University of Mississippi
eGrove

Touche Ross Publications Deloitte Collection

1965

Tax planning for estates

Bernard M. Mulvey

Follow this and additional works at: https://egrove.olemiss.edu/dl_tr

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
Quarterly, Vol. 11, no. 2 (1965, June), p. 27-32

This Article is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in Touche Ross Publications by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

Tax Planning for Estates

by Bernard M. Mulvey

Bernard M. Mulvey, our Director of Tax Research, was with the Appellate Division of the Internal Revenue Service before joining TRB&S. He is responsible for the weekly Tax Letter and Tax Research Files which emanate from the Executive office, and has written numerous articles on taxation. His most recent work, which appeared in the May issue of TAXES, "Year of Sale Depreciation", will be reprinted in the NEW YORK LAW JOURNAL shortly.

A native of New York City, Mr. Mulvey received his BS degree from New York University where he majored in accounting, and an LLB from St. John's University. He is presently completing his requirements for an LLM at New York University Graduate School of Law.

Mr. Mulvey is chairman of the Legislation and Tax Reform Committee of the New York University Tax Society and is also a member of the Federal Tax Forum.

Estate planning today has become a continuing lifetime proposition. An individual with wealth may face estate tax problems whenever he is involved in a financial or property transaction. His habits of gift-giving, his manner of buying property, the way he solves his marital problems—all have estate tax consequences.

However, to say that tax consequences are omnipresent is not to say that they should be the tail that wags the dog. It is important to remember that the most important factor in any estate plan remains the client's wishes for the disposition of his money. Any sound estate plan must be geared to the client and his particular economic and personal situation. Tax considerations alone should never dictate the disposition of an estate.

Tax planning should be undertaken only after what an individual wishes to do with his money has been established. While good tax plans must and do vary from individual to individual, there are certain basic tools used

by all estate planners in the construction of estate tax plans. In the following paragraphs we will discuss many of these, incorporating in our discussion several recent developments in estate taxation which may necessitate changes even in existing estate plans.

Use of Lifetime Gifts

The simplest way to reduce an estate tax is to give away property during one's lifetime so that there is less in the estate to tax at death. While there is a tax on gifts, the rates are about 25% lower than the estate tax rates. There is a separate set of brackets, permitting a shift from top to bottom rates, and the gift is computed at present value, which hopefully is less than value at date of death. In addition, through the use of the $3,000 annual exclusion and the $30,000 lifetime exemption, substantial amounts of property may be transferred without incurring any tax at all. (A husband and wife, by splitting the gifts made by either, may receive an annual exclusion of $6,000 and a joint lifetime exemption of $60,000).

While lifetime gifts may seem a simple method to use, in practice there are several pitfalls which must be guarded against. For one, only complete gifts or irrevocable transfers in trust in which the settlor relinquishes his rights and control over the property can succeed in removing the property from the purview of the estate tax. There must be a complete surrender of *all* interest and control since, under sections 2036, 2037 and 2038 of the Code, an estate tax will be imposed upon any life transfer in which: 1) possession or enjoyment is retained by the transferor until his death, 2) the transferor retained until his death the right to designate the persons who should possess or enjoy the property, 3) the transferor retained a life estate until his death, or 4) the transferor retained the power to alter, amend, revoke or terminate the gift until his death. Many a potential donor has had strong reservations about making such a complete surrender of his property to his intended beneficiaries during his lifetime!

One interesting development in this area is the current contention by the Internal Revenue Service that an individual who takes (or transfers) title to a residence in his wife's name, but continues to live in the house for the rest of his life, has in effect retained the possession or enjoyment of the property so that the residence is to be included in his gross estate upon his death. The IRS has sporadically attempted to assert this position in the past but early case law provided little support for it, the courts generally holding that the property would not be included in the decedent's estate if it was conveyed without any valid reservations or conditions whatsoever. On the other hand, a recent case[1] indicates that the courts are now looking more to the actual substance of these transactions to determine if, in fact, a complete and unequivocal gift was made. Thus, a husband who makes a legal transfer of residential property to his wife with an oral agreement or understanding (whether or not enforceable in a court of law) to the effect that he is to enjoy the use thereof for his lifetime may now be unsuccessful in any attempt to avoid inclusion of the property in his taxable estate.

