

1-1-1965

Pitfalls of Estate Planning Revisited

Samuel D. Thurman

Follow this and additional works at: <https://digital.sandiego.edu/sdlr>



Part of the [Law Commons](#)

Recommended Citation

Samuel D. Thurman, *Pitfalls of Estate Planning Revisited*, 2 SAN DIEGO L. REV. 1 (1965).

Available at: <https://digital.sandiego.edu/sdlr/vol2/iss1/2>

This Article is brought to you for free and open access by the Law School Journals at Digital USD. It has been accepted for inclusion in *San Diego Law Review* by an authorized editor of Digital USD. For more information, please contact digital@sandiego.edu.

PITFALLS OF ESTATE PLANNING REVISITED

*Samuel D. Thurman**

The following article is an address delivered by Dean Thurman to the members of the San Diego County Bar Association who were guests of the First National Bank of San Diego on May 14, 1964. Dean Thurman had been the guest speaker at a similar gathering some ten years prior, shortly after the passage of the 1954 Internal Revenue Code.

Dean Thurman outlines a few of the pitfalls encountered in estate planning under the 1954 Internal Revenue Code, as amended to the date of the address, with particular emphasis on changes brought about by the court decisions and Regulations promulgated since 1954. He specifically discusses additional problems encountered where a community property system is superimposed on the federal taxing scheme.

Because the opening remarks were directed to the particular group assembled, they have been omitted from this article. Case and article citations which were parenthetically included in the text of the address have been relegated to footnotes.

PITFALL NUMBER 1: INACTION

Ten years ago, I referred to inaction as probably the most common pitfall in estate planning, or more properly, a pitfall stemming from lack of planning. The difficulty is that many clients may be failing to do things that should be done and be completely unaware of their failure. Inaction in business soon shows up, whereas inaction in estate planning is often first discovered at death, and frequently at a time many years thereafter. In addition, the businessman who does not plan ahead can often compensate for his mistakes whereas the failure to plan an estate is usually irrevocable.

The distinction is also one between the lifetime accumulation of an estate and its ultimate disposition. Most men gradually become knowledgeable in the field of income tax and in the solution of business problems generally. Few, however, know much about the problems of planning an estate, many of these problems being exceedingly complicated and many requiring a knowledge of estate taxation. Their families may find that they have to live for many years with the mistakes made in failing to plan properly.

* Dean, College of Law, University of Utah; A.B., University of Utah, 1935; LL.B., Stanford University, 1939.

There are many reasons for this inaction on the part of all of us, for attorneys themselves are certainly not immune. We often state that we will wait until a major business crisis has been passed or that we will wait until a family problem is solved or until the family needs are a little clearer. Life, of course, has a way of presenting constant, albeit different, problems, and it is a rare individual who ever reaches a state where he can say there are no uncertainties in the future. At no point do we ever feel that a will, even with carefully drawn provisions, can ever be an adequate substitute for our own presence. Consequently, there is a human tendency to postpone the planning of an estate until a more fortuitous future time.

There are also the immediate pressures of daily life. Most of us require deadlines in order to get work done, and few of us have a definite date of death before us. It is interesting to compare the individual who is more or less aware of impending death. You can be certain that he gives estate planning a much higher priority on his list of things to be done than do the rest of us.

PITFALL NUMBER 2: PIECEMEAL PLANNING

Most of us probably are not guilty of complete inaction in planning our estates. A more common pitfall is that of piecemeal planning. Over the period of a lifetime the average individual probably has purchased a number of life insurance policies with varying settlement agreements and without much regard to the overall picture he is putting together. He probably has made a will or two, has put a number of miscellaneous pieces of property in joint tenancy, usually without thinking of the legal consequences, and has made a gift of other property either outright or in trust. He may have entered into partnership agreements that will play an important part in the estate that he has accumulated. Contracts to sell or buy closely held corporate stock are common, and employment contracts, pension and profit-sharing plans, and social security benefits all play an increasingly important part in today's estates. No person planning an estate can do an adequate job if he does not secure this overall picture. Coordination of all of these arrangements entered into over a period of years on a piecemeal basis is essential for effective planning that will meet your client's desires and the needs of his family.

PITFALL NUMBER 3: FAILURE TO MAKE APPROPRIATE INTER VIVOS GIFTS

Federal income and estate tax savings can be effected by making inter vivos gifts. These tax savings, however, are only possible where the gifts are irrevocable. Revocable trusts are frequently set up for

the convenience of the grantor in order to shift the burden of managing property or to make a trial run, so to speak, on a testamentary trust. The fact that they are revocable, however, means that no gift tax is payable, no income tax is avoided, and the principal is still taxed in the grantor's estate at the time of his death.

An irrevocable gift, on the other hand, can shift income taxes to those in lower brackets and can avoid estate tax, albeit at the price of possible gift taxes. Such gifts may be made outright or may be made in trust. The gift in trust can have many advantages, tax and otherwise. It can provide management of the assets and flexibility to meet family needs, both with reference to the income and to the principal. In addition, if the trust instrument is appropriately drafted, it can introduce at least a third taxpayer, the trust itself, into the picture in addition to the settlor and the beneficiary. The trust can become an income taxpayer if income is to be accumulated for future distribution.

The trust principal may also be removed from the grantor's taxable estate, unless the gift is made in contemplation of death, and estate tax may also be avoided at the later death of the beneficiary. This latter advantage is not possible when the initial gift is made outright.

Short Term Trusts

By the use of the short term irrevocable trust, income tax savings may be effected. Under the Internal Revenue Code such trust must be irrevocable for at least ten years or until the happening of an event that is not likely to occur within ten years. One important exception to this rule is that the trust is effective to transfer income for tax purposes when it is to last for the beneficiary's lifetime, regardless of the beneficiary's life expectancy.

