of $40,000 and a tax of $4,800. But on the subsequent death of the wife, the entire $200,000 would be subject to estate taxes amounting to $32,700.

Nor will a bequest of one-half outright and one-half in trust with a special power of appointment achieve the objective. In few cases, if any, does the estate passing under the Will equal the tax estate. Almost everyone owns assets that are not part of his probate estate. Jointly owned property, life insurance, many deferred compensation contracts form part of the tax estate but not of the probate estate. Indeed the largest parts of most estates pass ouside the Will.

Thus assume Mr. X has

Cash in Bank		$5,000
Residence, tax owned as tenant by the entirities with his wife		30,000
Life Insurance		60,000
U. S. "E" Bonds, payable at death to wife		10,000
Business interest		80,000
Miscellaneous		5,000
His tax estate will total	$190,000	$190,000
His probate estate will total only	90,000	

A bequest under the will of one-half his estate to his wife would amount to $45,000 less half the cost of debts and administration. How much would qualify for the marital deduction would depend on the recipients of the non-probate assets. If the wife was lump sum beneficiary of all the insurance then the residence, the insurance, the bonds and her bequest, a total of $145,000 would qualify but the maximum allowable deduction would only be $95,000. Such a clause would unnecessarily qualify $50,000.

Under the facts assumed the will should be so drawn that none of the wife's bequest will be subject to taxes on her death. But the difficulty with this solution is that assets do not remain static. He may sell the residence on his retirement and then cash the bonds on maturity. Suppose he invests these funds in stocks in his own name. Further assume his son needs a $20,000 short term loan in his business and father pledges his insurance with the Bank, and the beneficiary, as banks usually require, is changed to his estate. Now nothing outside the will qualifies and the marital deduction is wholly lost.

What is needed is a flexible clause. Such a provision should tentatively set aside $95,000. You would then subtract the insurance, the bonds, the residence or $100,000, leaving nothing to pass under this clause of the will. It would all pass to the wife but under a later clause giving her the income plus a special power of appointment—the typical non-marital deduction trust. If his assets had been shifted, as assumed, his wife under the clause would receive $95,000—the maximum allowable marital deduction.

A word of warning about the indiscriminate use of these clauses may be appropriate. They have been criticized and they can cause real trouble in a limited class of cases. Thus assume the case of a second wife who is not on speaking terms with the children of the first marriage. The husband's probate estate consists of $150,000. To placate the children who resented the second marriage he gave them $50,000. The Commissioner suggests that it may have been in contemplation of death. And just to make it interesting the Comimsisoner has "jacked up" the value of his business interest by $50,000.

Now under one of these clauses the widow is on the Commissioners side. If she tells enough family secrets to have the gift included as part of the taxable estate as one in contemplation of death, her bequest under the will is increased by $25,000. If she remembers that he told her he would not sell his business for twice the sum reported by the executor and therefor she says the Commissioner's proposed increase in value is very reasonable she is furnishing excellent evidence to further increase her bequest by another $25,000.

Those who object to the use of formula clauses do so with situations like this in mind. And, of course, you ought to have them in mind. But in 99% of the cases you have family harmony and all can be counted on to band together against the tax collector —the common enemy.

I think the best test of the desirability and practicality of these clauses is the testimony of those who have worked most intimately with the marital deduction in the seven years of its operation—the trust officers of the banks and I think there is almost universal agreement among them that the difficulties posed by the objectors are theoretical, not real. Their big complaint is that these clauses are not sufficiently widely used.

NON-MARITAL DEDUCTION BEQUESTS TO SPOUSES:

With respect to the portion of the estate that does not fall into the marital deduction trust, it would go into a testamentary trust similar to that outlined for the unmarried estate owner, with the wife as a discretionary beneficiary. Thus she may be designated as one of the benficiaries to whom the trustee in his discretion may pay all or part of the income and to whom he may distribute all or part of the principal with the proviso that he shall first exhaust the principal of the marital trust. The reason for this is to provide for the consumption of the taxable portion of her estate before consuming the non-taxable portion. She may also be given a special power of appointment during life and at her death, if this is desired.

LIFETIME GIFTS

LIFETIME EXEMPTION:

Under present law there is a gift tax exemption of $30,000. This means that any individual may give away $30,000 during his lifetime.

ANNUAL EXCLUSIONS:

In addition he may give away $3,000 each year to as many donees as he wants (provided the gifts are of a present rather than a future interest).

GIFT TAX MARITAL DEDUCTION:

If married, he may deduct one-half of any gift made to his wife. Thus if he gives her $100,000 he deducts $50,000 as a marital deduction, $30,000 as his lifetime exemption, and $3,000 as his exclusion, paying tax on $17,000.