Even if the donor has made the necessary outright transfer of the property in question, there always remains the possibility that an estate tax will be imposed if the transfer is determined to have been made "in contemplation of death." Under section 2035 of the Code, a *rebuttable* presumption is created that any transfer made by the decedent within the three year period prior to his death is made in contemplation thereof. On the other hand, transfers made before such three year period are *conclusively* deemed not to have been made in contemplation of death. Thus, if the donor survives for three years after the date of the gift, the Commissioner cannot assert that the transfer was motivated by thoughts of death.

The fact that the donor dies within three years from the date of the gift does not ipso facto result in inclusion in the estate. If it can be established that a dominant living purpose motivated the gift, then the presumption is rebutted. Thus, in cases involving young and middle-aged donors in good health, it is seldom that the "contemplation of death" presumption is not rebutted by the estate.

Even in situations involving elderly people, when there is some doubt whether the transfer will or will not be deemed to have been made in contemplation of death, such a transfer should still be advised in many cases. If death should occur within the three year period the estate has the right to introduce facts to prove that the thought of death was not the inducement for the gift. At the very least, this right gives the estate a powerful weapon in bargaining discussions with the Service. In the rare case where death occurs during the critical period and the gift is conceded to have been made in contemplation thereof, any gift tax paid or owed will serve to reduce the donor's gross estate by the amount of the gift tax (a gift tax is due on the transfer even if the gift was made in contemplation of death). In addition, a credit is given against the estate tax for the amount of the gift tax paid.[2] Because of this so-called double deduction, in

many cases estate taxes will actually be saved even if the gift is deemed in contemplation of death.

The purchase of property in joint ownership presents its own special problems. A common practice is for a husband to purchase (with his funds) property in joint ownership with his wife or children. It should be noted that upon the husband's death the full value of such property will be included in his estate for estate tax purposes.[3] Moreover, the husband may incur a gift tax liability at the time the property was purchased in joint ownership.[4] (Even if the wife did contribute part of the purchase price, the full value of the property is still presumptively included in the husband's estate. The burden is then placed on the estate to trace back and establish that the wife's personal funds were so used.)

Once it is determined that a plan of lifetime gifts should be adopted, a decision must then be made as to whether the transfers should be in the form of outright gifts or in trust. In many instances, an outright gift of the property may not be feasible (for example, the beneficiary may be incapable of managing the property). It is still possible to reduce the impact of estate taxes by making a gift in trust. To avoid inclusion, however, the trust must be an irrevocable and unamendable one (that is, the trust does not fall within the provisions of Sections 2036, 2037 and 2038 discussed above). By transferring the property in trust and designating a reliable trustee to administer the trust, the beneficiary will be afforded the necessary protection.

In addition, where the total contemplated gift is substantial, it may be especially advisable to utilize the trust form to save an estate tax on the second generation. Thus, if a testator were to make a testamentary bequest to his son, the property would be subject to an estate tax in his estate and, subsequently, in that of his son. However, if the bequest was in the form of a trust which gave the income from the property to the son and, at the death of the son, passed the principal to the son's children, there would be no inclusion of the principal in the son's estate.

It is important to remember that any systematic plan of gift-giving should not violate basic planning principles. Thus, gifts should not be made which would leave the donor frozen, or unable to conduct his usual business affairs. Other factors to consider are possible increases in the cost of living, later illness and other emergencies, and the possible effect on the liquidity of the donor's estate. These considerations may very well outweigh the tax advantages to be gained by the transfers. A final caveat: the plan should always be sufficiently flexible so as to permit changes as circumstances might, in future, dictate.

Use of Life Insurance

Life insurance is an essential part of most sound estate plans. In addition to its ability to protect dependents against the loss of the insured's future earning power, it can provide liquid funds for payment of estate expenses and anticipated tax liabilities, thus precluding any inconvenience in administering and settling the estate because of difficulties in obtaining necessary cash. In addition, this cash liquidity can make unnecessary any forced sale of assets (usually at a loss) because of tax-induced pressures.

Life insurance is often used as a means to fund business purchase arrangements. Thus, when a client has a partnership interest or owns stock in a close corporation, the difficulties of finding a market for his interest at the time of his death (or, on the other hand, the desire to ensure that his holdings do not fall into alien hands) often motivate him to enter into an agreement with his associates, employees, or the company itself whereby he obligates his estate to sell his business interest to the contracting party. The party of the second part, in turn, obligates himself to purchase the interest at a certain specified price. Insurance policies on the individual's life often provide the necessary money with which the purchasers meet their obligations under such a contract.