The grantor must not retain the power to change the beneficiary or to alter the beneficial enjoyment of the trust income or to control the trust primarily for his own benefit. It is also important to make sure that the income is to be paid to or accumulated for the benefit of someone else. The income may not be used for the grantor's own economic benefit, such as the discharge of his legal obligations or the payment of life insurance premiums on his own life.

The short term trust is not effective in saving estate tax to any great extent. The trust will either terminate at the grantor's death, in which case the entire trust property will be included in his gross estate, or he will have a reversionary interest that will in all probability be worth almost as much as the present value of the property.

A gift tax may be payable, the value of the gift depending upon the duration of the trust and the value of the property. The use of the annual gift tax exclusion, available if the income of the trust is to be distributed each year, and the grantor's lifetime exemption, applicable even to gift of a future interest, may eliminate most, if not all, of the gift tax.

The short term trust is frequently used by individuals in high income tax brackets even though they do not have substantial amounts of property. The person of substantial wealth is more frequently interested in escaping estate tax as well as saving income tax and consequently often prefers the permanent gift in trust.

One pitfall to bear in mind in connection with all irrevocable trusts is the *State Street Trust* case.¹ If the settlor names himself as trustee or as one of the trustees, normally fiduciary powers over investment or distribution may have the effect of including the property in his gross estate at death.

PITFALL NUMBER 4: JOINT TENANCY

Many taxpayers make the mistake of failing to separate community property and separate property. There are various presumptions in the code that assist in a determination as to which type of property is involved, but it will frequently be advisable to have a husband and wife enter into formal written agreements concerning their property.

This is particularly true with reference to one situation commonly encountered, the purchase of corporation stock with community property funds. Most corporations will not register stock as community property and will insist that it be registered in the names of individuals or, as most brokers seem to do without much thought given to the consequences, in joint tenancy with right of survivorship. It is in this situation where a formal agreement making it clear that the property is to remain community property becomes important. California does have a liberal rule which allows the parties to come forward at a later date and state that they did not understand that the property was to become true joint tenancy and that they still considered it community property. This is the *Tomaier* doctrine.² Internal Revenue agents are not happy with a rule of this kind and taxpayers frequently find it necessary to go to court if they claim an alleged oral understanding that the parties intended the property to remain community. A written agreement will usually obviate this problem.

¹ *State Street Trust Co. v. United States*, 263 F.2d 635 (1st Cir. 1959).

² *Tomaier v. Tomaier*, 23 Cal. 2d 754, 146 P.2d 905 (1944).

But what are the main disadvantages in commuting community property to joint tenancy?

In the first place, the surviving wife will have the burden of proof as to her contribution, which she may not be able to sustain. In such case the entire property will be included in the husband's gross estate.

Disadvantage number two is the difficulty of planning an estate where the property is in joint tenancy. The surviving wife will take the property outright and any such property will by-pass the will. There is nothing for the will to "bite" on and there can, therefore, be no planned widow's election. The husband cannot in such case leave the wife a life estate only, either in his own half or in his wife's. Any incidental probate savings at the husband's death (this is frequently the objective of individuals who place property in joint tenancy) may be far outweighed by such disadvantages.

In the third place, if the wife does succeed in proving that the joint tenancy was community property originally and that each spouse, therefore, contributed one-half so that only half will be included in the husband's gross estate, there will be no stepped-up income tax basis as to the one-half not included in his estate. The treatment is different from that accorded community property and this becomes a major consideration today with inflated property the general rule in most estates. If the property is left as community property, only one-half will be included in the gross estate for estate tax purposes, but both halves will get a stepped-up basis as of the date of death, or other applicable valuation date, for income tax purposes.

PITFALL NUMBER 5: FAILURE TO PLAN WITH LIFE ESTATES

Traditionally, the most common estate planning device has been the life estate to the wife, remainder to the children, type of disposition. Before the marital deduction, this was certainly true, and even since 1948 its popularity has continued. Separate and apart from estate tax considerations, husbands frequently want to leave their property in this manner. Why?

Husbands are willing to leave to their wives the entire income from all their property, including various powers of invasion, but are frequently reluctant to have any of the property go outright. The reasons for this are obvious: the fear that the wife's lack of business experience, or presumed lack of such experience, will result in mismanagement and loss of property; the fear that she will be importuned by relatives and others if she has unfettered control

over the property; the desire to eliminate probate at the wife's death; and no doubt the concern of some that a second husband may come along and take over the property the first husband spent a lifetime acquiring.

With reference to separate personal property, no problem is encountered by the husband in so disposing of his property. In fact, the husband can completely deprive the wife of any interest in such property; he may leave it outright to third persons and deprive her of any claim thereto. In this respect I believe California has been derelict in the protection of wives, except in the case of quasi-community property. Individuals who come to California from non-community property jurisdictions frequently bring with them substantial amounts of property acquired over a period of a lifetime. If this property stemmed from the husband's earnings, and would have been community property had the spouses been domiciled in California at the time of its acquisition, at the prior death of the husband one-half must go to the wife; he does not have a power of testamentary disposition over that half. This means that he can neither leave that half outright to a third person nor give his wife a life estate only in that half. It is now clear, however, that where the wife dies first she has no power of testamentary disposition over such property.

As to other separate property brought into the state or acquired while living within the state, the wife in California has no such protection. If the husband inherited the property before coming to California, the wife gave up all rights in it by way of dower and statutory substitutes when the parties left the separate property state. The non-community property states generally do not distinguish between inherited and earned property owned by the husband during his lifetime. In California, where separate property is involved, the wife gets better protection in the event of divorce than she does upon the husband's death; she may be able to get substantial alimony rights that would be a charge against his separate property. With the increasing number of individuals moving to California each year, on the average the wife probably lacks protection in much of the husband's property.

