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The Martial Deduction and Equalization Under the Federal Estate and Gift Taxes Between Common Law and Community Property States

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THE MARITAL DEDUCTION AND EQUALIZATION UNDER THE FEDERAL ESTATE AND GIFT TAXES BETWEEN COMMON LAW AND COMMUNITY PROPERTY STATES

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IN 1948, as the culmination of much dissatisfaction with the treatment of community property under the federal estate and gift tax laws, Congress adopted a new formula for the treatment of gifts and bequests between spouses; this formula was known as the marital deduction. It has remained practically unchanged since its adoption and still stands as an integral part of our federal estate and gift tax structure.

The basic purpose of the deduction was to provide equalization in estate and gift tax treatment between spouses residing in community property states and those residing in common law property states. The plan of this article is to analyze the marital deduction against the experience of eight years to determine whether or not it has lived up to this basic purpose.

I. THE FEDERAL ESTATE TAX

A. *Equalization Under the Adjusted Gross Estate Limitation*

1. *Statutory Framework: A Contrast Between the Marital Deduction and Community Property.* Under the pattern of the federal estate tax, the marital deduction is computed upon the estate of the decedent; it includes no part whatever of the potential estate of the surviving spouse. Thus, we cannot have a true splitting of the *total* family estate under the marital deduction; if any splitting is accomplished, it is a bisection of the *first* decedent's estate only.

But under the civil law, the total community property estate is split between the spouses. Each spouse dies owning one-half of the total estate. Obviously, there's a difference here. In a moment we shall explore it, but first let us examine the statutory mechanics that create this potential inequity.

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Section 2056 of the Internal Revenue Code,[1] which provides for the estate tax marital deduction, is built up of two parts: one consists of the clauses, provisos, and subparagraphs relating to the type of transfer that qualifies for the deduction; the other limits the dollar amount of the deduction, regardless of the nature of the transfers made in the estate. It is the latter that causes the above inequity. Subsection (c) of section 2056 establishes this "limitation on aggregate of deductions" by prohibiting any deduction in excess of "50 percent of the value of the adjusted gross estate. . . ." The "adjusted gross estate," as defined in subsection 2056 (c) (2), is a function of the decedent's gross estate; in over-simplified fashion, we might say that it is the gross estate of the decedent, as figured for estate tax purpose, less expenses of administration, claims and indebtedness of the estate, and losses incurred in administration.[2] In other words, the maximum deduction allowable is one-half the decedent's gross estate less claims, etc., otherwise deductible.

But community property is divided on a different principle. Each spouse is entitled to one-half of the community estate,[3] and consequently only his one-half of the total estate is taxable to the estate of the spouse first to die.[4] And if the estate consists solely of community property, no marital deduction is allowable.[5]

2. *If the Husband Dies First.* An example will make this difference in treatment clear. Let us assume a husband and wife

[1] I.R.C., §2056, as adopted by Public Law 591, c. 736, 83d Cong., 2d sess. (1954); 26 U.S.C. (Supp. II, 1955) §2056. Unless otherwise specified, all section references contained herein are made to the Internal Revenue Code of 1954.

[2] For a clearer picture, see I.R.C., §§2053, 2054. And note also the "Special Rule in Cases Involving Community Property" found in subparagraphs (B) and (C) of §2056 (c).

[3] For example, note Cal. Civ. Code (West, 1954) §161a, which states: "The respective interests of the husband and wife in community property during continuance of the marriage relation are present, existing and equal interests. . . ."

[4] *Arizona*: Greenwood v. Commissioner, (9th Cir. 1943) 134 F. (2d) 915 (dicta); T.D. 3138, 4 Cum. Bul. 238 (1921). *California*: United States v. Goodyear, (9th Cir. 1938) 99 F. (2d) 523. *Idaho, Louisiana, Nevada* and *New Mexico*: T.D. 3138, 4 Cum. Bul. 238 (1921). *Texas*: G.C.M. 7773, IX-2 Cum. Bul. 426 (1930). *Washington*: Lang v. Commissioner, 304 U.S. 264, 58 S.Ct. 880 (1938).

[5] The mechanics for eliminating community property are found in I.R.C., §2056 (c) (2) (B) and (C). The technique used by the code is to require that the decedent's adjusted gross estate (which, as we saw, limits the allowable deduction) be reduced, dollar for dollar, for each piece of community property included in the gross estate, provided the inclusion was only at one-half the value. Thus, if all the estate were one-half interests in community property, the adjusted gross estate would be reduced by an amount equal to itself, and no marital deduction would be permitted. But if the estate includes separate property of the decedent as well as his interests in the community estate, his estate will be entitled to a deduction equal to one-half the separate property less the claims, expenses, etc., not attributable to the community property. Treas. Reg. 105, §81.47d (b).

living in a community property state owning a community estate of $400,000, after deduction for claims, expenses, etc. How does their tax burden compare with that imposed upon a similar couple residing in a common law state? Suppose this second couple also owns $400,000 held in joint tenancy, of which the wife has contributed $100,000.[6] In both cases let us assume the husband, *H*, dies first.

	Common Law	*Community Property*
H's estate	$300,000	$200,000
Less marital deduction	150,000	—0—
	$150,000	$200,000
Less specific exemption	60,000	60,000
H's taxable estate	$ 90,000	$140,000

The common law states appear to have the better of it. In terms of approximate tax, *H*'s estate would owe a tax of $17,900 under common law concepts as compared to a $32,700 tax under community property rules. And this advantage in initial savings is inevitably present in all cases in which the spouses each own property in a common law state. For instance, if the above example were reversed, and the wife, *W*, died first, the discrepancy would be even more striking. If *H* survived her, her taxable estate would be zero ($100,000-$50,000 marital deduction and $60,000 exemption) in the common law case but $140,000 ($200,000-$60,000 exemption) in the community property situation.

This comparative advantage in initial saving of tax is equal to the tax upon one-half the estate of the surviving spouse as if that one-half were added to the first estate. Thus, the tax on *H*'s community property estate exceeds the tax upon *H*'s common law taxable estate by the marginal increase in tax if one-half of *W*'s estate were added to *H*'s estate. Or, in terms of a formula, we have:

[6] In any case in which the surviving spouse has no property of his own, the tax computations are identical in both cases. Thus, if in the above example, *H* were to own the entire $400,000 and all of it were to be included in his gross estate on his death, his estate would be entitled to a marital deduction of $200,000 as well as the $60,000 specific exemption, leaving a taxable estate of $140,000 (the same as our community property husband).

H's community property estate = H's taxable estate at common law + ½ (W's estate)

Thus, in the above example, we may substitute the figures:

($200,000-$60,000) = ($150,000-$60,000) + ½ ($100,000),
or $140,000 = $90,000 + $50,000

What practical difference does this make? We see a large discrepancy in initial tax, but we also realize that most of this tax advantage will be equalized when the surviving spouse dies. Take, as an illustration, our first example. Assume the wife, *W*, dies soon after *H*'s death, and she includes in her estate her own property plus any additions she may have received as a result of *H*'s marital deduction transfers.[7]

	Common Law	*Community Property*
W's original estate	$100,000	$200,000
Plus transfers from *H*	150,000	—0—
W's estate	$250,000	$200,000
Less specific exemption	60,000	60,000
W's taxable estate	$190,000	$140,000

Here the tax picture is reversed. In a community property state, *W*'s estate incurs a $32,700 tax as compared to $47,700 under common law rules. Thus the initial common law advantage is effectively wiped out. The overall tax burden becomes slightly greater for the spouses in the common law state ($65,600 versus $65,400) because of the progressive rates of taxation imposed upon estates. Being faced with a progressive rate of taxation, we find

[7] Note that as a general rule it is not sound tax planning to bequeath property in excess of the deductible amount to the surviving spouse. This generalization rests upon the maxim that one should design his estate plans as to incur no more than one estate tax per generation. Thus, if *H* leaves non-deductible property to *W*, that non-deductible property will be taxed both in *H*'s estate and in *W*'s estate before passing to their descendants. It is true that under the Internal Revenue Code of 1954, transfers of property between spouses may qualify for the credit for tax on prior transfers (§2013), but this credit seldom equals the additional tax burden. Furthermore, this credit is a disappearing thing reducing from 100% within two years after the first decedent's death to zero if more than ten years elapse before the second spouse dies.

that it is generally cheaper taxwise to divide the total family estate into two equal units than to use any other division (as in our first example of one to three).[8]

What practical effect does this difference in treatment have? Is it a matter of any serious concern? The answer depends upon the importance to the family estate plan of the initial saving in tax. Suppose, for instance, we are comparing two one-million dollar estates—one in California, the other in Michigan. And let us assume that in each case the estate is owned equally between the spouses. If the California property is community property, we have the following difference in tax result:

