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ESTATE PLANNING AND THE 1954 REVENUE CODE

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The new Internal Revenue Code adopted August 16, 1954, made changes in estate tax, income tax and gift tax provisions, which among other things, but to a limited degree, affect all types of estate planning devices. Affected by the new law will be revocable and irrevocable trusts, wills, insurance dispositions and joint tenancies.

Generally, the effective date of the new law as to income taxes covers income commencing with the calendar year 1954; for estates, those dying after August 16, 1954, the date of enactment; and for gifts, those made in 1955.

In the case of a revocable trust, on death of the settlor, the assets of the trust although not a part of the probate estate, are a part of the taxable estate and yet under the old law if the amount of funeral expenses and claims exceeded the amount of the probate estate (which, of course, could happen where all or most of a man's property was in a living trust, or in joint tenancy) such excess could not be deducted simply because it was not in the probate estate: Now it can be deducted if such claims are paid within the fifteen months allowed for filing the Tax Return. In addition, it allows as a deduction amounts expended in administering property not subject to claims, provided the claims are paid within the fifteen months. This would include commissions paid with respect to trust property included in the gross estate and attorney's fees paid in contesting matters with respect thereto.

INCOME TAX: The Clifford Regulations with some changes are now codified in the new Code. These Code sections deal generally with determining when income from certain assets will be taxable to the grantor in spite of the fact that he has transferred them to a trust which is irrevocable. This is, of course, a very important consideration in establishing such trust because in nearly every case of an irrevocable living trust the purpose of creating it is to save both income taxes and estate taxes.

Here are five situations in which the income of the trust is still taxable to the grantor even though he has transferred the assets producing such income to an irrevocable trust. (Here we are reminded that the only type of trust which can possibly result in lessening the income tax of the grantor is an irrevocable trust as distinguished from a revocable trust).

1. Section 673 provides that when a trust is for a term of ten years or less, with the corpus or income then reverting to the grantor, the income is taxable to the grantor and not the Trustee or the beneficiaries of the trust. (Under the Clifford Regulations

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this period was fifteen years if the grantor or his wife possessed certain administrative powers). There are exceptions to this rule, (a) where the trust is for the benefit of qualified charities, and, (b) where the reversionary interest of the grantor is to take effect upon the death of the person or persons to whom the income is payable even though such person may have a life expectancy of less than ten years. The Code definitely settles what was not too definite under the Clifford Regulations, viz, that reversion of a trust to the settlor any time after ten years, will not cause the income to be taxable to him during the ten year period.

2. Section 674 provides that regardless of the duration of the trust (here we are no longer speaking of short term, ten year trusts), the income will be taxable to the grantor, if the beneficial enjoyment of the trust corpus or income is subject to a power of disposition, or discretion, by the grantor or a non-adverse party, or both, without the approval of an adverse party. (An adverse party is one having "a substantial beneficial interest" which would be adversely affected by the exercise or non-exercise of such power). Thus if the grantor retains the right to direct the trustee (or if the grantor retains such right as trustee himself) during the pendency of a trust, to make discretionary payments to various beneficiaries, then the income of the entire trust will be taxable to such grantor.

This rule as above stated would deprive trusts of one of their greatest advantages (aside from tax considerations), viz, the power of a trustee who is not an adverse party (which is the usual situation) to distribute income or corpus among several beneficiaries according to their needs, and as the unforeseeable future may make and change those needs.

There are a few exceptions to this rule which are worth noting:

First. A grantor may retain control over discretionary distributions, and still not be taxed with the income of the Trusts, by retaining the right to appoint by his will (other than income accumulated in his lifetime).

Second. He (or a non-adverse party) may retain a power to distribute corpus, if such power is limited by "a reasonably definite standard", set forth in the Trust instrument, such as "for educational purposes".

Third. A power may be retained over income during legal disability or during the minority of certain beneficiaries.

There are certain other exceptions to the rule which are quite restrictive in their application.

There is an important exception to the rule also which permits giving a trustee or trustees (other than the grantor) power to distribute, apportion or accumulate corpus or income to or among beneficiaries, or within a class of beneficiaries, in the sole discretion of the trustee, provided that no more than one-half the trustees can be related or subservient to the grantor's wishes, as defined in the

Code. This makes it possible for Trust Companies and Banks to continue their magnificent services to the community by protecting widows from the evil designs of unscrupulous villians and second husbands, and shielding wayward sons and innocent daughters from their own weaknesses and extravagances in a wicked and scheming world after father's protective arm is removed.