In sharp contrast to the separate property states, all of the community property states preclude the husband from making a testamentary gift of more than one-half of the community property to someone other than the surviving wife. This limitation applies not merely to outright testamentary gifts to third persons, but it also precludes the husband from leaving the wife's half to her in trust;

she need not accept a life estate to her with a remainder to the children. The husband cannot give away the remainder interest in his wife's half of the community property without her consent, yet this is precisely the result that many husbands desire. With reference to the husband's half, this device can be used. With reference to the wife's half, she can say, "I will not accept that; I will take the property outright."

Estate Tax Consequences

Where separate property is involved, the husband has the choice of paying an estate tax on the entire amount of the property at his death with nothing taxable at the wife's subsequent death. This can be done by giving the wife a life estate only in the entire property. If he prefers, he can provide for an estate tax on half the property at his death and half at the death of the wife. This can be done by giving her a life estate in half with a disposition in the other half that qualifies for the marital deduction. Whichever route is taken, the entire estate eventually is subject to estate tax in one or the other estate.

Compare the situation with reference to community property. Whether the husband's half is left to the wife outright or whether she is given a life estate only, the federal estate tax consequences are the same; only one-half of the community property is taxable at his death, her half of the community property escaping tax at that time. Of course, at her later death it makes a difference whether she received her husband's half outright or received only a life estate.

Suppose, however, that the husband attempts to leave all of the community property in trust with a life estate to the wife and remainder to the children. Under this type of provision it is still true that only one-half of the community property is taxed at his death. This was decided a number of years ago when the Commissioner claimed unsuccessfully that the entire community property should be taxed in the husband's estate in such case.³ There is, of course, no problem of securing a marital deduction when community property is involved and the half to which the wife is entitled will escape estate tax at his death.

At first blush, it seems that any tax at the death of the wife has been escaped in this case. Half of the property was taxed when the husband died. Since the wife has only a life estate, possibly including some limited powers of invasion, it will not be taxable at her death. Actually, however, what is the situation? The husband has given his half of the community property to the wife and the

³ Pacific Nat'l Bank, 40 B.T.A. 128 (1939).

children. There will be no tax on this half at the subsequent death of the wife inasmuch as a life estate given by a third person is not taxable. As to the wife's half, however, she has really given this to herself and to her children by acquiescing in the husband's will. Instead of claiming her half outright, as she is entitled to do, she has really made a present gift of a remainder interest in her half of the community property and the cases are clear that a gift tax would be then payable. The wife has made the gift of her half just as clearly as if she had put the property in trust directly. The value of the remainder interest which she has given will, of course, depend upon her age.

Furthermore, her entire interest put in trust in this fashion will be included in her gross estate at her death under Internal Revenue Code Section 2036. This is a reserved life estate situation where the entire value of the property, not merely the remainder interest or her life estate, will be included in her gross estate with some credit for the gift tax paid on the remainder interest. Thus there is apparently no community property advantage in such a situation. It would seem that the end result is the same as in the case of separate property where the marital deduction portion would be taxable at the wife's death. I am certain this is what Congress desired—half of the tax when the husband dies, the other half when the wife dies.

The Widow's Election

But, and this is the interesting point in a community property jurisdiction today, suppose that the husband adds in his will the familiar clause stating that all of the community property, his half and his wife's half, is to go into a testamentary trust, life estate to the wife, remainder to the children, but if the wife elects to take her half outright instead of leaving it in trust, then she is to get nothing from his half of the community property. She is to be cut off from any interest in the husband's half if she elects not to go along with the trust he has set up, even though it takes in her half of the community as well as his.

Why are such provisions commonly encountered? In effect, after death a second look at the husband's estate and at the wife's needs is afforded by this election device. There is also the old reason: added pressure is put on the wife to leave her half in trust and keep only a life estate so that third persons, possibly later husbands, will not get their hands on it. There is the feeling in many cases that the wife is much better off with her half in trust so far as management is concerned. In addition, it seems that there are now good tax reasons for such a provision, with respect to the gift tax, the estate tax, and the income tax.

In the *Siegel* case,⁴ the Court of Appeals for the Ninth Circuit held that under such a provision, the gift of a remainder interest to the children deemed to have been made by the wife would not be taxable to the extent that she received consideration from the husband. In this case, the consideration would be a life estate in his half of the community property. It now becomes a bargain transaction. The husband says, "I will give you a life estate in my half of the community property if you will give our children a remainder interest in your half." This, in effect, leaves the wife with a life estate in the entire property. The difference in value between the life estate which the wife gets from the husband and the remainder interest in her half depends upon the age of the wife. The Regulations point out, for example, that if the widow is age fifty-one the life estate and the remainder interest are approximately equal in value. In such case no gift tax is due.

What is the estate tax situation? In the absence of the type of provision which forces the wife to an election, there is an estate tax on the wife's half of the community property at her death, but where the widow is forced to an election, the *Vardell* case⁵ held that the consideration argument is equally valid. Section 2036, which would tax a reserved life estate to the wife, recognizes that this value is reduced to the extent that the wife received consideration for conveying the remainder and reserving a life estate. Inasmuch as the entire value of the wife's property would be includable under Section 2036, and the consideration given from the husband's half of the community, namely a life estate to the wife, would never quite equal the value of the wife's interest, some federal estate tax would be payable. However, it would be less than a tax on the wife's entire interest, depending upon her age. If the husband, on the other hand, gives additional consideration, such as a part of his separate property, for her acquiescence in the trust there may be sufficient consideration moving to her to equal the value of her community property half with a consequent complete elimination of estate tax at her death.