	Common Law	*Community Property*
H's gross estate	$500,000	$500,000
Less marital deduction	250,000	—0—
	$250,000	$500,000
Less exemption	60,000	60,000
H's taxable estate	$190,000	$440,000
H's approximate tax	$ 47,700	$126,500

The inequality between the two property systems amounts to $78,800 in taxes; in effect only one-quarter of the family estate is taxed on *H*'s death in Michigan, whereas one-half is taxed on *H*'s

8 This suggests another formula for estate planning, which may or may not be useful. From a pure tax standpoint, we should design our marital transfers so that the wife's potential estate will be equalized with the husband's. To accomplish this result, we may use the following formula as a guide:

$$\text{Marital deduction} = \frac{(H\text{'s estate} + W\text{'s estate})}{2} - W\text{'s estate}$$

or

$$\text{Marital deduction} = \frac{(\$300{,}000 + \$100{,}000)}{2} - \$100{,}000$$

$$\text{Marital deduction} = \$100{,}000$$

This is considerably less than the maximum marital deduction available to *H*'s estate ($150,000), but a marital transfer of $100,000 from *H* to *W* does equalize the two estates at $200,000 apiece, thus accomplishing our objective. But beware of these nice mathematics: not only are they impossible of achievement in practice, but also they impose an almost insuperable drafting and administering problem upon those who must carry out the testator's mathematical desires. There are usually other, and perhaps even less expensive, methods of accomplishing the same result. Perhaps *W* may dissipate part of her excessive assets by high living or by inter vivos gifts.

death in California.[9] Both percentage-wise and money-wise, this difference in initial tax is substantial: in this example, the California spouses pay almost three times the taxes paid by the Michigan spouses at *H*'s death.

Not until the death of *W* are the two situations equalized; at that time, unless *W* has spent or given away the property, *W*'s estate in Michigan will consist of three-quarters of the total but in California only one-half. Thus the effect of the inequality in treatment is merely to postpone the collection of the tax for the period of *W*'s remaining life. This postponement of the tax has several important advantages to the couple in the common law state. During her life the surviving spouse has the use of the amount of taxes so postponed and may invest it for her own benefit. If the surviving spouse is comparatively young, the life income earned on this saving may be substantial.

Furthermore, the wife is given this additional period of time in which to eliminate, if possible, a major share of the postponed tax. To the extent that her estate is depleted, whether by spending, losses, casualties, poor management, etc., the postponed estate tax will never be paid. She can also dispose of a good portion of her estate at gift tax rates and again eliminate the postponed estate tax. Thus the theoretical disadvantage of splitting family estates into two unequal shares may never be actually suffered.

As to their community property interests, the California spouses have no such option. Because community property must be eliminated from the adjusted gross estate ceiling, one-half of the family estate is taxed at *H*'s death without opportunity for realizing the initial saving of tax on the additional one-quarter.

To sum up then, we find that a substantial inequality in treatment exists under the present marital deduction formula when the husband dies first. At common law, an initial saving in the tax may be realized that is not available to community property spouses. Theoretically this initial advantage will be wiped out on the wife's death, but there is no certainty of its occurring. And, in the interim, the wife in a common law state has the use and enjoyment of the saving in tax money not available to her community property sister.

[9] Compare the statement of John W. Snyder, Secretary of the Treasury, on March 11, 1948, to the Senate Finance Committee, Hearings on the Revenue Act of 1948, 80th Cong., 2d sess., p. 20 at 26 (1948).

3. *If the Wife Dies First.* The community property states are the ones enjoying an advantage if the wife dies first. Again we are assuming that the wife in the common law jurisdiction is the poorer spouse. In the community property states, she is treated as being a co-equal owner with her husband of their community property. In our first example of the $400,000 estates, owned $300,000 to *H* and $100,000 to *W* in the common law state, we find the following situation:

	Common Law	*Community Property*
W's estate	$100,000	$200,000
Less marital deduction	50,000	—0—
	$ 50,000	$200,000
Less specific exemption	60,000	60,000
W's taxable estate	—0—	$140,000

Under this example, at *W*'s death, no estate tax at all is paid in a common law state as contrasted to a $32,700 tax for the civil law spouses. Again it appears as if it is better for a couple to reside in a common law state. But this saving, phenomenal as it may be, is only the initial saving; its price is high.

On *H*'s subsequent death, we must add to his estate the transfers received from *W*. Therefore, on *H*'s death, the picture is the following:

	Common Law	*Community Property*
H's estate	$300,000	$200,000
Add transfers from *W*	50,000	—0—
Total *H*'s estate	$350,000	$200,000
Less specific exemption	60,000	60,000
H's taxable estate	$290,000	$140,000

Now the tax burden is reversed. *H* at common law pays a tax of $78,500 against the civil law tax of $32,700. The overall tax burden on both estates is $13,100 greater for the spouses residing in a common law state than that resulting to the community property couple ($78,500-$65,400). The reason is obvious. Every dollar deducted by *W* as part of a marital transfer to *H* is added to *H*'s already larger estate, swelling its size even more. In other words, property is deducted from *W*'s low bracket estate to be transferred to *H* where it is taxed at the highest rates applicable to his estate.

Thus the value of the initial saving in this case is completely wiped out.[10] In order to salvage any part of the extra tax to be due on his death, *H* would have to take steps during his lifetime to dispose of the property (for instance, by gifts or consumption), or he would have to remarry to qualify someone else as his surviving spouse so that a marital deduction would be allowable in his estate.

All the advantage lies with the community property states in this situation where the poorer spouse dies first. The couple in the common law state has lost the chance to split the larger estate between themselves for estate tax purposes. If the poorer spouse dies without any property, their *entire* estate will be taxed in one estate with no opportunity for equalizing the tax with that levied on their community property counterparts.

In larger estates, this tax disadvantage becomes almost catastrophic. Consider the difference in tax on a $2,000,000 estate, first, if split between the spouses and, second, if taxed all to the husband. In the first case, the tax is approximately $753,200, but in the second only $651,400 (2 *x* $325,700), the difference being $101,800, or about 5 percent of the total family estate. But isn't this merely a chimerical inequality? Can't the spouses in a common law state equalize their holdings by gifts between themselves and thereby avoid the tax catastrophe resulting from the death of the poorer spouse first?

4. *Gifts from Husband to Wife.* What is the relative tax picture if the richer spouse attempts to plan against the catastrophe outlined in the prior section by gifts to the poorer spouse? Can the

[10] These examples illustrate another general rule of tax planning of the marital deduction. Never create deductible transfers in the estate of the poorer spouse unless you have first designed an acceptable means of getting rid of the property from the richer spouse's estate prior to his death. In this situation, the old, familiar life estate to the richer spouse, remainder to children would be the most advantageous transfer to be considered for the poorer spouse's estate. Although such a transfer would not qualify for the marital deduction, being a prohibited terminable interest under I.R.C., §2056 (b), it would not later be includible in the richer spouse's gross estate. I.R.C., §2033.

estates of the two be equalized prior to the death of either in order to avoid the loss of the marital deduction? The answer must be that although such gifts are possible, they are not very economical. An example will show the reason why: Take a $1,000,000 estate owned all by *H* in a common law state, but as community property in the other case. Suppose *H* in the common law state tries to equalize *W*'s holdings by giving her $500,000 before his death.

	Common Law	*Community Property*
H's original estate	$1,000,000	$500,000
Gifts to *W*	500,000	—0—
H's estate	$ 500,000	$500,000
Gift tax on transfers[11]	42,525	—0—
H's estate at death	$ 457,475	$500,000

Now the estates are equalized; regardless of who dies first, the maximum gross estate will be $500,000, just as in the community property state. But the price paid for this prior-to-death equalization is a gift tax of $42,525, a more than minor inequality between the two property systems, because no gift tax liability at all is incurred in the automatic division of interests in community property.