3. Section 675 sets forth administrative powers, which when exercisable by an non-adverse party, will cause the income of the trust to be taxable to the grantor. Generally, these powers are as follows: (1) a power enabling the grantor or any person to deal with the property for less than a adequate consideration, (2) a power which enables the grantor to borrow directly or indirectly without adequate interest or security, (3) a situation where the grantor has actually borrowed from the trust on a loan without adequate interest and security, and has not repaid the loan before the beginning of the taxable year, (4) a power of administration as in this section defined, exercised in a non-fiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity.

4. Section 676 provides the grantor shall be taxed with the income, if he or a non-adverse party, or both have the power to revoke the trust and revest it in the grantor. Of course, we are considering irrevocable trusts, so if this power exists the trust is not irrevocable.

5. Section 677—This is the well known rule that the grantor of an irrevocable trust will be taxed with the income, if the income (without the approval of an adverse party) may in the discretion of the grantor or any non-adverse party, or both, be

(a) Distributed to grantor or accumulated for him, or ,

(b) Applied to insurance premiums on his life (except where proceeds used for certain charities).

An important exception—Income is not taxable to grantor. merely because in trustees (or grantor's) discretion, it *may* be used for "support or maintenance" of a beneficiary whom grantor is legally obligated to support except to the extent such income is so applied or distributed. The above considerations had to do with the effect on grantor's income tax by retention or granting certain powers. Now we consider estate tax consequences.

It may turn out that the reservation by the grantor of some of the powers above discussed, even though not causing the grantor to be taxable with the income, may under the estate tax provisions cause the trust to be includable in his gross estate. Briefly, the provisions covering a situation wherein irrevocable trust will be taxable to the grantor's estate are as follows:

1. Where the trust is set up in contemplation of death
2. Where the grantor reserves the power to amend, revoke or alter the trust alone or with any person (whether or not adverse)

3. Where the grantor makes a reservation of the income (here also the grantor would be taxable with the income)
4. A transfer which is considered to take effect at or after the death of the grantor

The new Code made only one substantial change in these provisions, which affects the provisions governing transfers to take effect at or after death. Before 1954, transfers were divided into two classes, pre October 1949 transfers and post October 1949 transfers. A transfer prior to October 1949 was considered as a transfer intended to take effect at or after death and therefore includable in the grantor's estate, if (1) the beneficiary had to survive the decedent *and* the decedent possessed any interest or right in the property, such as a possibility of reverter. Transfers after October 7, 1949 were considered as taxable under this section, if the beneficiary had to survive to possess or enjoy the property *or* if the grantor possessed an interest in the property. Therefore, on transfers after October 1949 and prior to the 1954 code, the government had a two-pronged device for holding the assets taxable in the grantor's estate. The 1954 Code has softened this area and has put the taxability generally on the same basis that existed prior to October 1949. Under the provisions of Section 2037 the transfer in trust or otherwise is not considered as taking effect at or after death unless the beneficiary must survive to enjoy the property *and* the decedent retained a reversionary interest which, immediately before death of the decent, exceeded 5% of the value of the trust. Therefore, in setting up an irrevocable trust, it is always advisable to avoid any possibility of reverter to the grantor by naming enough contingent beneficiaries, or by providing for an ultimate disposition to charity in the event all beneficiaries die before enjoying the property.

GIFT TAX (To Minors): A very important change has been made under the gift tax provisions of Section 2503 regarding irrevocable gifts in trust for the benefit of minors. Prior to the 1954 Code a transfer in trust for the benefit of a minor providing for accumulations until the minor became of age constituted a gift of a future interest and therefore the annual $3000 exclusion was not available. The new Code provides that a gift in trust for a minor shall be considered as a gift of a present interest, and therefore makes available the $3000 annual exclusion, if the corpus and income *may* be expended for the benefit of the minor before attaining twenty-one, and if not so expended will pass to the minor at majority, and if he dies before reaching the age of twenty-one, then to his estate or as he may appoint by a general power of appointment. Thus for the first time, husband and wife seeking to reduce the size of their estates, for death tax purposes, can place periodic gifts of $6000 a year in trust for each minor child, which can accumulate the income until each child attains twenty-one years,

without incurring a gift tax or using any of their $30,000 lifetime exemptions. This law doesn't take effect until January 1, 1955.