GIFT SPLITTING:

If he is married he may split any gift to a third person, with his wife. Thus if he gives his son $100,000, he may treat $50,000 as having been given by him and $50,000 as being given by his wife. Each has an exemption of $30,000 and an exclusion of $3,000. Here the tax is computed as though he gave $17,000 and his wife $17,000. But note that if any gifts are split all must be split.

Assume W has used $15,000 of her exemption, H, none of his. H gives his son $51,000 thinking he is thereby exhausting both of their exemptions ($45,000) plus using their annual exclusions ($6,000). Each, however, is treated as having made a gift of $25,500. This comes within his exclusion and exemption, leaving $7,500 of his lifetime exemption unused. He may deduct from W's half her $3,000 and her remaining $15,000, which leaves $7,500 subject to tax.

What he could have done was to have made a gift this December of $36,000 using part of his exemption and exhausting hers. Then next he could give the balance and charge it all against his exemption by electing not to split, since there is a new election each year.

RELATION OF GIFT TAXES TO ESTATE TAXES:

The gift tax rates are fixed at exactly three-quarters of the estate tax rates. This, however, does not mean that a lifetime gift saves only twenty-five percent of the potential estate tax. The saving will always be very much larger than this because of the $30,000 gift tax exemption, the $3,000 annual gift tax exclusion per donee, the gift tax marital deduction where available, the gift splitting privilege which doubles the exemption and exclusions, and most important the fact that the property transferred is removed from the highest estate tax bracket but taxed at the lowest gift tax bracket. Thus an unmarried donor with an estate of $200,000 who gives $50,000 to two donees will incur gift tax of $705, but will avoid potential estate taxes of $15,000 plus estimated administration expenses of $2,500. Thus the gift will save him $17,000.

GIFTS IN CONTEMPLATION OF DEATH:

But at 50 or 55 the average estate owner has little interest in saving death taxes. He has twenty-five years of good living ahead and he remembers the depression of the early thirties. The reason he has $200,000 is that he has never willingly parted with anything. His reaction to a gift of $50,000 to save $17,000 of death costs is that this is something he can do just as well 10 or 15 years from now. Generally the client who is prepared to make really substantial gifts is somewhere between 75 and 80, his health leaves much to be desired, he has finally resigned himself to the inevitable. But a lifelong business instinct to buy everything at reduced prices is still strong. He wants the cost of dying to be kept at a minimum.

Your first reaction as his advisor is that any transfer by him is surely to be found to be in contemplation of death. What of it? A gift in contemplation of death is not a crime. Even if it were our donor would not be around to be put in jail at the time when the transaction is first examined. Are there any undesirable consequences that should cause us to hesitate to make gifts in contemplation of death? I hope to convince you that in practically all cases the estate owner will be better off by making such gifts.

FACTORS FAVORING GIFTS IN CONTEMPLATION OF DEATH:

(a) *Three-Year Limitation:* It is surprising how many people who are 80 live to be 83. This is particularly true of the group we are talking about—those with substantial bank balances. There is always a chance that your donor will outlive the three-year statutory period. If he does the Government cannot tax the gift as one in contemplation of death no matter how clear the evidence. Here is where we add the Doctor to the traditional estate planning team. If he can keep the old gentleman alive for three years, he will be home tax free.

(b) *Litigation Possibilities:* The Government has never been successful in contemplation of death cases. Taxpayers usually pay and sue for refund in the district court in order to get a jury. And the juries have been good to the taxpayers. In the *Heiner* case[1] Justice Stone pointed out that the Government had been successful in winning only about 20% of the cases that went to trial. Thus even if the decedent dies within the three years, all is not lost. John Wannamaker gave away $1,000,000 at 90 and the jury found

[1] Heiner v. Donnan et al., 3 USTC § 913; 285 U.S. 312, 52 S.Ct. 358.

he was not thinking about death and taxes when he did it.

(c) *Settlement Possibilities:* Because of the Government's lack of success in these cases the Service is eager to compromise. In the *Horlick case*[2] $8,000,000 of stock was given to the children. The Commissioner included it as a gift in contemplation of death. After some negotiation the taxpayer consented to a proposed deficiency of $4,000,000 on account of the gift. This was a pure compromise. It was not clear whether it was arrived at by valuing the total stock at half its value or by treating half of the property as given in contemplation and half not. On its face the latter position would seem absurd. Since it was all given the same day, it is a little difficult to see how he could have been motivated by thoughts of dying as to half the shares and not as to the other half.