If, after this planning, the richer spouse dies first, the entire amount of gift tax paid is wasted. In the above example, *H* could have transferred the entire $500,000 to *W* tax-free at his death; by his prior act of making gifts he incurred a needless gift tax liability. On the other hand, *H* can still place himself in a better position than his community property twin by transferring one-half of his remaining estate to *W* and thus paying an estate tax on only one-quarter of his total estate:

11 Computed as follows, taking account of the gift tax marital deduction (I.R.C., §§2502, 2523):

Gross gifts		$500,000
Less marital deduction (½)	$250,000	
specific exemption	30,000	280,000
Taxable gifts		$220,000
Gift tax on $220,000		$ 42,525

	Common Law	Community Property
H's estate	$457,475	$500,000
Less marital deduction	228,737	—0—
	$228,738	$500,000
Less specific exemption	60,000	60,000
H's taxable estate	$168,738	$440,000
Estate tax	$ 41,318	$123,500
Gift tax	$ 42,525	—0—
Total tax	$ 83,843	$123,500

This, of course, is another manifestation of the inequality in the marital deduction formula pointed out in the first section of this article. And this advantage is only in the initial saving in tax; the overall tax picture will drastically change this advantage, because the one-quarter deduction from *H*'s estate will be added to the top of *W*'s estate. Three-quarters of their entire estate will be pyramided in her taxable estate. Thus, there is little to be gained in the search for equalization from the device of gifts to the poorer spouse.

And even if the poorer spouse dies first, still no real tax equalization is achieved. Perhaps we have mitigated the tax catastrophe outlined in the prior section, but we have done little beyond that. Assuming that *W* dies first, leaving no property to *H* to prevent a pyramiding effect in his estate, we find that the transfers to the second generation beneficiaries are still more expensive for the couple in the common law state:

	Common Law	Community Property
W's estate	$500,000	$500,000
H's estate	457,475	500,000
H's gifts to *W*	500,000	—
W's estate tax	123,500	123,500
H's estate tax	112,892	123,500
H's gift tax	42,525	—
Total tax burden	$278,917	$247,000

5. *Gifts to Others.* Let us return again to our million dollar example. Suppose again the million dollar estate is owned all by *H* in a common law state as contrasted to community property ownership. As we saw, it does not make tax sense for our common law *H* to attempt to equalize his wife's holdings by giving her $500,000. But what of the utility of giving the same $500,000 directly to their children?[12]

	Common Law	*Community Property*
H's estate	$1,000,000	$500,000
Gifts to children	500,000	—0—
	$ 500,000	
Gift tax on transfer[13]	85,050	
H's estate at death	$ 414,950	$500,000

Thus we have transferred half of *H*'s common law property out of his estate. Consequently his estate will be taxed as if he had taken advantage of the marital deduction whether or not *W* survives him. Thus the tax catastrophe that might result from *W*'s prior death, coupled with the loss of the deduction, has been cured by this expedient.

But at what price? *H* has had to pay a federal gift tax of $85,050 for the privilege of splitting his estate at common law. Is this tax payment wasted if *H* dies first, as it is in the case of taxable gifts directly to *W*? The answer is, no. By paying the $85,050 gift tax, *H* has effectively transferred the $500,000 beyond the effective reach of the estate tax levied not only on his own estate but also on *W*'s. The upshot is that he has transferred half of his estate at

[12] If necessary, the gift can be from *H* to *W* for life, remainder to children. For purposes of the gift tax, no marital deduction would be allowable against the value of the life estate to *W*, but the value of the remainder could properly be split between *H* and *W* as a joint gift. I.R.C., §2513. See Part III, C infra.

[13] Computed as follows, taking advantage of the split gifts provision (I.R.C., §2513):

Gross gifts		$500,000
Less *W*'s share of gifts (½)	$250,000	
specific exemption	30,000	280,000
Taxable gifts		$220,000
Gift tax on $220,000		$ 42,525
2 *x* tax (for tax on *W*'s share)		$ 84,050

gift tax rates, which up to a certain point[14] is cheaper than a transfer at estate tax rates. If we compare the community property *vs.* common law situation, this conclusion is made clear:

	Common Law	*Community Property*
H's estate at death	$414,950	$500,000
Less exemption	60,000	60,000
H's taxable estate	$354,950	$440,000
H's estate tax	$ 99,284	$126,500
W's estate at death	—	$500,000
Less exemption		60,000
W's taxable estate	—	$440,000
W's estate tax	—	$126,500
Gift tax on *H*'s transfers	85,050	—
Total tax liability	$184,334	$253,000

This surprising turn of events does not mean that the common law spouses have an advantage; all it means is that the community property married couple should get busy and make similar inter vivos gifts to realize the same saving in tax.

The only true inequality remaining in this situation is the difference in settlements available under the two property systems; in the community property case, the spouses achieve the splitting of their estate during their lifetime without (1) incurring a lifetime transfer tax, or (2) giving up their control and management of their property. In the case of a couple at common law, both disabilities must be incurred in order to prevent the complete loss of the opportunity to split their estate. As planners in common law states well know, this is a high price to pay; no one is more reluctant to relinquish control over property than he who earned it.

6. *Conclusion.* The basic statutory framework of the marital deduction in itself works substantial inequity between the two property systems. Community property division is effected upon

14 Generally, gift tax rates are only 75% of the estate tax rates levied upon the same brackets.

the total community estate; the marital deduction split is available only as to the common law estate of the first spouse to die. The result is a series of inequalities:

(1) If the spouses have approximately equal estates, only one-fourth of the combined estates need be taxed under the common law system as against one-half in the civil law states on the first death.

(2) If one spouse himself owns practically all of the couple's property and he dies first, the result at common law is practical equalization with community property splitting; one-half of the combined estates is taxed in either case. This situation appears to be the one for which the marital deduction formula was designed.

(3) Again, if at common law one spouse has all the property but he survives his spouse, there will be no tax on the prior death of his spouse. But on his death, all of the estate will be taxed in his estate. If, by way of contrast, all the property were community property, one-half would be taxed in each estate.

Only in the "classic case," that is, where the husband owns all the property at common law and he dies first, is equalization achieved; in the other situations postulated, substantial inequality exists between the two property systems. To what extent is the "classic case" the typical one in common law states? Certainly it is not the invariable one. Despite insurance company and trust department statistics, in some cases wives do die before their husbands. Nor is it inconceivable that some of their property may be the wives' own. And it is here where the inequalities arise.

B. *The Terminable Interest Rule as an Equalizing Device*

1. *Introductory.* At the time the 1948 amendments to the federal estate tax were proposed, serious concern was expressed over the possibility that estate planners in common law states would use the marital deduction to pass property to the decedents' beneficiaries without paying any estate tax at all. The typical situation that caused them concern was this one:

H to *W* for life, remainder to *C*.

If the value of the life estate to *W* were not taxable in *H*'s estate on *H*'s death, it never would be taxable: under traditional estate tax rules, no part of the property is taxed in *W*'s estate on her death, despite her life estate.[15]

Because of this possibility, the "terminable interest rule" was inserted into the marital deduction provisions. Basically, the rule disqualifies from the measure of the deduction any interest passing to the surviving spouse which will terminate or fail

> ". . . on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur . . . [*and*] an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse). . . ."[16]

Because, in the above transfer, *W*'s life estate in the property is one that will terminate on her death and will be succeeded by the remainder interest in *C* on her death, the value of her life estate does not qualify for the deduction.[17]

If we attempt to break down the marital deduction rule into its component factors, we find that the following conditions must be present before the rule applies to deny the deduction:

(1) The surviving spouse's interest must have been *carved out* of the decedent's interest; if it is co-equal to the decedent's interest, the terminable interest rule does not apply.

(2) The partial interest given to the surviving spouse must be *less in point of time* than the decedent's interest; if it is co-equal to the decedent's interest timewise, the terminable interest rule does not apply.

(3) The surviving spouse's partial interest in point of time must be *succeeded by the interest of the other beneficiary* who shares in the decedent's interest; if the other taker's interest precedes or is contemporaneous with the surviving spouse's interest, the terminable interest rule does not apply.

(4) The succeeding partial interest in point of time taken by the other beneficiary must have been created by the decedent out

[15] I.R.C., §2033; Treas. Reg. 105, §81.13; Hugh D. Rhodes, 41 B.T.A. 62 at 73 (1940), nonacq. (as to another issue) 1940-1 Cum. Bul. 8, affd. (8th Cir. 1941) 117 F. (2d) 509; Mary Clare Milner, 6 T.C. 874 at 881 (1946), acq. 1946-2 Cum. Bul. 4; Williams v. United States, (Ct. Cl. 1930) 41 F. (2d) 895 at 897; Davis v. United States, (D.C. N.Y. 1939) 27 F. Supp. 698 at 700. See Helvering v. Safe Deposit & Trust Co., 316 U.S. 56 at 59, 62 S. Ct. 925 (1942).

[16] I.R.C., §2056 (b) (1).

[17] Treas. Reg. 105, §81.47b (d), example (i).

of his interest for *less than a full and adequate consideration;* if the succeeding taker paid for his interest, the terminable interest rule does not apply.[18]

2. *Effect on the "Life Estate to Wife, Remainder Over" Settlement.* The terminable interest rule was designed to disqualify the "life estate to wife, remainder to others" type of transfer. Consequently, we find that in common law states the use of this type of transfer has been abandoned in any case in which the estate planner's objective is the creation of a marital deduction bequest.