Under section 2042 of the 1954 Code, proceeds received from insurance policies on the life of a decedent are includible in his gross estate only if the policy is payable to his estate or executor or if the decedent retained any incidents of ownership in the policy at the time of his death. Incidents of ownership include the power to assign the policy, to borrow on the policy, and to designate or change the beneficiaries of the policy. Section 2042 repealed the premium payment test existing under the 1939 Code so that the mere payment of the insurance premiums by the insured is no longer a ground, in and of itself, for inclusion of the proceeds in his gross estate. It is now possible, therefore, for a person to transfer substantial amounts of assets free of transfer taxes (except perhaps the gift tax) through premium payments on policies on his own life. As seen above, as long as said person is not the owner of any of the incidents of ownership in the policy at the time of his death, and his estate is not the beneficiary of the policy, Section 2042 will not be applicable.

One cautionary note should be sounded, however. The

insurance provision in the Code has never been regarded as exclusive and insurance proceeds not includible in the gross estate under section 2042 may still be taxed as property transferred in contemplation of death, or as a transfer intended to take effect at death. Thus the Commissioner has, in the past, repeatedly attacked transfers of insurance made within three years of the transferor's death under the "contemplation of death" provision.

In recent days, the Service has been contending that even the premiums paid on such policies by the insured within the three years preceding his death constitute gifts in contemplation of death under the statute. In this vein, there is some indication that the Service, relying on Liebmann v Hassett[5] (a case which arose under the 1934 Act) will attempt to include in the gross estate not just the given premiums but, instead, that portion of the total proceeds of the policy which the premiums deemed paid in contemplation of death bear to the total premiums paid.

There are at least two possible taxpayer counter-attacks to this new Treasury onslaught. First, the taxpayer can argue that, in view of the legislative history affecting life insurance, it would seem that the Treasury is attempting (at least in part) to reintroduce the premium payments test which was expressly repudiated by Congress when it enacted section 2042 of the 1954 Code. However, in the writer's opinion, such an argument would be ineffective to prevent the inclusion in the gross estate of at least the *actual* premium cost paid by the decedent during the three years before his death. It is doubtful that the courts would go along with the thesis that a gift which is made in contemplation of death to pay life insurance premium costs should be treated differently from any other gift made in contemplation of death.

On the other hand, the legislative intent argument might be successful in countering any Treasury attempt to include in the decedent's estate a portion of the insurance proceeds based on the relationship between premiums paid during the critical period and the total premiums paid. While it is true that in Liebmann v Hassett (which arose before there was a premium payments test) the court included in the gross estate of the decedent that portion of the proceeds of the insurance policy which was related to the premiums he paid, the court was basically faced with the problem of valuing a gift of a life insurance policy which it had initially determined to be part of the decedent's gross estate because it had been made in contemplation of death. Thus, policy proceeds were placed in the insured's estate in Liebmann because a gift of the policy had been made in contemplation of death; not because the insured had paid any or all premiums in contemplation of death.

A second possible counter-attack can be derived from the statute itself. It should be remembered from the previous discussion that section 2035 only creates a rebuttable presumption that any gift made within three years of death is made in contemplation thereof. Thus, even if one were to assume that section 2035 does have applicability in the area of insurance premium payments (which in the writer's opinion it does), it is important to note that a transfer involving life insurance does not in and of itself create an inference of contemplation of death. If the taxpayer can show that a dominant living purpose motivated the payment of the premiums by the insured (e.g. payments were made pursuant to the provisions of a separation agreement), there will be no inclusion in the insured's gross estate by virtue of section 2035.

While these two approaches may have to be relied upon in current cases involving decedents, it is possible to avoid the predicament completely by proper estate planning which would ensure that the beneficiary himself pays the premiums after the policy has been transferred to him. This may not be such an easy undertaking.

If the beneficiary is capable of paying the premiums from his own financial sources, there is no difficulty. However, more often than not, a gift of life insurance is made to a spouse or other object of the insured's bounty who lacks sufficient personal funds to make the premium payments. If the insured were merely to transfer the necessary funds to the beneficiary who, in turn, made the necessary payments, it is likely that the government would contend that the insured indirectly had made the payments. However, whether or not the government has authority to trace back through the years the sources of premium payments, as it did under prior law, remains to be seen.