But the Commissioner has authority to settle cases whenever there is substantial doubt as to the law or the facts. Whenever there are risks that the case may be decided either way, he can settle on a fair appraisal of these risks. But compromises like the Horlick case do not represent the usual approach.

Every estate tax return will have in it a number of questionable items. There may be gifts in each of the three years immediately preceding death. Here, depending on the strength of the arguments, the taxpayer may yield on the last or last two gifts in exchange for an agreement not to include the first.

In every state there will be valuation problems. Reasonable minds may differ considerably as to the value of the closely held stock or unimproved real estate. Assume the Commissioner is arguing for a $200,000 valuation of the stock in the family business, the taxpayer for a figure around $125,000. This can only be settled by each side giving a little. In this type situation it is extremely comforting to have a contemplation-of-death gift. Even if a weak case it will furnish a powerful bargaining weapon in settling the other issues. The taxpayer may concede the gift as in contemplation of death in exchange for a low value. Or he may concede a high value if the gift is omitted.

In either event the fact that the gift was made will result in very substantial reduction in estate taxes, if the matter is compromised.

[2] Horlick v. Kuhl, 45-2 USTC § 10, 228; 62 Fed Supp. 168.

(d) *Cases That Cannot Be Settled*: There may be gifts so clearly prompted by thoughts of death that no compromise is possible and the taxpayer either concedes the issue or loses after litigation. Even in these extreme cases the gift in contemplation of death will prove profitable because of the peculiar wording of the statutory provisions. You get a kind of double deduction that can best be illustrated by an example:

SAVING INVOLVED IN GIFTS IN CONTEMPLATION OF DEATH:

1. Net Taxable Estate			$400,000	
Estate Tax			94,500	
Passes to Heir				$305,500
2. Net Estate			$400,000	
Gift to Heir	$200,000			
Gift Tax	31,000			
Total			231,000	
			$169,000	
Net Estate at Death	$169,000			
Inclusion of Gift in Contemplation of Death	200,000			
Net Taxable Estate		$369,000		
Estate Tax	$ 84,900			
Less Gift Tax Credit	31,000			
Total Tax Payable		53,900		
Net Estate at Death			$169,000	
Tax after Credit			53,900	
			$115,110	
Passes to Heir on Death				$115,100
Passes by Inter Vivos Gift				200,000
				$315,100

SUMMARY

Property Passing to Heir, Partly by Gift in Contemplation of Death, Partly by Will	$315,100
Property Passing to Heir by Will	305,500
Difference	$ 9,600

You always save an amount equal to the top estate tax bracket on the amount of gift tax incurred.

FORM OF GIFT:

To remove the property from the estate of a donor the gift must be complete. This means that he may not reserve a life estate, either in the form of the income from or the use of the property.

He may not retain any power to amend or revoke the gift or change the beneficiaries. While remote possibilities of reverter do not have the same disastrous effect they once had the only sensible transfer is one that completely divorces the donor from any interest in or control over the property.

It is possible under the new Code to delay the possession and enjoyment of the donee. Frequently donors are willing to give, provided their donees do not get the use of the property until the donor's death—they want to retain the satisfactions that belong to the holder of the family purse strings. Under the 1954 Code you may create a trust with directions in the trustee to accumulate the income until the death of the donor, without adverse tax consequences.

JOINT OWNERSHIP:

Joint Tenancies between spouses provide no tax advantages. There may or may not be tax disadvantages.

No gift taxes need be paid on the creation of joint tenancies between spouses of real estate. The full value of the property will be included in the estate of the spouse who paid the purchase price and the surviving spouse will then get a new cost basis. Thus many of the tax objections to joint tenancies of real estate between spouses that existed prior to 1954 have been eliminated and there will be many cases where it will be desirable to own the family residence jointly with right of survivorship.

Once you get beyond the family residence individual ownership is préferable. Gift taxes are payable on the creation of joint tenancies of personal property with no estate tax advantage. Further they create a risk of over qualifying property for the marital deduction. Thus if H and W own $200,000 of securities purchased by H, the tax on his death is only $4,800 because of the marital deduction. But on W's later death it will be $32,700. If he owned them individually and left them to W under the type of will we have been discussing the combined taxes on both deaths would only be $9,600 instead of $37,500.

Another objection to jointly owned property and one frequently overlooked is the difficulty of establishing who paid the purchase price. Over the years H and W may pool their resources and buy securities with the excess over expenses each year. Assume that in a particular year H received a $10,000 bonus. W inherited $8,000 from an Uncle. Fortune having struck them they buy a new car, take a trip to Europe, and refurnish the living room. These items cost $9,000, the balance goes into stock. Whose money paid for what. Where both work or have incomes, imagine the difficulty of tracing stock purchases made from joint accounts, where some of the securities have been held for 15 or 20 years. The effect of the presumption that the entire purchase was paid by the decedent means, in many cases, the full value will be included in the estate of whichever spouse dies first because of the inability of the survivor to sustain the burden of proof the statute thrusts upon him.