Little concern was expressed in Congress at the time the terminable interest rule was adopted. Any furor raised by lawyers in common law states in opposition to the virtual scrapping of a valuable time-tested estate settlement was overruled by the nonchalant answer that it was necessary as "a matter of equalization." Why a matter of equalization? Because, the argument ran, a husband cannot control the disposition of his wife's one-half community property interest. He cannot leave her with only a life estate in her one-half, because she already owns a fee interest in that one-half. In order, therefore, to equalize qualitatively the modes of property settlement between the two systems of property ownership, we must exclude from the marital deduction any type of common law settlement that gives the surviving spouse any interest less than an absolute one in the property transferred.[19]

But was this assumption true? Has the disqualification of the life estate to the surviving spouse created substantial equality between the two property systems? The record speaks for itself.

Normally, it is true that a decedent has no interest in or control over his surviving spouse's community property. However, in the

18 Perhaps it would not be too wrong to say that we have created a modern-day "law of shifting uses" to plague ourselves just as medieval lawyers prior to 1536 had to contend with the true "shifting use." In any event, the author has found it of value to apply the concept of a "shifting use" to interests created under an estate tax transfer to assist him in applying the terminable interest rule. As you will recall, a "shifting use" was "(a) use which is so limited that it will be made to shift or transfer itself, from one beneficiary to another, upon the occurrence of a certain event after its creation. For example, an estate is limited to the use of A and his heirs, provided that, upon the return of B from Rome, it shall be to the use of C and his heirs; this is a shifting use, which transfers itself to C when the event happens." BLACK'S LAW DICTIONARY, 4th ed., 1711 (1951).

19 S. Rep. 1013, 80th Cong., 2d sess., 1948-1 Cum. Bul. 285 at 305. Sugarman, "Estate and Gift Tax Equalization—The Marital Deduction," 36 CALIF. L. REV. 223 at 236 (1948); Surrey, "Federal Taxation of the Family—The Revenue Act of 1948," 61 HARV. L. REV. 1097 at 1127 (1948). In addition, estate planners in common law jurisdictions were probably not too concerned about exchanging the life estate-remainder settlement for the opportunity of obtaining a plan for splitting estates between spouses for tax purposes.

case of the husband dying first, the surviving widow may be put to an election under his will; if she wants to take under his will she must consent that her one-half share of the community property be disposed of under the terms of the decedent's will as if it had been the property of the decedent. Her other choice is to renounce the will and content herself with her vested one-half interest.[20]

The customary use of this so-called "widow's election" is to create in the surviving widow a life estate in the whole community in exchange for her yielding up the remainder interest in her one-half. The arrangement for this exchange of interests may be made either prior to or after death, but regardless of the mechanics, the widow's consent is normally treated as revocable until her husband's death.

In order to be specific, let us consider an actual case. In *Pacific National Bank of Seattle, Executor,*[21] the issue arose whether the whole or merely the decedent's one-half of the community estate should be included in his gross estate under one of these widow's elections. The decedent was the husband. Prior to his death he had executed a will that disposed of the entire community estate by pouring it into an inter vivos trust previously established by him; basically, the trust provided a lifetime income for his wife with the corpus to be paid to his son after her death. Attached to the will and incorporated by reference in it was a consent form in which his wife agreed that her half of the community property should pass into the trust and that she would take only those interests in the property that were established by her husband's will.

Because the will disposed of the entire community, the Commissioner attempted to include the entire community in the decedent's gross estate. In this attempt he failed. The Board held that the property retained its character as community property despite the execution of the consent; hence only his own half could properly be taxed in the decedent's estate.[22]

Here all of the property is transferred in husband's estate, yielding only a life estate in the wife with remainder over. Yet an estate tax is paid only on one-half to the community. What we have done is to recognize the creation of a terminable interest in the surviving

20 According to de Funiak [PRINCIPLES OF COMMUNITY PROPERTY §217 (1943)], the election is available principally in California and Texas. Apparently it is also found in Washington. Falknor, "Liability of the Entire Community Estate for the Payment of State Inheritance Tax Where Husband Undertakes to Dispose of Entire Community Estate by Will and Wife Elects to Take Under the Will," 5 WASH. L. REV. 55 (1930).

21 40 B.T.A. 128 (1939), acq. 1939-2 Cum. Bul. 25 at 28.

22 *Accord:* Coffman-Dobson Bank & Trust Co., Executors, 20 B.T.A. 890 (1930), acq. X-1 Cum. Bul. 13 (1931).

spouse without forfeiting the estate tax advantage of splitting the community estate between the spouses. The fact that the surviving widow's interest terminates on her death does not affect the community property separation of the two estates on her husband's death.

But, in fairness to community property states, two distinctions between this type of widow's election and the common law life estate-remainder over settlement must be recognized. First, in the widow's election situation, the wife must affirmatively consent to the transfer; in common law jurisdictions her statutory rights in taking against the will must normally be asserted by her and are usually considerably less in scope than an outright fee interest in one-half the estate. Second, the wife will be treated as having made a gift of her remainder interest at the time of her husband's death when her consent becomes final. Not only will she incur a gift tax at the time of his death,[23] but also it is probable that the entire value of her one-half of the property remaining in existence at the time of her death will be taxed in her estate as a transfer subject to a retained life estate.[24]

This result shows us forcibly that neither the fisc nor the common law states are put at a disadvantage revenue-wise because of the use of the widow's election in community property states. One reason for outlawing the life estate-remainder over settlement was to prevent the escape of property from estate taxation. Where the widow had no interest in the property in which she acquires a life interest on her husband's death, there is no taxable event that would place any portion of the property in her estate on her death. Consequently, a deduction in her husband's estate would permit the property deducted to escape the levy of the tax collector.

But where the life estate is drawn out of the widow's *own* property, as in the case of the widow's election, her death does create

23 Chase National Bank, 25 T.C. No. 74 (1955). The amount of the gift made by the wife at the time of her husband's death is the subject of intense controversy at the present time. Is it the value of her one-half community estate less the value of her life estate therein, i.e., the remainder interest in her estate? Or is it the value of her remainder reduced by the consideration she receives for making her transfer, i.e., by the value of her life estate in her husband's one-half? In the Chase National Bank case, the Tax Court sustained the taxpayer, holding that the value of her gift is her remainder less her life estate in the decedent husband's estate. *Accord,* Mildred Irene Siegel, 26 T.C. No. 91 (1956).

24 I.R.C., §2036. It has been suggested with some force that the measure of the estate tax on her death must be reduced proportionately to reflect the consideration received by the decedent wife at the time she made her gift, i.e., the estate tax may be levied only on that portion of her property that represents the property transferred by her for which she had received no consideration. Brookes, "Tax Consequences of Widow's Elections In Community Property States," 1951 UNIV. SO. CAL. TAX INSTITUTE 83, 101 (1951).

a taxable event and the property is taxable in her estate. Thus the property excluded from the husband's estate is included in the wife's estate at a later date.

The discrimination that exists between common law and community property states is a qualitative one. A type of settlement is available in community property states that is denied to spouses in common law states. How important in a quantitative sense the life estate to wife, remainder over transfer is to families in common law states we can only guess. We know, however, that this type of disposition is a traditional one and that it is customarily employed by testators to control the disposition of the non-deductible half of their estates. As to the deductible one-half, the testator must choose between the immediate tax savings that result from the deduction and the dangers of entrusting that half of his estate to his wife's hands in the form of an absolute transfer.

Is this a proper result of a policy of integration when a community property husband can accomplish the result denied to his counterpart in the common law state and still obtain the tax savings inherent in splitting the community estate? Does the terminable interest rule serve a useful purpose in achieving integration if its effect can be avoided in community property states through the medium of the widow's election? True, the widow's election requires the consent of the widow to take effect, but is this family agreement a sufficient reason to justify the complexities of the terminable interest rule?

3. *Effect of the Competency of the Surviving Spouse.* Very recently a potential area of serious discrimination between common law and community property states was eliminated by a ruling of the Revenue Service.[25] The question presented was this: what effect does the mental competency of the surviving spouse to accept and to dispose of property have on the marital deduction?

As a general rule, if a bequest is made directly and absolutely to the surviving spouse, the decedent's estate will be entitled to deduct it, regardless of the spouse's competency or incompetency. All that needs to be done is to appoint a guardian for the purpose of holding title to the property transferred.[26] The same, of course, is true of a community property spouse's ownership of her property: her disability does not deprive her of the ownership of her one-half.