LIFE INSURANCE: No lawyer can ignore the importance of life insurance in planning an estate because (1) it is so widely held, (2) because in amount it frequently represents a large part of the estate, and (3) because it so often plays an important part in fixing the amount of the estate tax, and it must also be considered in the income tax picture of the beneficiary.

First, the *income* tax considerations. Under the old law, there was no income tax assessed against a beneficiary on payment of life insurance on the death of the insured. This is unchanged. Neither were instalment payments taxed even though a part of such payments represented interest earned on the principal sum of the policy. This has been changed by the new law so that the income portion of the instalment payments to the beneficiary (computed on a formula basis) is to be included in the beneficiary's income, except that a beneficiary who is the spouse of the insured has a $1000 annual exemption with respect to such income portion. This rule applies only where the death of insured occurred after the enactment of the Code, August 16, 1954, so that existing payment plans are not affected.

Next, there is an important change in the *estate* tax provisions with respect to insurance proceeds payable by reason of death (Section 2042). The old law is unchanged that insurance payable to the decedent's estate is taxable in his estate. Prior to the 1954 Code, insurance on the life of a decedent, even though paid directly to a beneficiary, was also taxable in his estate, if (1) the insured paid the premiums, *or* (2) he retained incidents of ownership. One or the other of these tests caught most insurance for estate tax. Under the new section the premiums test has been abandoned and the taxability is determined solely by the incidents of ownership. If the insured had no incidents of ownership at the time of his death, the insurance is no longer ordinarily taxed in his estate, even though he has paid all the premiums. Incidents of ownership include the right to change the beneficiary, the power to borrow on the policy, and the right to receive the cash surrender value. Under the new Code, incidents of ownership also include a "reversionary interest" (whether by express terms or operation of law) if such value exceeds 5% of the value of the policy immemediately before the death of the insured.

Therefore, if insurance is now taken out on the husband's life by the wife, giving her all the incidents of ownership, then on the husband's death it will not be included in his gross estate even though he pays all the premiums.

If the necessary gift tax were paid, existing insurance owned by the husband could be transferred to the wife and he could continue paying the premiums.

This right of the husband to pay premiums on his life insur-

ance without thereby including it in his estate is, of course, important, because in many, if not most cases, the only income available for insurance premiums is that earned by the husband.

It will undoubtedly make insurance even more attractive in estate planning; first, because a man contemplating a substantial insurance program for the purpose of building up his estate need not be deterred because he is paying the premiums by any consideration that he is thereby increasing his estate tax. In the second place; one who is planning insurance purchases naming as beneficiary his wife or children, will be able to pay premiums up to $6000 per year for each beneficiary, (using the marital deduction in case of the wife and his wife's annual exclusion together with his own in case of the childen) without paying any gift tax on such premiums—again assuming that he does not retain incidents of ownership.

JOINT TENANCY: Two changes of importance, (1) respecting cost basis, and (2) respecting gift taxes. Any changes affecting joint tenancy are important because so much property is held in joint tenancy.

(1) Cost Basis. Take the usual case—a husband buying real or personal property with his funds, (say for $10,000), and putting title in his and his wife's names in joint tenancy. He dies, and the entire property will be included in his taxable estate at its date of death (or optional date) value (let us say $20,000). Then the widow sells the property for $20,000. What is her cost basis for capital gain or loss purposes? Had she inherited it, or acquired it by will, her cost would have been $20,000 under the old law. But, if she acquired it by joint tenancy ownership, her cost would have been her husband's cost of $10,000. Under the new law it is the estate tax value ($20,000). So under the new law she will have no capital gain. This new rule applies also to certain other values included in the estate tax, e.g. property which is brought back into the estate as having been transferred in contemplation of death (provided the donee has not sold it before donor's death, in which case its value would be the value as of the date of such sale). The same rule also applies to property placed in a trust with income reserved to grantor (which is taxed to the deceased as above noted). In fact, any property will take a new date of death cost basis, if acquired from a decedent by reason of death, form of ownership, or other conditions (including exercise or non-exercise of a power of appointment) if by reason thereof the property is included in the decendent's gross estate.