Needless to say, this type of consideration makes the Commissioner unhappy. In all probability, Congress had in mind consideration that would still be in the wife's estate when she died, a substitute for the property she gave away. Here the consideration is a life estate in the husband's half which will be worthless when she dies, with nothing to be taxed at that time unless there is unspent income from the trust. The Court of Appeals for the Fifth Circuit has said

⁴ *Comm'r v. Siegel*, 250 F.2d 339 (9th Cir. 1957).

⁵ *Estate of Vardell v. Comm'r*, 307 F.2d 688 (5th Cir. 1962)

that the life estate is consideration nonetheless, and the fact that it becomes worthless at the wife's death is immaterial. If a different result is desired tax-wise, it is up to Congress to do something about it. This brings about a decided advantage in a community property state. A similar plan will work in a non-community property state only if both spouses have property. In the usual case, with the husband earning the income, it takes community property to make the plan succeed.

When we turn to the income tax consequences of the widow's election to take under the will, we possibly enter what Judge Minor Wisdom of the Fifth Circuit described as a "taxpayer's utopia."⁶ There is a definite possibility that the income received by the wife from the husband's half of the community property will be received tax-free, or substantially so. The law is clear that a purchaser of a life estate may amortize the purchase price during his life against the income received. A taxpayer may even be so bold as to claim that the first income received should be treated as a recovery of his purchase price and that only the subsequent income would be subject to income tax. The purchase price in the case of the widow's election is the remainder interest in her half of the community property which she transferred to her children. Thus the widow has purchased a life estate and is entitled to amortize this cost.

As an offset to this advantage, the Commissioner may claim that the transfer of the remainder interest is a taxable exchange under the income tax with a consequent capital gains tax. However, where this transfer is effected immediately after the husband's death, there will probably be no capital gain due to the stepped-up basis provisions of Section 1014(b)(6).

PITFALL NUMBER 6: FEAR OF POWERS OF APPOINTMENT

We have talked about the life estate to the wife, remainder to the children, situation as perhaps the most common estate planning device. Today most testators want to take added precautions to see that the wife is protected in the event the income is not sufficient. At the same time they want, so far as possible, to avoid an estate tax at her subsequent death. This is true, of course, only where there is no claim to a marital deduction in the husband's estate. In order to accomplish these objectives, the husband has several alternatives.

Where the property is placed in trust, it has become increasingly popular to give the trustee broad discretionary powers to distribute principal to the wife whenever additional funds are required for her

⁶ *Ibid.*

maintenance or support, or even for her general welfare. Even a provision this broad will not have untoward tax consequences, and such a power when vested in an independent trustee will give the wife the protection desired. In addition, the trustee can be authorized to use income and principal to pay all bills of the wife rather than to distribute money directly to her in the event of her ill-health or incapacity.

In lieu of such broad powers, or in addition thereto, powers of appointment, including powers to invade capital, can be given to the wife herself. Where these are donated powers, that is powers with reference to the husband's separate property or to his half of the community property, Section 2041 is extremely liberal in permitting substantial flexibility while at the same time imposing no estate tax at the death of the wife.

One of the most neglected estate planning devices is the power of appointment. To many lawyers the field is a hazy one, filled with various pitfalls such as the rule against perpetuities, and any subject not thoroughly understood is suspect. Consequently, there is a reluctance to create powers of appointment in a client's estate, powers which might frequently come closer to achieving non-tax objectives than any other device and, in addition, save substantial amounts of taxes. Although a power of appointment can be complicated, it need not be and often the most advantageous results can be obtained by the giving of a clear, simple power to dispose of property.

In the first place, an understanding of terminology is essential. Although property lawyers and tax lawyers do not always define powers of appointment in the same way, both do use the same names in designating the parties. The person who creates the power is called the donor of the power. The one to whom the power is given is the donee of the power, the wife in this case. The person to whom the property is appointed is the appointee. The one who takes, if the donee of the power does not appoint, is the taker in default of appointment. The most typical case would be: *A* by will, leaves property to *B* for life with a power in *B* to appoint the remainder by will, but if *B* does not appoint then the property is to go to *C* and his heirs. If *B* exercises this testamentary power and appoints to *D*, *A* is the donor, *B* is the donee, *D* is the appointee, and *C* is the taker in default of appointment who in this case, of course, would take nothing.

Compare this disposition with the one more commonly encountered where *A* leaves property to *B* for life, remainder to *C* with no power in *B* to alter the disposition. Here it is clear that *B* has

only a life estate and both his interest and *C*'s are testamentary gifts from *A*. There is no federal estate tax upon the death of *B* and this has traditionally been the most common estate planning device, especially prior to the introduction of the marital deduction. Even today it is frequently advisable for *A* to leave at least a portion of his property in this fashion, this part not qualifying for the marital deduction in the case of separate property.

But what is the tax picture when *B* is given some kind of power to dispose of the remainder interest in Blackacre? Does it make a difference whether it is a general or a more limited power? Does *B* have to exercise the power before there are federal estate tax consequences? These and other questions come to the fore when we enter the powers of appointment area.

In the first place, no property over which the decedent has a donated power of appointment is included in his gross estate unless it is a general power, defined as one exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; in other words, one that can be exercised directly or indirectly for the benefit of the decedent. The general power may be one exercisable either during life or by will, not necessarily both, and results in tax whether exercised or not. It is important to notice that Section 2041 is not dependent upon a lifetime transfer of an interest in property under Sections 2035, 2036, 2037, and 2038. Reserved powers over property owned previously by the decedent would not come under Section 2041 but might be taxed under some other section.