[25] Rev. Rul. 55-518, Int. Rev. Bul. 1955-33, 11.

[26] Letter Ruling (unpublished), March 16, 1950, CCH Fed. Estate and Gift Tax Rep. ¶2070.30 (1956).

A problem arises, however, in certain cases in which less than a full and absolute interest in fee is transferred to the surviving spouse. Not all such transfers are disqualified by the terminable interest rule. For example, a transfer in trust providing a life estate to the wife together with a general power to appoint the takers of the corpus on her death would qualify for the deduction as one of the recognized exceptions to the terminable interest rule.[27]

Generally, we find that any interest that is transferred to the surviving spouse in such a manner that it would be taxable in her estate (if she still possesses it at death) will qualify as a deductible interest in the decedent's estate. Thus we have a number of fairly common and well recognized exceptions to the terminable interest rule; consider, for example, these illustrations:

(1) Transfer in trust, income to surviving spouse for life, corpus to her estate.[28]

(2) Transfer in trust, income to surviving spouse for life, corpus to whomever the surviving spouse may appoint.[29]

(3) Transfer of life estate to surviving spouse, remainder to whomever the surviving spouse may appoint.[30]

(4) Payment of interest or installment amounts on life insurance proceeds to surviving spouse, remainder of proceeds at her death to whomever the surviving spouse may appoint.[31]

In all but the first case we find that the surviving spouse must be given a power to appoint the corpus in order for the transfer to qualify. For this purpose, of course, a power in the surviving spouse to consume the corpus is the equivalent of a power to appoint.[32] The problem that exists is this: if the surviving spouse must be given a power over the corpus in addition to her life estate, will

[27] One cannot help being wryly amused at this turnabout in legislative concern over the qualitative integration of community property and common law concepts. As we pointed out above, one of the reasons for disqualifying the life estate-remainder over settlement was the alleged fact that such a settlement was not available to a testator in community property states. Consider, however, the life estate plus power of disposition type of settlement. It too is unavailable to testators in community property states unless the consent of the testator's spouse is first obtained. But the latter qualifies for the marital deduction whereas the former does not. Why the difference? In the latter case, the property will be included in the surviving spouse's gross estate, but not in the former. This factor, then, ought to be the true test of whether or not an interest is to be deductible: any interest that would be includible in the survivor's estate ought to be deductible in the decedent's estate.

[28] I.R.C., §2056 (b) (5); Treas. Reg. 105, §81.47a (b) (2).

[29] I.R.C., §2056 (b) (5); Treas. Reg. 105, §81.47a (c).

[30] I.R.C., §2056 (b) (5).

[31] I.R.C., §2056 (b) (6); Treas. Reg. 105, §81.47a (d); Rev. Rul. 55-277, Int. Rev. Bul. 1955-19, 22.

[32] Treas. Reg. 105, §81.47a (c), (d).

the transfer qualify in the event she is unable to exercise the power? In other words, is it the existence of the power or its exercisability that determines whether or not the deduction is allowable?

The code does not spell out the answer to this question. All that section 2056 requires is that the power be "exercisable by such spouse alone and in all events."[33] In the regulations we find an amplification of this language, but with no direct answer to our inquiry. The regulations state, "The power in the surviving spouse is exercisable in all events only if it *exists* immediately following the decedent's death."[34] If our emphasis is correct that all that is required is the *existence* of an unqualified power, then the incapacity of the holder of the power would be immaterial.

This problem was touched upon but evaded by the Tax Court in *Estate of Frank E. Tingley*.[35] There the testator had created a life estate and power of complete invasion in his widow, subject to a condition that her power "shall cease in the case of her legal incapacity from any cause or upon the appointment of a guardian, conservator, or other custodian of her person or estate." Although the widow was at all times mentally responsible, the Commissioner challenged the estate's right to deduct the value of this property as part of its marital deduction. The Commissioner conceded that the test of whether or not the power was "exercisable in all events" had to be determined as of the date of the testator's death. But, he argued, on that date it was not absolutely certain that the widow's power over the corpus was indefeasible. She would lose the power if she later became incapacitated or a guardian were appointed for her.

The court avoided a decision on this issue by interpreting the testator's language to permit a forfeiture of the widow's power under conditions short of legal incapacity. Concerning our problem, the court stated,

> "If he [the testator] had referred to legal incapacity alone, the situation might well be different . . . [because] any surviving spouse with a power to appoint by will could later lose the power . . . [if she became] legally incapable of writing a will exercising the power and Congress may not have intended that such an event by operation of law would deny the marital deduction wherever the power was to be by will."[36]

[33] I.R.C., §2056 (b) (5), (6).

[34] Treas. Reg. 105, §81.47a (c). Emphasis added.

[35] 22 T.C. 402 at 405 (1954).

[36] Judge Arundell dissented in a succinct opinion that well summarizes the problem: "The mere possibility that she would be deprived of her right to withdraw the property

This case did, however, serve the purpose of dramatizing and publicizing the problem. As a result when the Commissioner considered the effect of a person's incompetency under the inclusion of property in his estate, he also ruled on the effect of incompetency upon the marital deduction. The facts postulated in the ruling were these: the surviving spouse had been made the life-time income beneficiary of her husband's trust erected in his will. She was also granted a general power of consumption and disposition over the trust corpus. But from the time of her husband's death to her own demise she was mentally incompetent. Despite the fact that she was never actually able to exercise the power granted her, the Commissioner ruled (1) that the corpus of the trust was includible in her estate, and (2) that the value of the trust property at the time of her husband's death qualified for the marital deduction.

Thus a potential threat of inequality between the two property systems was eliminated. Apart from the violence that the ruling may do to the literal language of the statute, we believe it clear that the ruling is consistent (1) with the theory of equalization, and (2) with the underlying principle that property includible in the surviving spouse's estate ought to be deductible in the decedent's estate to the extent of one-half thereof.

4. *Effect on Other Traditional Types of Property Settlements.* At common law a widow was entitled to dower in her husband's lands on his death; customarily, dower gave her a life interest in one-third of his real property. Similarly, a widower received an estate in his wife's lands on her death known as curtesy; this estate too consisted of a life interest, but in all, rather than in merely one-third, of his wife's real property.

Because both dower and curtesy create no more than a life interest in the surviving spouse, both marital estates are disqualified under the terminable interest rule.[37] We may find it curious, perhaps, that two of the traditional forms of passing property at death between husband and wife fail to qualify for the very deduction that had been designed to lighten the tax load upon interspouse transfers. This means, of course, that these common law forms of marital transfer will pretty well be abandoned by richer

should she be pronounced legally incompetent does not seem to me a valid reason for denying the marital deduction. Such an unfortunate possibility always exists and would operate effectively to extinguish the right of any surviving spouse to draw down property given with the power to consume or appoint." Id. at 407.

[37] Rev. Rul. 279, 1953-2 Cum. Bul. 275 at 277.

families simply because of the economic discrimination against them. A premium has been placed upon the writing of a will by residents of these states as a result of the discrimination against the intestacy forms of transfer.

Under our modern law, both dower and curtesy have been replaced by statutory substitutes. If these substitutes create no more than a life interest, or interest otherwise terminable, in the surviving spouse, then they too will be disqualified from the marital deduction.[38] On the other hand, a statutory substitute that creates a fee interest (or other similar non-terminable interest) in the surviving spouse will be deductible.[39]

Similarly, under community property rules, the community estate is automatically split between the spouses on the death of one because of the equal ownership of each spouse in the community estate. Local property concepts give the estate the same break as if the marital deduction were allowable.

What is the result? Has equalization been achieved? Consider for a moment the plight of one who dies intestate. If he had the good fortune to live in a community property state, his total community estate is automatically split with his spouse. If he resided in a state that has retained common law dower, his estate loses the marital deduction because of the terminable interest rule. If, on the other hand, his state of residence provided a statutory substitute for dower that gives his widow a fee interest, the value of the property transferred to her is deductible.[40]

[38] Id. at 278 (discussing the Alabama substitute). The same rule is true as to allowances for support under local law. Rev. Rul. 83, 1953-1 Cum. Bul. 395, Rev. Rul. 56-26, Int. Rev. Bul. 1956-5, 10; Estate of Nelson, 24 T.C. 30 (1955).

[39] Pitts v. Hamrick, (4th Cir. 1955) 228 F. (2d) 486. See Treas. Reg. 105, §81.47a (b) (1) (iii).