(2) Then there is an important gift tax change in joint tenancy Under the old law if property was purchased in joint tenancy, and one party contributed more than the other to the purchase price, then a gift for gift tax purposes took place at the time of such purchase. (This rule did not apply to survivor Government Bonds or survivor bank accounts—and still does not).

Under the new law, however, in the case *only* of joint tenancy (a) *real property,* (b) *in the joint names of husband and wife,* the transaction will not involve a gift tax at that time for the spouse furnishing the larger part, or all, of the purchase price, unless he elects to so treat it. If he does not so elect, there will be a gift tax when the joint ownership is ended (other than by death) unless the spouses divided the proceeds proportionately to their contributions. Thus, husband and wife buy real estate, he contributing two-thirds of purchase price, and she (from her separate property) contributing one-third. There is no gift tax returned at the time of such purchase. If they sell the property, there is still no gift *if* they divide the proceeds two-thirds and one-third. There is a gift tax on the difference if they divide on a different percentage basis. It will be observed that the cost basis rule first discussed applied to any joint tenancy ownership, whereas this gift tax rule applies only to real estate in joint names of husband and wife.

Some changes have been made with respect to powers of appointment. Under the new 1954 Code, if a power of appointment is includable in the decedent's estate, the beneficiary takes on a net cost basis regardless of whether the power is exercised or not by the decedent. The taxability of power of appointment is still determined on the same basis as under the 1939 Code, depending primarily upon whether the power is a general or special power.

ACCUMULATED INCOME: Generally, income accumulated in an irrevocable living trust, or a testamentary trust, is (and was under the old law) taxed to the trust and not to the beneficiary. Under the new law, if income is accumulated after December 31, 1953, and a distribution is made to the beneficiary in a later year in excess of that year's distributable net income by $2000 or more, the excess is taxed to him as income in the year in which it is distributed to him, but the amount of tax shall not exceed the amount which would have been applicable had the income been paid him in such prior years, even though that same income had been previously taxed to the trust up to the full amount of income which had been accumulated over the preceding five years, starting with the last preceding year. The beneficiary, however, gets a credit for the tax previously paid by the trust.

There are several important exceptions. First, if any annual distribution to the beneficiary exceeds current distributable income by $2000 or less, such excess is not taxable to beneficiary as income under this Throwback Rule. Thus, if distributions of accumulated income are limited to $2000 in any year, the beneficiary need not treat such $2000 payment over that year's current distributable income as taxable income. Second, the rule does not apply to accumulations distributed during the minority of a beneficiary; and third, it does not apply when the distributions are made to satisfy "emergency needs" of a beneficiary. This is an important exception because most distributions over the current

distributable income *can* be justified as an emergency, or they wouldn't be made. Finally, the rule for taxing the past five years of accumulations does not apply to amounts paid as a final distribution of the trust if made more than nine years after the date of the transfer of property to such trust. Therefore, it is conceivable that a father may set up a series of trusts providing for accumulation of income (taxable to the trustee) for nine years and one day, ten years and one day, etc., thereby getting the income into the hands of his son at the desirable intervals without incurring additional tax liabilities, and the $2000 over-ride may be included in this plan. In the case of an estate, it will no longer be possible for an executor to make distributions within first sixty-five days of the following year and have them treated as current distributions. They must be made by the end of the taxable year of the estate. The Throwback Rule does not apply to estates in course of administration.

Gifts or bequests of specific sums or specific property payable all at once or in not more than three instalments are not considered as accumulation distributions. For instance, if a beneficiary is to receive $75,000 payable $25,000 at twenty-five years, $25,00 at thirty, and $25,000 at thirty-five, and if the payments are not required to be made from income, those payments are not considered as accumulation distributions.

The Code has also divided testamentary and irrevocable trusts into two classifications, a simple trust and a complex trust.

A simple trust is one which is required to distribute all of its income currently (but not to a charity) and will now receive a $300 exemption. All other trusts are considered as complex and receive only a $100 exemption as heretofore. The $300 exemption may become important to offset capital gains taxable to the trustee in small trusts.