A good approach to obviate this line of attack (using for example purposes the husband-wife relationship) might be to have the husband revise his estate planning techniques. By adopting a systematic plan of making outright gifts of property having an income potential to his wife during his lifetime, the husband can provide his spouse with an independent source of income (that is, one in which no restrictions are imposed as to the use of the income). Subsequently, if the wife were to take out a policy on her husband's life (naming herself as beneficiary), or the husband were to transfer an existing policy

to his wife, relinquishing all incidents of ownership, she would then be in a position to make the premium payments. In this way, no part of the insurance proceeds or premiums would be included in the husband's gross estate (assuming the husband lived in excess of three years from the date the policy was transferred), since case[6] law has held that whereas the principal property transferred by a husband to a wife is traceable back to the husband, the income from such principal is deemed to be the sole property of the donee wife, ab initio. Of course, the husband must pay a gift tax on the value of the transferred property and/or the life insurance policy, but this would be at a substantially lower rate.

No discussion of the latest developments in this insurance area would be complete without reference to the recent Supreme Court decision in Commissioner v Noel.[7] In the Noel case the Third Circuit had held that the proceeds from an airplane accident insurance policy (commonly called flight insurance) were not includible in a decedent's gross estate as "life insurance" under section 2042(2). The court reasoned that, unlike the life insurance policy, such a contract was in effect an agreement to indemnify the insured (or in case of death, his beneficiary) for any loss sustained by reason of a certain event (an accident) which might or might not occur. Life insurance, on the other hand, was deemed to be a contract by which the insurer agreed to pay a specified sum upon the occurrence of an inevitable event (the death of the insured), regardless of its cause. The Court, in construing section 2042(2), held that its purpose was to encompass only the regular type of life insurance policies in which it could be said that the insured acquired an immediate estate, and not accident policies in which neither insured nor beneficiary acquired anything more than a defeasible right.

The Supreme Court, however, rejected the Third Circuit viewpoint in its holding that Federal estate taxes could be collected on flight insurance proceeds. In the Court's viewpoint, the only way in which such taxation could be avoided would be for the insured to irrevocably sign away his right to the policy, including his right to change the beneficiary. (It would seem to the writer, however, that any such irrevocable transfer of rights will inevitably be attacked by the Service under the "contemplation of death" provisions).

Use of the Marital Deduction

As provided in section 2056 of the Internal Revenue Code, there may be deducted from the gross estate of a decedent an amount equal to the value of property passing to his surviving spouse to the extent that such property does not exceed 50% of the decedent's "adjusted gross estate." In general, the "adjusted gross estate" is equal to the gross estate reduced by the amount of any community property included therein and less expenses, claims, losses and certain taxes.

This marital deduction is one of the most important tax savings devices for estate planners. When properly utilized, it can effectuate substantial savings in the transfer taxes paid by a family in passing its wealth from one generation to the next. However, a word of caution — the courts construe the marital deduction provision strictly and deny the benefits thereof in cases where the terms of the instrument are at variance with the requirements of the Code.

The basic requirement in section 2056 is that property qualifying for the marital deduction must be includible in the surviving spouse's gross estate if still in his or her possession at time of death (the terminable interest restriction). The simplest form of qualifying provision is an outright bequest to the spouse. On the other hand, an example of a bequest that would be disqualified is one "to my spouse for life, remainder to x" since, in this latter case, the value of the subject property would not be included in the surviving spouse's estate upon death.

As can be seen from the above, problems in this area will arise when, for one reason or another, an outright gift to the surviving spouse is considered inadvisable. (For example, a husband wishing his wife to receive income from a marital trust solely, can qualify the trust for the deduction by granting the surviving spouse a general power of appointment as to the remainder.) In such case, careful will drafting is called for to ensure that the disposition does not violate the terminable interest provisions.

One recent development in this area has been the issuance of Revenue Procedure 64-19.[8] The background prompting its issuance was as follows. Soon after the marital deduction was first introduced into the tax law, estate planners devised ingenious formulas to ensure that the deceased's estate would receive the maximum marital deduction (that is, fifty percent of the adjusted gross estate). The so-called pecuniary formula bequest was introduced under which, in terms, the surviving spouse was left property in an amount exactly equal to fifty percent of the testator's adjusted gross estate, as finally determined for estate tax purposes (less property passing to the widow outside the will but includible in the gross estate).