GIFTS OF PRESENT AND FUTURE INTERESTS:

Adults: To obtain the $3,000 annual exclusion the gift must be of a present interest. That means the donee must be given something he can presently enjoy. If the income is to be accumulated or if it may be accumulated in the discretion of the trustee or if it may be sprayed among two or three beneficiaries the exclusion will be denied. Further a gift in trust of $3,000 will not get the full exclusion since it is in part a gift of a future interest. Only the right to the income is a present interest. How much this right to the income is worth will depend on the age of the donee since the value of his right is measured by his life expectancy.

Infants: Prior to the new Code there was substantial doubt whether any gift in trust to an infant would qualify. Congress has now provided that if the trust income and principal may be expended for the infant and if it will pass to him or his estate at 21 or is subject to a general power of appointment, the exclusion shall not be denied because of his infancy. But this may be paying too high a price for the exclusion. Generally it is not possible to foresee what kind of person the infant will be at 21 and whether it will be in his best interests to have the property forced upon him.

As a generalization too much attention is given to obtaining the $3,000 exclusions. They require the sacrifice of too many sound family objectives and income tax saving techniques to justify the slight saving in gift taxes they achieve.

SELECTION OF PROPERTY:

The most talked about property for gift purposes today is life insurance. A gift of life insurance policies under the new law has much to recommend it. The donor feels no poorer, his donee no richer. The gift tax cost is small. What is removed from the estate is large.

Thus a gift of a $100,000 policy with a $20,000 cash surrender value has a gift tax value of only slightly more than $20,000 but it removes $100,000 from the taxable estate. There are some pitfalls to avoid. Gifts of insurance policies are almost certain to be found to be in contemplation of death. If the donor survives the three-year period he is safe. But the payment of premiums may also constitute gifts in contemplation of death. If the donor continues to pay the premiums, the insurance purchased with the last three premiums will probably be included in his estate. Therefore, it is wise to give the oldest policies. Thus if a policy is 20 years old at the date of gift and the donor pays 6 premiums thereafter, only 3/26 of the face is includible. Whereas if he had purchased a new policy 3/6s or 50% of the face amount would be includible. It may also be wise to use the old policies because Congress may again change the law to reinstate the premium payment test. But, based on past experience, it will not be retroactive.

Don't give policies on which there are existing loans. These gifts are going to cause trouble since it is not impossible that the donor-borrowers will be found to have retained an incident of ownership in the policies given. The regulations define an incident of ownership as an economic interest in the policy. If the policy serves as the primary source of repayment of the donor's obligation it is not too far fetched to say that he has an economic interest in it.

COST BASIS CONSIDERATIONS:

For purposes of gain on a later sale of gift property the donee takes his donor's cost basis. For purposes of loss he takes the lower of his donor's cost or market value at date of gift. Assume our donor has three stocks, each of which has a present value of $100. Stock X cost $10, Y $90, and Z $150. If he gives X stock his donee is burdened with a large potential capital gains tax. If he gives Z a valuable capital loss deduction may be wasted since the loss will no longer be available to the donor and his donee will have a $100 basis for loss purposes. Here, absent other considerations, the Y stock may be preferable. The cost basis factor will always be important where the asset is depreciable. How important it will be in other situations will vary with the likelihood that the asset may not be indefinitely retained by the donee.

Generally speaking low basis property should be retained to become a part of the donor's estate for then the angel of death will give it a stepped-up basis i.e., market value at the date of the owner's death. High basis property should be sold by the donor and the proceeds given, thus obtaining for the donor the benefit of the tax loss.

There will be times when low basis property should be given. Thus if Father, whose income is substantial, is about to sell stock which cost him $10,000, for $40,000, he faces a capital gains tax of $7,500. By giving the stock to his three children, who then sell it, the capital gains tax may be as low as $2,040. This is so because the children represent three separate tax paying entities, each with $600 exemptions and each starting at the beginning rates. If the children have other income only slightly less savings may be realized through transferring the stocks to separate trusts for the children.