Some changes have been made in the provisions governing the marital deduction. Heretofore, the property given to the wife, in order to qualify for the marital deduction, had to pass outright to the wife, or be set up as a separate fund in a trust for her with income for her life and the unrestricted power in her to dispose of the property on her death. Now, in addition to the above, the husband may give his wife the life income from property (i.e. by a legal life estate) with right to dispose of it on her death and without a trust, and it will qualify. I think the old trustee method will still continue the most popular however.

There is another new addition to the marital deduction methods which may develop popular usage. Now a husband can set up one trust giving his wife the income from a certain percentage of the entire corpus, with a right to dispose of that same percentage of the principal on her death. Her share of the trust will now qualify for the marital deduction. This does not involve segregating or ear-marking any specific assets out of the trust as

hers. Her part of the trust could remain commingled with the non-marital assets in the trust.

All other rules with respect to the marital deduction have been retained. The requirements for qualification are still (1) the property must be includable in the decedent's gross estate, (2) the decedent must be a citizen or resident of the United States, (3) the spouse must survive and the interest must pass or have passed to the surviving spouse and must not be terminable in nature.

RELIEF FROM SECOND ESTATE TAX. The old Estate Tax law allowed a deduction for property previously taxed within a five-year period, but allowed no deduction where the property was received from a husband or wife. Now there is a new method of computing the credit; the period is increased from five years to ten years (but on a sliding scale of credit) and a credit is now allowed for property left by one spouse to another to the extent the property did not give the first estate a marital deduction. Thus, under the old law, it might not pay for a husband to give his wife more than the fifty percent which would qualify for the marital deduction, because if she died within the period there was no credit in her estate for such overage. Now there would be a credit for it, and there could well be situations which would warrant such provisions. Under the old way a deduction was allowed for property actually included in the decedent's estate upon which another person had paid a gift tax on account of a gift to the decedent. Under the new law no credit is allowed because of gift taxes paid by a person other than the decedent on the transfer of property to the decedent included in his gross estate.

The $50 flat exclusion for dividends received applies to estates and trusts, to the extent the dividends are not allocable to a beneficiary.

Then four percent credit is also allowed on income received after July 31, 1954 (but in 1954 it may not exceed 2% of 1954 taxable income).

REDEMPTION OF ESTATE STOCK: In 1950 the law was amended to permit redemption of stock by a corporation from an estate without the proceeds being treated as a dividend to the estate for income tax purposes, provided, (a) the amount of such redemption did not exceed the death taxes in the estate, and, (b) the stock of such corporation constituted more than 50% of the net estate. This law was amended in 1951 to change the provision that the stock constitute 50% of the net estate, to read that it must constitute at least 35% of the gross estate of the deceased.

The new Code amends this provision to permit the same procedure in *either* event (viz, the corporate stock comprising 35% of the gross estate, or 50% of the net estate) and equally important, increases the amount which may be thus redeemed without income tax charged to the estate, to include not only death taxes

but *funeral* and *administration expenses* as well. The law has certain other liberalizing provisions also. The result of this is that where a decedent was the main, or, one of the main stockholders in a close or family corporation, and such corporation had built up a surplus of undistributed profits, this is a means of distributing such profits on the death of such large stockholder without incurring an income tax as for dividends paid, and can, therefore, be a very important tax saving device. It might be stated that Colorado adopted the old Federal law in 1953, using the test of 50% of the net estate, but limiting it as under the old Federal law to the amount necessary for death taxes.

In January of this year the members of the Denver Bar Association approved the Bar Primary plan for the purpose of endorsing candidates for judicial office. Through this method it was felt the best qualified candidates, based on experience, temperament, ability and integrity, would be selected. As a result of the balloting the following ten men were endorsed for the nine vacancies on the District Court Bench:

William A. Black

Joseph E. Cook

Albert T. Frantz

Frank E. Hickey

Joseph M. McDonald

Robert H. McWilliams, Jr.

Floyd F. Miles

Robert W. Steele

Joseph J. Walsh

Charles E. Works

Mitchel B. Johns was endorsed for the Superior Court Bench.

Every lawyer, regardless of whether or not he resides in the City and County of Denver, should make every effort to influence as many voters as possible for the election of these candidates.

A well-qualified judiciary is the best method of safeguarding the interests of the public.