Usually the donee of the power has some interest in the property, such as a life estate, in addition to his power to appoint during life or at death, but it is possible to have a power of appointment over property in which the donee of the power has no property interest. It should also be observed that under Section 2041 a power to consume, invade, or appropriate property may constitute a power of appointment and in certain cases may qualify as a taxable general power.

Section 2041 provides, however, and this is important, that a power given the wife to invade the principal for her own benefit is not to be deemed a taxable general power if this power of invasion is limited by an ascertainable standard which can, in fact, be very broad. For example, the Code provides that a standard relating to the health, education, support, or maintenance of the wife would not be deemed a general power. Here we have a very useful device whereby the donee of the power can be given substantial control over a trust in addition to her life estate and still have the bequest

from the donor treated, for tax purposes, as though she had been given only a life estate with no power to invade. The ascertainable standard rule is not a difficult one to satisfy and the donee of the power can have wide latitude with reference to invasion of the corpus.

Another increasingly popular provision that enables the wife to be given considerable discretion and yet not be taxed at her death is the right annually to withdraw \$5,000.00 or five per cent of the value of the trust property without limit as to use, such right to lapse at the end of each annual period if not exercised. Under such a power, there will be included in the wife's estate only the amount of principal that she could have withdrawn at the time of her death, in addition, of course, to any amounts actually withdrawn that had not been consumed. The lapsed rights of prior years will not be taxed even though technically they constitute gifts of remainder interests to the children with a reservation of a life estate in the wife.

Frequently, a husband desires to give his wife some freedom in withdrawing limited amounts of capital while at the same time recognizing that this may not always be an adequate protection to her. The independent trustee can in such cases be given unlimited discretionary power to invade capital on her behalf where necessary and the tax at her death will still be avoided.

PITFALL NUMBER 7: THE MARITAL DEDUCTION— USE AND MISUSE

Although the chief purpose of the Revenue Act of 1948, which introduced the marital deduction for individuals having separate property, was said to be that of extending to married residents of all states the tax benefits enjoyed in community property states, it is doubtful whether this objective was fully achieved. In a common law state, for example, where the husband owns all of the property the parties cannot really achieve a position equivalent to that in a community property state without paying a substantial gift tax.

In a non-community property state if the wife who has no property dies first, there is, of course, no marital deduction. Although there is no tax when the wife dies, there is a full tax when the husband dies and the benefit of one \$60,000.00 exemption is lost, the wife having no estate. The community property states, on the other hand, have a built-in marital deduction: when the wife dies, half of the community property is taxed but she can, either by bypassing the husband or by giving him a life estate only in her half, avoid a tax on her half at his death. In California, it is particularly impor-

tant for the wife to have a will in order to prevent the entire community property from being taxed at the husband's subsequent death. In the event of intestacy, all of her community interest will pass to her husband, unlike the law in some of the other community property states.

Owners of separate property, whether in California or elsewhere, should be fully aware of the tax savings possible by use of the marital deduction. This deduction is available only to married persons who own separate property and it is allowed when property passes to the surviving spouse under certain prescribed conditions. These conditions generally insure that the property qualifying for the marital deduction will be subject to estate tax at the death of the surviving spouse. The maximum marital deduction is limited to fifty per cent of the adjusted gross estate.

A pitfall to be avoided is the use of the marital deduction in cases where the tax saving at the death of the first spouse will be less than the additional tax at the death of the survivor. This can happen if the survivor owns other property and will be in a higher tax bracket, or if the property used to obtain the marital deduction is likely to increase in value during the survivor's lifetime. In some instances a full tax payable in the husband's estate with a non-taxable life estate in the wife is preferable.

The Stapf Case

In December 1963 the United States Supreme Court, which does not hear many tax cases these days, handed down a decision of interest to the community property states.⁷ The husband died leaving both community and separate property. By will he put his wife to an election, requiring her to acquiesce in a trust in all the community property for the benefit of their children in return for a substantial interest in his separate property. The wife elected to take under the will and claimed a marital deduction. The government contended that the value of the community property relinquished by the wife was in excess of the separate property given by husband and claimed that having received no net benefit she was not entitled to a marital deduction. The executor argued for the "plain meaning of the statute" and the Fifth Circuit upheld his contention. The Supreme Court reversed, holding that no marital deduction could be taken. This decision has important consequences in a community property state where the husband has separate property which might otherwise qualify for the marital deduction. The widow's election formula must be watched carefully in this case.

⁷ *United States v. Stapf*, 375 U.S. 118 (1963); *rehearing denied*, 375 U.S. 981 (1964).

PITFALL NUMBER 8: CONFUSION RE COMMUNITY PROPERTY LIFE INSURANCE

Much confusion abounds as to the nature of this type of property. This was even more true ten years ago. In fact, the paucity of authority with reference to community property life insurance led me in 1957 to devote a good part of six months to research in this field. I concluded that there were a great many questions under the 1954 Code that required court answer.⁸ Several of these have been passed upon since that time. For example, many taxpayers contended that where the husband had taken out insurance on his life but had paid the premiums with community funds, there would be no estate tax at the prior death of the wife. It is now fairly clear that this is not so; the wife's half interest in the community property life insurance is taxable. Her interest is not taxable under the insurance section, Section 2042, which applies only in the case of insurance on the life of the deceased but under Section 2033 dealing with miscellaneous property in which the decedent had an interest. The tax would be on the replacement value of her interest, not the proceeds value.

The difficulty in analyzing community property life insurance stems in large part from the failure to distinguish rights in the policy during life and rights in its proceeds following the insured's death, as well as from a lack of understanding of the methods of transferring life insurance interests. A further source of confusion arises from the fact that although occasionally the same individual may possess all rights in the policy as well as in its proceeds, these rights may be, and usually are, divided in varying combinations. A system of community property compounds the difficulty by effecting a basic and pervasive division of rights and ownership interests as between the spouses.