GIFT OF FUTURE INCOME:

No income tax shifting occurs when the property given represents merely a right to future income. If a bond, a capital asset, is given the interest thereafter earned is taxable to the donee. But a donor may not transfer the tax on the later interest by cutting off the coupons and giving them while he retains the bond. To borrow the analogy of Mr. Justice Holmes the fruit continues to be taxable to the owner of the tree. This fruit-tree doctrine has made it impossible to shift the tax liability on earnings, past or future. It effectively prevents assignments of next year's bonus or of fees or commissions, earned but not yet paid. Nor will gifts of next year's trust income, or future rents or dividends be recognized for tax purposes.

On the other hand it is well settled that if a capital asset is given the tax on the later received income will fall on the donee.

This is true even though much of the gain is attributable to the period when the property was still in the hands of the donor. Stock may be given away just before an extraordinary cash dividend is to be paid. The entire capital gain on a capital asset that cost the donor $10, was worth $90 when given, and is sold for $100, is taxable solely to the donee. These rules frequently furnish substantial tax saving opportunities.

There is one exception to the general rule that gifts of future income will not be recognized for tax purposes. A 10-year trust, income to the donees, capital to return to the donor at the end of the 10-year period will under the new Code, effectively shift the tax to the donee. This offers attractive savings to limited groups who have no real interest in estate tax savings or who hesitate to part irrevocably and finally with their capital. The relatively young man of wealth, the high salaried executive with limited capital, the individual whose principal source of income is a life estate in real property or a trust; none of these people are immediately troubled by death taxes. They are looking only for relief from the heavy burden of high income tax brackets.

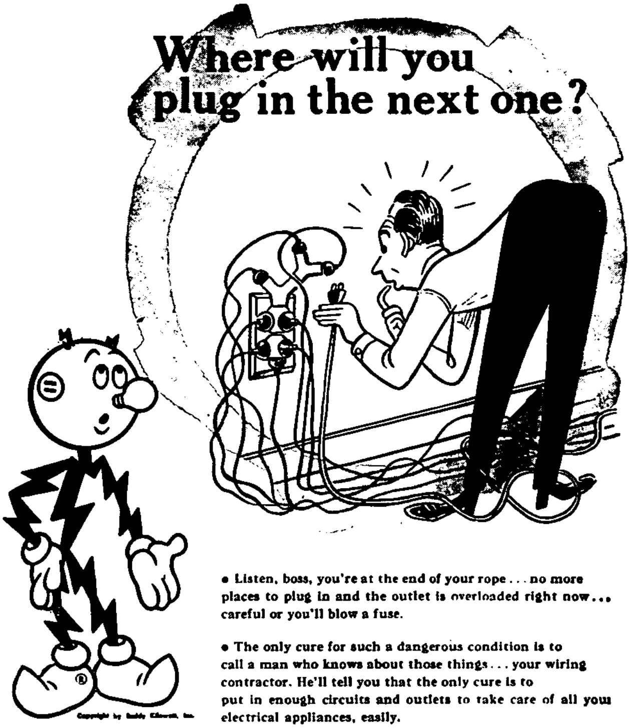
To take a concrete example: Jones is a top executive with salary of $60,000 and capital assets of $150,000. He is married and 55 years of age. Once he retires his capital and the income it produces will be really important to him. But at the moment the heavy income tax drain ($3,600 after the dividend credit on the $6,000 his capital produces) is his big concern. He can create, under the new Code provisions, three 10-year trusts of his capital, income to be accumulated for his three children or used to pay insurance premiums on policies on their lives, corpus to be returned to him at 65 and the accumulations or the policies delivered to his children. Such a gift has a gift tax value of about $45,000—well within his and his wife's lifetime exemptions. The trusts over the 10-year period will pay in income taxes $9,600 whereas if he retains the assets during this period he will pay in taxes $36,000. Thus he can build for his children a fund of $50,000 at net loss of income to him of $24,000.

It may be well to conclude with the suggestions that all substantial gifts should be to trusts rather than outright.

USE OF A TRUST:

1. Avoids estate taxes on the deaths of the donees. Remember the example of the wealthy industrialist who gave the stock to his wife and got it back a few years later by inheritance but only after the Government collected $114,000 in taxes.

2. Trusts offer tremendous income tax savings possibilities. They serve as second tax pocketbooks. Create separate trusts for each primary beneficiary in order to have several tax entities. Authorize the trustee to purchase insurance on the lives of the beneficiaries. This will make the portion used taxable to him. Give the trustees discretionary power to spray the income among the family and thereby keep it in the lowest tax brackets.



• Listen, boss, you're at the end of your rope . . . no more places to plug in and the outlet is overloaded right now... careful or you'll blow a fuse.

• The only cure for such a dangerous condition is to call a man who knows about those things . . . your wiring contractor. He'll tell you that the only cure is to put in enough circuits and outlets to take care of all your electrical appliances, easily.

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