[40] Not only is there a difference in result at the time the first spouse dies, but an additional discrimination occurs when the second dies. Here it appears that the community property spouses are worse off. In the absence of a will, the decedent's half of the community customarily passes to the surviving spouse and will be includible in her estate on her death, subject, of course, to a possible credit for the tax levied on the property in the prior estate. In a common law dower state, all the property is taxed in the husband's estate and none in the wife's. But in the common law substitute states, the husband will be entitled to a deduction in his estate for his wife's statutory interest; on her death only that interest will be included in her estate. On an oversimplified basis, we might consider the following graphic comparison, assuming that the husband dies first.

% of both spouses' property included	Common law dower	Common law substitute	Community property
In *H's* estate	100%	50%	50%
In *W's* estate	-0-	50%	100%
Total included	100%	100%	150%

This is not equalization. The availability of the marital deduction depends upon local property concepts, not upon whether or not the surviving spouse is the beneficiary of the decedent's estate. Because of the terminable interest rule, a decedent in a dower state must execute a will in order to gain the benefit of the deduction; his brethern in other states may obtain its benefits without writing a will, provided their spouses survive them.

And so we find that a rule, that of the terminable interest, designed to equalize the conflicts in property systems may itself be the cause of substantial inequality.

5. *Effect on Annuities.* Generally we think of annuities as terminable interests. And, as terminable interests, we would expect to find them disqualified from the marital deduction. And, on further reflection, we would agree that this is properly so. After all, a husband in a community property state cannot create the equivalent of an annuity in his wife's community property which she owns outright. But, as we saw above, this test of what a community property spouse can or can not do is more illusory than real.

Actually an annuity is deductible or not depending upon (1) what its terms are, and (2) who bought it. By this we mean to imply that not all annuities are disqualified. In order to determine what types of annuities are deductible, we must retrace our steps in analyzing the basic characteristic of a "terminable interest." An interest can be considered terminable only if the decedent has at some time split his ownership of the property passing to the surviving spouse between her and some other person who will take the property after her.[41] An annuity is a terminable interest only if some interest in it passes to another person after the death of the annuitant (in this case the surviving spouse). We can imagine two situations in which this condition would be present: (1) the surviving spouse's annuity contains a refund feature that may be payable to a secondary beneficiary on her premature death, or (2) the surviving spouse holds the annuity jointly with another who may become the sole annuitant as survivor. But if the annuity is payable only to the surviving spouse for her life, without refund feature, it is not a terminable interest. Nor would it be a terminable interest if the surviving spouse's interest is that of a survivor annuitant on a joint and survivor annuity.[42] A refund annuity in favor of the surviving

[41] See discussion, Part B (1) supra.

[42] Treas. Reg. 105, §81.47b (d), example (iv), Bureau Letter, May 12, 1949, P-H Federal Tax Service, ¶76,258, 1949.

spouse may also qualify in the event that the refund is payable to her estate, not to any other person.[43] In these cases, the surviving spouse takes the entire interest in the annuity on the decedent's death and no interest in it passes to another person (other than her estate).

The second part of the test must also be met: who bought the annuity is as important for the purpose of the terminable interest rule as its type. The two examples of annuities discussed above would be deductible only if purchased by the decedent himself. If the annuities were bought by his executor out of the liquid assets of his estate, the annuity would be disqualified even though it is not technically a terminable interest.

Why this strange result? The short answer is found in the code itself.[44] Any interest that expires or lapses after a period of time is considered non-deductible if purchased by the executor under instructions from the decedent. It is immaterial whether or not any other person may succeed to the interest after its failure in the hands of the surviving spouse. In other words, interests purchased by an executor under orders from the decedent are subject to a more restrictive terminable interest rule than those purchased by the decedent himself.[45]

What does all of this add up to? First, we see that these rules actually permit one to design an interest that is deductible in the decedent's estate but yet is not taxable in the surviving spouse's. Suppose, for example, a decedent, in a common law state, buys an annuity out of his property for his wife. In order to prevent the accrual of a gift tax, he retains all the incidents of ownership, including the right to surrender, until his death. The annuity falls into his gross estate. Because it is not a terminable interest, his estate is entitled to deduct it as part of the available marital deduction. The annuity, however, expires by its terms on the death of his surviving spouse. Hence nothing is includible in her estate

43 S. Rep. 1013, 80th Cong., 2d sess., 1948-1 Cum. Bul. 285 at 339, 340. But because an estate is not a permanent entity, the value of the refund will ultimately inure to the benefit of a person other than the surviving spouse; yet the annuity is not deemed to be a terminable interest.

44 I.R.C., §2056 (b) (1) (C).

45 Treas. Reg. 105, §81.47b (e). Parenthetically we should add that interests purchased by an executor under a general direction to sell and invest are not disqualified merely because they may fail through the lapse of time; only if another person will succeed to the interest on such failure will the interests brought under a general power be disqualified. This liberalization is, of course, a rephrasing of the more usual terminable interest rule. The restrictive rule applies only in the case of a particular direction to the executor to purchase an obligation "the discharge of which would . . . have the effect of an annuity for life or a term." S. Rep. 1013, 80th Cong., 2d sess., 1948-1 Cum. Bul. 285 at 340.

on her death. Thus we can pass property to a surviving spouse for her enjoyment without the burden of estate taxes, either before or after the transfer.[46]

Again we must conclude that this is not equalization. Under community property concepts, the surviving spouse owns a fee interest in her one-half. But under this application of the marital deduction formula, she owns only a contract right for installment payments that will cease on her death. In a community property state only the owner of the property could transmit his interest into such an annuity. The husband, for instance, could not convert his wife's one-half share of the community into an annuity owned solely by her without her consent.[47] Thus, in this area we find that qualitative inequality exists between the two property systems, despite the adoption of the marital deduction and its terminable interest rule.

6. *Effect of the Rule of Strict Construction.* The legislative exceptions to the terminable interest disqualification[48] have been strictly construed and applied; by and large it is more common for a contested deduction to be denied than to be sustained. And in denying the deduction, the courts have been less concerned with the underlying philosophy of the marital deduction than they have been with maintaining the so-called legislative principle that "deductions should be strictly construed against the taxpayer and in favor of the sovereign." This attitude, too, has played its part in subverting the original purpose of Congress of equalization between the different property systems.[49]

Consider first the exception for a life estate coupled with a power of disposition over the corpus. Such a transfer was expressly

[46] The price, of course, is the entire consumption of the property, which may be the reason that this device has not appeared more attractive. If the future testator wants to conserve any portion of the property, he can insert a provision for refund payable to his spouse's estate in the event of her premature death. The value of such a refund would not prevent the annuity from being deductible in his estate, but it would be includible as part of the surviving spouse's estate.

[47] It would require a partition of the community into two separate estates. If the husband purchased an annuity on her life, both he and she would own equal one-half interests in it as long as it remained community property. DE FUNIAK, PRINCIPLES OF COMMUNITY PROPERTY §1 (1943).

[48] See discussion at Part B (1) supra.

[49] Perhaps only Congress should be blamed for these discrepancies between theory and practice. At any rate, the attitude of the courts and the Commissioner of Internal Revenue toward the marital deduction has forced Congress to lead the way in eliminating some of the more glaring errors in the judicial gloss that has been deposited upon the marital deduction section since its inception. See §210, Technical Changes Act of 1953, 67 Stat. L. 615, 624, and compare I.R.C. (1939), §812 (e) (1) (F) and (G) with their counterparts, I.R.C. (1954), §2056 (b) (5) and (6).

made deductible under the original language of the marital deduction section, provided the transfer was made in trust.[50] Consequently, if the equivalent transfer were made in terms of a legal life estate coupled with a power of invasion or disposition over the remainder, the transfer was held to be non-deductible, solely because it was not in trust.[51] Whether or not the property would be includible in the surviving spouse's estate was immaterial; the controlling question was whether the transfer was in trust or not in trust.

Interestingly, we find that in certain of these cases dealing with legal life estates, an argument has been made that the Rule in Shelly's Case (or its statutory counterpart) transmutes the surviving spouse's life interest plus the power to consume into a fee interest. Hence, her interest being an absolute fee, it is deductible. Thus far the argument has been rejected, but in each case the rejection has been bottomed upon an analysis of local precedent.[52] But if local law determines this question,[53] equalization would be hopeless of achievement.

This particular question has been eliminated for estates of decedents who die after August 16, 1954. Equalization has been obtained by rewriting the federal rule to include this situation. Under the provisions of section 2056 of the Internal Revenue Code of 1954, an interest, whether legal or equitable, is deductible if a life interest and power to appoint the remainder passes to the surviving spouse.[54] According to the Senate Report, the amendment was required "because of doubt under the law of the various States as to what constitutes a 'trust' it is not clear when a legal life estate

[50] I.R.C. (1939), §812 (e) (1) (F) which reads in part as follows: "In the case of an interest in property passing from the decedent in trust, if under the terms of the trust his surviving spouse is entitled for life to all the income from the corpus of the trust . . . with the power in the surviving spouse to appoint the entire corpus free of the trust. . . ."