In recognition of the fact that life insurance is but another form of property the California cases are clear that such contracts may be separate property, community property or mixed, depending upon the source of the premium payments. Thus, to the extent of determining whether a policy is community property or not, the test of premium payment continues effective, despite its abandonment by Congress as an ultimate criterion of taxability.

Where the wife is named beneficiary and the husband reserves, but does not exercise, the right to change beneficiaries, the entire proceeds go to her at the husband's death, one-half as a gift from her husband. As to such gifts, her consent in writing is of course not

⁸ Thurman, *Federal Estate and Gift Taxation of Community Property Life Insurance*, 9 STAN. L. REV. 239 (1957).

required, but where the husband has, without receiving consideration, named someone other than his wife as beneficiary without her written consent, the gift violates Section 172 of the California Civil Code.

The California courts have consistently held that the gift in such cases is not a nullity but is voidable at the option of the wife, following the insured's death, to the extent of one-half the policy proceeds. The doctrine that a wife in California can claim one-half of the proceeds of a community life insurance policy as against the named beneficiary, even where the policy makes no reference to her interest and names only her husband as owner and where all dealings have been between the husband and the insurance company, was first enunciated in 1923.⁹ It came as a shock to many who owned insurance as well as to insurance companies and immediately received criticism. However, the frequently announced adoption of the doctrine by the California Supreme Court has made the question of correctness of the decision academic.

Where the wife fails to revoke the gift as to one-half of the proceeds following the husband's death, she is deemed to have made a gift to the named beneficiary to that extent. Where she appropriately releases her community interest in a policy during the life of both spouses, she has made an *inter vivos* gift. There is, however, a significant difference in the amount of the gift in the two cases. In the former situation the gift pertains to the face value of the policy whereas the gift prior to the insured's death involves only the much smaller replacement value.

The recognition by the California courts that the wife does have substantial, probably vested, interests in a community life insurance contract, and that by the same token the husband's interest in his wife's one-half of the community property is only as her agent during their joint lives, has important federal tax consequences. Upon the death of the husband, even though the entire proceeds are payable to his estate, the wife may claim one-half as her community share free of tax. The same result follows where the husband names a third person as beneficiary: only one-half of the proceeds will be included in his gross estate. Under state law the decedent is the true owner and has the incidents of ownership of no more than that portion, even where the policy purports to vest in him powers over the entire policy.

If it is desirable to avoid estate tax entirely at the death of the husband it becomes necessary to shed incidents of ownership during

⁹ *New York Life Ins. Co. v. Bank of Italy*, 60 Cal. App. 602, 214 P. 61 (1923).

his life. The most effective method is to make an irrevocable assignment of all interest in the policy in the same way that a transfer might be made of interests in other forms of property. Such an assignment may be made to an irrevocable trust, or directly to the named beneficiary, or to someone not previously named as beneficiary. When such an assignment is made to the beneficiary, the right to change beneficiaries having previously been reserved, the assignee now acquires rights as lifetime owner of the policy, in sharp contrast to his previous status as one with a mere expectancy during the insured's life. A gift for federal gift tax purposes will have been made by the husband in such case and, if the wife joins in the assignment to a third person, each has made a lifetime gift of one-half the replacement value, not the face value. In this respect—the wide variation in lifetime values and values after death—life insurance differs markedly from most other forms of property.

Another method of shedding incidents of ownership is to name a beneficiary irrevocably. It must be remembered, however, that just as in the case of an assignment, if community property is involved, even the naming of a beneficiary irrevocably cannot be made effectively in California by inter vivos gift without the written consent of the wife unless she herself is the beneficiary. During the lifetime of both husband and wife she can presumably revoke the "irrevocable" designation and return the policy to the community. Furthermore, at the death of the insured, she can claim one-half the proceeds. Only by her written consent will her husband's designation of the beneficiary be truly irrevocable where community property is involved.

Care must be exercised to see that reversionary clauses in the policy do not exist, Section 2042 providing that the policy will still be included in the insured's gross estate if the value of any reversionary interest exceeds five per cent of the value of the policy immediately prior to the insured's death.

The Tyre Case

In *Tyre v. Aetna Life Insurance Company*,¹⁰ the husband took out insurance on his life, paid for it with community funds, and provided that upon his death his wife should receive an annuity based on her life expectancy. If she failed to survive him by ten years the monthly payments were to be divided among three daughters for the balance of the ten year period. Such a guaranteed period is, of course, frequently seen and makes good sense. The wife in this case,

¹⁰ 54 Cal. 2d 399, 353 P.2d 725, 6 Cal. Rptr. 13 (1960).

however, asserted her community property rights and requested payment of the full face amount of the policy, \$20,000 in cash, or in the alternative, asked for \$10,000 in cash, the wife's community interest, and the remaining \$10,000 in the annuity form provided by the insured.

The insurance company in this case argued that the husband as manager of the community property had the power during his lifetime to enter into this contract. A divided California Supreme Court concluded that this was not a lifetime management problem but rather a testamentary disposition and that the husband had power to dispose of only one-half of the community property. It made no difference that this was an insurance policy and not a formal will. The court next concluded that the wife was forced to an election in this case and that by claiming her \$10,000 outright she had disqualified herself as the beneficiary of her husband's half. Consequently, she was entitled only to the \$10,000. The husband's half became payable to the three daughters, the secondary beneficiaries, on an annuity basis measured by the wife's life.

Although the husband should be able to put his widow to an election by appropriate provisions in an insurance policy just as he might in a will, I find no evidence in this case that the husband intended to do so. He did not explicitly specify that she was to have no interest in his half if she elected to take her half outright, and I believe she had a valid claim to an annuity interest in the husband's half as well.