Problems arose when the assets in the estate appreciated before the date of distribution over their federal estate tax values. Under the income tax laws, the satisfaction of a pecuniary bequest with such appreciated property would result in a capital gain to the estate.[9] The problem was met by the use of a provision in conjunction with any formula bequest which permitted the executor to satisfy the marital bequest by a distribution in cash or in kind, at values as finally determined for estate tax purposes.

This power granted to the executor enabled him to manipulate the assets in the estate so that in many cases the estate got the full fifty percent marital deduction when much less than fifty percent of the estate (at date of distribution values) was distributed to the widow. Particularly in cases where the wife had a substantial estate of her own, the executor would allocate to her those assets that had depreciated in value from the federal estate tax valuation date. The appreciated assets were, in turn, diverted over to the residuary beneficiaries (usually the children).

Revenue Procedure 64-19 attempts to solve the problem by setting forth certain rules whereby the marital deduction will be allowed in the full amount of a pecuniary bequest if under applicable state law or by the express or implied provisions of the will either:

1) the fiduciary must distribute in satisfaction thereof assets having a market value on the date or dates of distribution at least equal to the amount of the bequest, or

2) the fiduciary must distribute assets, including cash, fairly representative of appreciation or depreciation in the value of all property available for distribution.

If the estate cannot show that either of these requirements is met, the Service presumably will disallow a marital deduction for the bequest.

Ever since the marital deduction was first introduced in the Internal Revenue Code, estate planners have devised elaborate schemes for its maximum utilization. In too many instances, the testator's wishes have been sacrificed solely to effectuate a savings in the estate tax. It should be emphasized that a married estate owner is not compelled to use the marital deduction. Thus, if a client doesn't want his wife to have the requisite degree of control over the property or even if he just prefers to leave the bulk of his property to someone other than his wife, his wishes should control. Again, if his wife has a substantial estate of her own, any estate tax savings now through the use of the marital deduction may subject *her* estate to even greater estate taxes. In short, the point to keep in mind is that the marital deduction is merely a device to save taxes and, in common with similar devices discussed above, should never be recommended or employed without careful consideration of all relevant factors.

Conclusion

Once an estate tax plan is decided upon, using any or all of the devices mentioned above, it should not then be pigeon-holed pending the eventuality of death. A system of periodic review should be adopted so that the plan can be reexamined in the light of the current family and economic conditions and the ever-continuing evolution of estate tax provisions.

The time has long since passed when a standard-form will, purchased at the corner drug store, constituted an adequate estate plan. However, unlike the income tax area, there is still a high degree of unawareness as to possible alternatives and elections in this ever-growing field. Expert advice should be utilized at all stages of the estate planning process so that the fruits of a lifetime of work are not dissipated.

If the entire estate planning team, the accountant, the attorney, the insurance man, and the trust officer, cooperate in the planning process, the benefit of the experience, knowledge, and advice of each in his separate field can be coordinated to provide a plan to satisfy the client's wishes and, at the same time, take advantage of the best methods of minimizing taxes.

[1] In *Union Planters National Bank, Exr.* v. *U.S.*, 65-1 USTC 12,298, the Court charged the jury . . . "if at the time Mr. Ladd deeded his interest in the property to Mrs. Ladd in 1958, there was an implied agreement or understanding between them that he would have the right to live in the property, the property was properly a part of his estate . . ."

[2] Section 2012 of I.R.C. Because of the limitations placed on the credit, there may be instances where the credit allowance is less than the actual gift tax paid.

[3] See section 2042 of the I.R.C.

[4] The gift tax would be imposed on one-half of the value of the property purchased in joint ownership less any part of the purchase price furnished by the donee. Note that section 2515 of I.R.C. which provides that the creation of a tenancy by the entirety (or joint tenancy) in respect to real property between husband and wife will not constitute a gift unless the donor elects to have the transfer so treated. There will be a gift tax consequence upon termination of the tenancy.

[5] 148 F. 2d 247

[6] See *Ford* v. *Kavanaugh,* 108 Fed. Supp. 463

[7] 332 F. 2d 950

[8] Technical Information Release 553

[9] See *Suisman,* 8 Fed. Supp. 217