[51] Estate of Edward F. Pipe, 23 T.C. 99 at 104 (1954), on appeal to Second Circuit; Estate of Michael Melamid, 22 T.C. 966 at 968 (1954); Estate of Frank E. Tingley, 22 T.C. 402 at 406 (1954), on appeal to First Circuit; Estate of Julius Selling, 24 T.C. 191 at 197 (1955), acq. on another point Int. Rev. Bul. 1955-40, 6, on appeal to Second Circuit.

[52] Estate of Edward F. Pipe, 23 T.C. 99 at 101 (1954) (New York); Estate of Julius Selling, 24 T.C. 191 at 197 (1955) (New York); Estate of Frank E. Tingley, 22 T.C. 402 at 406 (1954) (Rhode Island); Estate of Harrison P. Shedd, 23 T.C. 41 at 44 (1954), on appeal to Ninth Circuit (Arizona).

[53] Under the regulations, the Commissioner has assumed that local law controls this question. Treas. Reg. 105, §81.47b (d), example (ii). And in Estate of William Walker Wynekoop, 24 T.C. 167 at 171 (1955), acq. Int. Rev. Bul. 1955-47, 6, the Tax Court used local law to bail out the estate.

[54] I.R.C., §2056 (b) (5) reads in part as follows: "In the case of an interest in property passing from the decedent, if his surviving spouse is entitled for life to all the income from the entire interest . . . with power in the surviving spouse to appoint the entire interest. . . ."

will qualify as a trust."[55] One may properly wonder, in view of this statement, whether or not the courts that had ruled on the matter were right in their decision that only transfers meeting all the traditional requirements of a trust would qualify.[56]

What of trust transfers themselves? Have the courts been restrictive or liberal in applying the statutory language of the marital deduction? Again the record forces us to conclude that the courts have lost sight of the underlying philosophy of the deduction in their search for "jot and tittle" compliance with the statute.

Perhaps the most common mistake has arisen in the case of a testator who wishes to qualify half his estate for the marital deduction by passing it to his wife and to pass the other half to his children subject to a life estate in his wife. Certainly there is nothing improper in such a plan and it is common knowledge that this is a typical family settlement. But what happens if the testator's draftsman fails to state with specificity that the testator intended to erect two trusts, one to his wife for life, remainder to children, subject to his wife's power of appointment, and the other to his wife for life, remainder to children, without a power of appointment in her? Suppose he just gives her a power of appointment over one-half the corpus? *Held,* no deduction allowable. The decedent had intended only one trust; because the surviving spouse had been granted a power of appointment over only part of that trust, her interest failed to qualify under the statute which requires that her power extend to the "entire corpus."[57]

Again Congress has had to step in to correct a discrepancy between theory and practice. Section 2056 of the 1954 code now permits a deduction for property transferred to the surviving spouse for life, to the extent that she has a power of appointment over the

[55] S. Rep. 1622, 83d Cong., 2d sess., 125 (1954).

[56] In Estate of Edward F. Pipe, 23 T.C. 99 at 102 (1954), this contention was advanced: the estate argued that under New York law a life tenant in possession was considered a trustee holding the property for the ultimate benefit of the remainderman. The argument was rejected in the Pipe case because Mrs. Pipe had been given more than a life estate—she had the power of disposition and of consumption as well. When you recall that the court had already ruled that these additional powers were insufficient to give her a fee, you realize that the court was paying only lip service to the concept of integrating the husband's and wife's estates to prevent the double inclusion of the property.

[57] Estate of Louis B. Hoffenberg, 22 T.C. 1185 at 1186 (1954), affd. per curiam sub nom. Hoffenberg v. Commissioner, (2d Cir. 1955) 223 F. (2d) 470; Estate of Harrison P. Shedd, 23 T.C. 41 at 45 (1954) (where the court admitted "substantial compliance" with the statute is "no compliance"); Estate of Arthur Sweet, 24 T.C. 488 (1955), on appeal to Tenth Circuit; Estate of Frank Clifford Bickers, 14 T.C.M. 901 (1955), T.C. Memo. 1955-224; Rev. Rul. 54-20, 1954-1 Cum. Bul. 195.

remainder. If the life estate and the power reach only part of the corpus, the estate's deduction is limited to that part.[58]

Both of these trouble spots have been eliminated by corrective legislation. But in view of the attitude of the courts, we may fairly assume that new areas of controversy will arise. For instance, what will be the result if the testator creates but one trust, with a life estate in the whole to the surviving spouse but with a power of appointment over only one-half the corpus? Will the courts deny the deduction of one-half the trust property because the surviving spouse's income and power interests are not co-terminous?

If we consider these cases and the judicial attitude they reflect from the viewpoint of equalization, we see that they represent a frustration of that objective. We find that in common law states, through inadvertence or error, property is taxed in first the husband's and then the wife's estates. The same situation cannot, of course, arise as to community property because the interests of the spouses are fixed by law, not by the endeavors of an estate draftsman. And these interests control the incidence of federal estate taxation.

C. *Elimination of Community Property From the Adjusted Gross Estate*

1. *Introduction.* As a matter of general principle, property that is already split between the spouses should not also gain the benefit of the marital deduction. If it did, the property would be taxed only to the extent of one-fourth of its total value in the decedent's estate; the other three-quarters would not be taxable until the death of the surviving spouse.[59] Consequently, the statutory framework of the deduction provides for the elimination of community property.

However, this scheme of elimination is not as simple as it may seem. It would be unfair to withhold the deduction completely from spouses in community property states because such spouses may own property separately as well as in the community form.

[58] I.R.C., §2056 (b) (5): "In the case of an interest in property passing from the decedent, if his surviving spouse is entitled for life to all the income from the entire interest, or all the income from a specific portion thereof . . . with power in the surviving spouse to appoint the entire interest, or such specific portion. . . ." A similar amendment has been made to cover the handling of insurance proceeds. I.R.C., §2056 (b) (6). Cf. Rev. Rul. 1954-553, 1954-2 Cum. Bul. 303; Estate of Joseph E. Reilly, 25 T.C. No. 46 (1955).

[59] This result would be no worse than that obtaining to a common law husband who gives half of his property to his wife before death. He is taxable on only one-quarter, and the other three-quarters (less than consumed) are taxed in his wife's estate.

And if a husband or wife acquires property separately, it is not split between them in ownership as it would be if acquired as community property.[60] On the death of the owner, separate property is included in full in his estate; hence, if no deduction were allowable to the owner, he would be unable to split that part of his estate with his surviving spouse. In other words, the owner of separate property would be placed in the same position as a property owner in a common law state prior to the Revenue Act of 1948.

For this reason the marital deduction was not completely denied to the community property states. Instead, the deduction was made available in community property states, but on a reduced basis. The approach of the statute was to require that all community property be eliminated from the adjusted gross estate limitation placed upon the amount of the deduction. Thus the ceiling on the marital deduction allowable was lowered, pro tanto, by the value of all community property included in the decedent's gross estate. By lowering the ceiling, Congress hoped to eliminate the possibility that community property spouses would realize a double deduction on the death of the first spouse.

An example will make the mechanics of this reduction clear. Suppose *H* and *W* have amassed a community estate of $400,000. On *H*'s death, one-half ($200,000) of this amount is includible in his estate. But in order to compute *H*'s adjusted gross estate, *H*'s executor must first reduce his gross estate by the amount of community property included in it.[61] Because the entire estate consists of *H*'s interest in their community property, *H*'s executor must reduce the gross estate by itself; consequently, the adjusted gross estate is zero and *H*'s estate is entitled to no marital deduction.