The lifetime management argument would appear to be valid if the husband sets up an annuity rather than an outright distribution of the proceeds for the benefit of the wife where no interest is given to secondary beneficiaries. The *Tyre* case is similar to the life estate in the wife, remainder to the children, arrangement and the husband cannot deprive the wife of the complete interest in her half although he should be able to provide for an annuity to the wife in lieu of outright payment of the proceeds if her payments are not reduced by virtue of guaranteed payments to secondary beneficiaries.

Life Insurance Proceeds

Life insurance policies may be made payable in several ways. Frequently the proceeds are paid in a lump sum to an individual beneficiary. This has all of the disadvantages of any other kind of property left outright to a surviving spouse and many husbands prefer the use of settlement options with the insurance company. Under these options, the proceeds may be paid in installments or in a fixed

amount for a fixed number of years or as a life annuity either with or without a guaranteed period.

In some instances, the life insurance is paid directly to the insured's estate in order to pass under the terms of the insured's will. Such proceeds are, of course, subject to the claims of creditors and may be subject to state inheritance taxes.

The life insurance trust is a device that is perhaps too frequently overlooked. Under such an arrangement the trustee named as the beneficiary collects the proceeds and invests the funds. Income and principal are paid out according to the terms of the trust with many resulting advantages.

All of the insured's policies can be administered as a unit and the flexibility in a trust can be almost unlimited as contrasted with insurance company settlement options. The trustee, furthermore, can often have a much closer personal relationship with the beneficiary than can the insurance company.

Flexibility in investment is also an important factor to consider. Someone has said that prediction is difficult, particularly with reference to the future. Prediction of future economic conditions is impossible, but is not necessary if the insurance proceeds are placed in trust with a reliable and capable trustee. The trust can also afford necessary liquidity in the settlement of an estate. The trustee, for example, can be authorized in his discretion to lend money to or purchase assets from the estate. This is often highly desirable.

The advantage of life insurance in creating a definite amount of liquid capital at death through purchase on the installment plan during life has often been referred to. Sometimes neglected is the equally important problem of determining the most effective methods of payment of the proceeds following death.

The Wife's Interest in Community Property Life Insurance

Having addressed groups in most of the eight community property states in recent years, I have concluded that there is probably more confusion with reference to the wife's interest in community property life insurance than in any other aspect of community property.

In the first place courts have stated repeatedly that there is no property interest in life insurance. Such statements have their origin, I believe, in cases around the turn of the century when, generally speaking, there was nothing of value in life insurance policies during lifetime. Almost all of the early policies provided only for term

insurance, somewhat in the nature of fire insurance. Today most policies probably have substantial lifetime values.

A second reason for the confusion in this area stems from the failure to distinguish the contractual rights of an insurance company as set forth in the policy from the property rights or the ownership rights. The contractual rights deal with the beneficiary, the terms of payment, whether outright or in installments, forfeiture rights, etc. Companies selling life insurance in community property states often ignore the fact that the wife may have property rights in the policy in conflict with the various contractual provisions.

A third argument sometimes advanced is that if the wife predeceases her husband her heirs should have no greater rights in the community property life insurance than the wife herself had. It is clear that the wife during lifetime cannot cancel the policy and demand its cash surrender value or any part of it inasmuch as the husband is the manager of the community property. At her death, however, the situation is different. A life insurance policy can be partitioned; the company can issue two distinct policies, both of which will insure the life of the husband. The husband will own one-half of the insurance and the individual who succeeds to the wife's interest, if someone other than the husband, will own the other half. It will no longer be community property. Compare 100 shares of General Motors stock purchased by the husband out of his earnings. The wife may not, during their joint lives, have the stock split into two 50-share certificates, short of divorce, and yet upon her death if the wife leaves her interest to the children quite clearly they can have the stock split. Community property life insurance should be no different.

In the fourth place, many fail to distinguish between the rights of a beneficiary and those of a co-owner. In separate property states the wife can also be an owner or co-owner of a policy but this does not happen as frequently as in a community property state where she automatically becomes a co-owner. The wife has these rights of ownership whether named as beneficiary or not.

Fifth among the reasons why there has been confusion in this area is that insurance policies frequently present complicated problems of valuation. The tax authorities and the courts tend to limit these values to two, either the cash surrender value (terminal reserve is the more accurate term) or the face value at death. There can, however, be many other values and this leads to complications in understanding the nature of the property interest in insurance. Term insurance, for example, owned by an individual known to have incurable

cancer can be very valuable and yet the policy would be a difficult one to evaluate.

In California if the wife does not leave a will, or if she has a will which leaves everything to the husband, there is normally no problem concerning her interest in community property life insurance. In such case it is clear today that a federal estate tax will be payable at the time of death of the wife, based on the lifetime value of her half interest in the policy, and later the full proceeds will be taxed at the death of the insured husband. Consideration should be given to leaving the wife's interest in the policy to the children or to some third person in order to avoid the tax on half of the proceeds at the death of the husband. I suspect that in many cases, unless her interest in community property life insurance is specifically mentioned, there may be a tendency to overlook this type of property in her estate even though the wife purports to dispose of all her property by will.

PITFALL NUMBER 9: PREMATURE GIFTS TO MINORS

When I last spoke to you, I talked about this pitfall where tax avoidance has played a far too important part. Although I believe that clients, and certainly attorneys, are more sophisticated today and realize the shortsightedness in many cases of making outright gifts to minors for the sole purpose of saving taxes, there is no doubt but that our tax laws still tempt many parents to make unwise gifts of this nature. Let us take a brief look at some of these dangers.

Although minors may own property outright, state laws frequently require that a guardian be appointed. This is especially true where the asset is one that requires active management. The guardian is necessary not only to protect the minor against indiscretion or lack of judgment, but also to make possible the transaction of business that third persons would not otherwise enter into. Some assets do not always require guardianship. For example, a savings account or a life insurance policy or a United States Savings Bond might be owned outright by the minor although a guardian may be required if it becomes necessary to do something with reference to such property prior to majority. In the case of inheritance by a minor, the court may require a guardian in order to receive the property.

What are the disadvantages of a guardianship? The guardian is generally limited in powers of investment. He must generally post bond and must make regular reports to the court. The guardian is usually limited in the use of income and principal for the minor, and, again, there is frequently the necessity of court supervision. But far more serious is the fact that when the child becomes of age the

guardianship terminates. The books are filled with instances of tragedies resulting from children receiving unfettered control over property at too early an age. A further difficulty may arise in the event of the death of a child. Distribution under state law will frequently be contrary to the desires of the parent. Today some of the difficulties of guardianship can be avoided by outright gifts to minors made to a custodian for the minor's benefit. Rather broad laws now permit the custodian to exercise broader discretion than the guardian, but the major difficulty, that of termination of the protection at age twenty-one, still remains.

The answer in many instances is the placing of property in trust for the minor. This can be either an inter vivos or a testamentary trust. The trust can, of course, provide for great flexibility, not possible in a guardianship or a custodianship, and this flexibility can extend to investment powers as well as the disposition of income and capital. The trust need not terminate at age twenty-one and very frequently it is desirable to have it terminate in installments at more advanced ages. Provisions for the death of the child can be made and great flexibility can be possible with reference to different members of the family. Possible savings in income taxes should not be overlooked. Under a trust arrangement, part of the income can be taxed to the child and the balance to the trust. Thus there can be an additional splitting of income for tax purposes beyond the removal of income from the parents' higher tax brackets.

PITFALL NUMBER 10: IMPROPER USE OF PENSION OR PROFIT-SHARING PLANS

If a client is fortunate enough to participate in a pension or profit-sharing plan that qualifies under Section 401 he should make certain that the profits are not made payable to his estate. If they are not made so payable they can escape estate tax and in recent years substantial values have grown up in thousands of such plans. Not only can this interest escape tax at the death of the husband but if made payable to the wife in a proper fashion it can escape tax at her subsequent death. The husband should think twice before making these benefits payable outright to the wife, thus rendering them taxable at her death. No marital deduction is available to him, the marital deduction applying only in the case of property included in the husband's gross estate. It would thus seem wise to have the interest from a qualified plan paid under an annuity arrangement, leaving no value at the wife's death, or paid in a lump sum to an irrevocable trust with life income only to the wife.

PITFALL NUMBER 11: NEGLECT OF THE CHARITABLE DEDUCTION

The most significant estate tax deductions are the marital and charitable deductions. John D. Rockefeller III left an estate of \$80,000,000. The federal estate tax and the New York estate tax would have aggregated almost \$70,000,000 if these two deductions had not been available. The total tax actually paid was approximately \$200,000. This result was accomplished by dividing the estate into two parts, one of which went into a marital deduction trust for the benefit of the wife and the other into a charitable trust with members of the family as trustees. The family was able to retain almost complete control of the family fortune and yet escape with almost no estate tax.

PITFALL NUMBER 12: UNDERVALUATION OF PROPERTY

In the desire to minimize estate tax, property in the gross estate is sometimes placed at a lower figure than necessary. There are a number of reasons why an assertion of a higher value, where the value is debatable as it often is, may be desirable. This is particularly true where the saving in income tax may exceed the additional estate tax. Estate tax valuation will generally establish the stepped-up basis for later taxes on gains and for depreciation. High valuation should be considered, of course, where the estate is under \$60,000 and no federal estate tax is due. Where the items in question are depreciable or where the item is inventory and the estate tax rate will be less than the ordinary income tax rate of the intended beneficiary, consideration should be given to a higher value. The same may be true if the property qualifies for the marital deduction, if the item in question has been bequeathed to charity or if the beneficiary intends to make a deductible charitable gift and his income tax rate is higher than the estate tax rate. There may also be other situations where a minimum value for estate tax purposes will be more costly in the long run.

PITFALL NUMBER 13: FAILURE TO REVIEW AN ESTABLISHED PLAN

There are many obvious reasons to review one's estate plan—the occasion of entering into a partnership or purchasing a business, the purchase of a new home, the buying of life insurance policies, the birth of children in the family, divorces, and other events. But separate and apart from such occasions when one quite naturally thinks about his financial picture, one should make it a practice to take an overall view at fairly frequent intervals. The extent to which a change in the value of one's business or other assets, gradual changes in his family, changes in the tax laws, to mention but a few, can alter the picture often is overlooked. Planning for the future is in all

respects a never-ending task and to consider the task finished at any point in one's life is to incur the danger of leaving a structure that is unsound for the family's future.

CONCLUSION

It might be well to remind you that an attorney is not bound to stand idly by, having once prepared a will or otherwise set up an estate plan, and watch future changes, coupled with the procrastination of the client, impair the value of the plan that was set up. As stated in Opinion Number 210 of the Ethics Committee of the American Bar Association:

Many events transpire between the date of making a will and the death of the testator. The legal significance of such occurrences is often of serious consequence, of which the testator may not be aware, and the importance of calling the attention of the testator thereto is manifest. It is our opinion that, where the lawyer has no reason to believe that he has been supplanted by another lawyer, it is not only his right, but it might even be his duty to advise his client of any change of fact or law which might defeat the client's testamentary purpose as expressed in the will.