But suppose *H* had also been possessed of $150,000 of separate property, acquired by him from the estate of his father. In this case *H*'s estate would total $350,000, including his $200,000 interest in the community estate. Again *H*'s executor must reduce the gross estate by the amount of community property included in it. Thus the $350,000 estate is reduced by $200,000, leaving an adjusted gross estate of $150,000. Because the maximum marital deduction allowed would be 50 percent of the adjusted gross estate, *H* could pass up to $75,000 to *W* as a deductible transfer.[62]

60 DE FUNIAK, PRINCIPLES OF COMMUNITY PROPERTY §1 (1943).

61 I.R.C., §2056 (c) (2) (B); Treas. Reg. 105, §81.47d (b).

62 This illustration has been oversimplified. In addition to the reduction for community property, *H*'s executor must also reduce *H*'s gross estate by claims, expenses and losses. I.R.C., 2056 (c) (2) (A). Because *H*'s community interest is being eliminated in toto under another reduction clause, the reduction for claims, expenses and losses is confined

One further principle should be kept in mind. It is immaterial whether the decedent passes his interest in community property or in separate property to his surviving spouse. If he has an adjusted gross estate, either type of property passed to his surviving spouse will qualify for the marital deduction.[63] From a practical standpoint, this liberalization does no harm, because it is impossible to use it to gain a double deduction; all that it accomplishes is to give the estate planner in a community property state a greater degree of flexibility in deciding which property shall pass to the surviving spouse and which shall go to other beneficiaries. But it is only when the gross estate includes some separate property that the deduction is allowable at all.

This is the basic approach of the statute; only where separate property (or its statutory equivalent) is encompassed in the gross estate will any marital deduction be allowable. The statutory approach appears fair enough on its face. But, as always, we must ask: how has it worked out?

2. *Separate Property Resulting from a Conversion of Community Property.* Because it is normally possible for spouses in a community property state to convert their interests in community property into separate property, Congress had to engraft a further protective device upon the reduction clauses of the adjusted gross estate. Otherwise a double deduction could be obtained by the simple expedient of converting all of the spouses' community property into separate property; then, in the absence of this additional protective device, the decedent might die leaving an adjusted gross estate equal to his separate property and thus qualify for the marital deduction an estate that had already been split between the spouses through its former community ownership.

To eliminate this possibility, Congress required that the gross estate be reduced by "converted community property," as well as by community property, in the process of computing the decedent's

to only those claims, expenses and losses attributable to non-community property. I.R.C., §2056 (c) (2) (B) (iv). For the purpose of deciding which claims, etc., are attributable to community property and which to separate property, an arbitrary apportionment is made based upon the proportion that the community property included in the estate bears to the entire gross estate. We have the following formula:

$$\frac{\text{Amount of reduction for claims, expenses and losses}}{\text{Total claims, expenses and losses}} \;::\; \frac{\text{Gross estate less community property}}{\text{Gross estate}}$$

[63] S. Rep. 1013, 80th Cong., 2d sess., 1948-1 Cum. Bul. 285 at 345.

adjusted gross estate. By "converted community property" we mean any separate property of the decedent that was acquired by him in exchange for his interest in community property.[64]

Basically, what this device does is to freeze property for the purpose of the marital deduction into community property if it was at any time acquired as community property. It makes no difference how the property may have been transformed or exchanged prior to death. Neither a change in form of ownership nor a partition of the property will be recognized; if the altered property is included in the decedent's gross estate, it must be excluded from his adjusted gross estate just as if it retained its character as community property to the date of his death.

These principles are pervasive and far-reaching; they exclude not only partitioned community property but also newly-acquired property purchased with funds derived from property that was formerly community property. It is easily possible to conjure up situations in which property that never was itself community property receives the same treatment as community property under these rules.[65] Thus the problem of eliminating community property from the adjusted gross estate often becomes a nasty problem in itself.

And added to this basic problem are the complications that arise in the case of an unequal conversion of community property —one in which one spouse gets a larger share than his one-half of the community. If such a conversion were made, the spouse receiving the larger share would ordinarily be treated as having made a gift of one-half of the excess to the other. For the purpose of the marital deduction this excess property is treated as true separate property in the estate of whichever spouse acquires it; consequently, it need not be eliminated from the adjusted gross estate as converted community property.[66]

An example may serve to clarify this statutory refinement to the concept of converted community property. Suppose *H* and *W* agree to a conversion of their community property, *H* taking a car

64 I.R.C., §2056 (c) (2) (C).

65 By way of illustration, consider the case where a husband agrees that his wife's earnings are to be her separate property. Suppose *W* carefully keeps her earnings and does not commingle them with community funds in a joint or community bank account. And suppose she buys in her own name a car which is her separate property. If she dies first, her adjusted gross estate would not include the value of her car because the car had been acquired "by the decedent in exchange . . . (for) property held as such community property." See Treas. Reg. 105, §81.47 (d) (b).

66 I.R.C., §2056 (c) (2) (C) (ii).

and stocks worth $20,000, and *W* holding out for their home worth $30,000. If *H* dies first, all of the property received by him in the conversion would be excluded from his adjusted gross estate; he received none of the excess and therefore all of his separate property was a product of his one-half community interest. But if *W* dies first, a different result obtains. *W* received $10,000 in excess of *H*'s share. Therefore only $20,000 of her interest in the home is treated as converted community property; the remainder is treated as her separate property and is includible as part of her adjusted gross estate.[67] These rules relating to conversions are restricted only to the amount of separate property received by the decedent in the conversion that is not in excess of the amount received by his spouse.

All of these safeguards, as we have seen, are necessary to carry out the basic purpose of equalization. Unless we had these exclusionary rules relating to converted community property, spouses in community property states could readily evade the restrictions on the use of community property by merely changing the form of their holdings from community to separate property.

But there is still one area into which these conversion rules do not reach. If the spouses converted their community ownership into separate property prior to January 1, 1942, then the property is treated as separate property for the purposes of the marital deduction.[68] In this one situation, the spouses may build up an adjusted gross estate out of separate property previously converted from community property and thereby pay a tax on only one-quarter the entire community estate on the first death. In other words, as to this property the equivalent of a "double deduction" is available.[69]

67 If the values of the separate property obtained as a result of the conversion change before death, the amount of converted community property and excess separate property is determined by applying the ratio that these two types of property bore to one another when converted. This conversion ratio is then used to divide the total value at death of the property resulting from the original conversion. Treas. Reg. 105, §81.47d (b), example (2). See also the example appearing in S. Rep. 1013, 80th Cong., 2d sess., 1948-1 Cum. Bul. 285 at 345-346.

68 I.R.C., §2056 (c) (2) (C) (i).

69 Under the 1939 code, this "double deduction" of converted community property was available not only for conversions occurring before January 1, 1942, but also for conversions made in the period January 1, 1943 to April 2, 1948. I.R.C. (1939), §812 (e) (2) (C) (i). This supplementary period of grace was stricken out of the Revenue Act of 1954 as introduced in bill form in the House of Representatives. See H.R. 8300, §2056, 83d Cong., 2d sess. (1954). No explanation for dropping the supplementary period was given in the Committee Report, H. Rep. 1337, 83d Cong, 2d sess., A319 (1954). The explanation may lie, however, in the adoption of the Revenue Service of the theory of Commissioner v. Mills, (9th Cir. 1950) 183 F. (2d) 32. There the court invalidated a treasury regulation that

To this extent, at least, we find that the reduction clauses are not accomplishing full parity between the two systems of ownership. The disparity, however, is diminishing because the cut-off date, January 1, 1942, is receding year by year and the amount of property qualifying for this special benefit is steadily diminishing. This special advantage cannot, of course, be obtained for any new community property owners who were not already entitled to it on January 1, 1942.

3. *Exceptions to the Reduction for Community Property Clauses.* Not all community property falls under these rules outlined above. According to the code, only community property that is split between the spouses for federal estate tax purposes must be eliminated from the adjusted gross estate;[70] other types of community property are included as part of the adjusted gross estate just as separate property is included.[71]

The regulations have restated this test positively to permit the inclusion in the decedent's adjusted gross estate of any community property "in which the surviving spouse had at such time merely an expectant interest."[72] The most prominent illustration of this type of property is "pre-'27" community property in California. Prior to July 29, 1927, a California wife had not much more than an expectancy in community property; she had to survive her husband to take her one-half. Hence, when the husband died, the entire community was included in his gross estate for estate tax purposes.[73] Because the entire property is included in the husband's gross estate, it all qualifies for his adjusted gross estate.[74]

purported to treat all conversions of community property into separate property as taxable gifts of the husband if made after December 31, 1941 and prior to the Revenue Act of 1948. See Treas. Reg. 108, §86.2 (c). If these conversions were no longer to be treated as gifts when made, the reason for giving them special treatment under the marital deduction reduction clauses disappeared. See T.D. 6015, 1953-1 Cum. Bul. 396.

70 I.R.C., §2056 (c) (2) (B), which reads in part: "For purposes of clauses (i), (ii), and (iii), community property . . . shall be considered as not 'held as such community property' as of any moment of time, if, in the case of the death of the decedent at such moment, such property (and not merely one-half thereof) would be or would have been includible in determining the value of his gross estate. . . ."

71 With the exception, of course, of property which traces its ancestry to community property of a type that is split between the spouses; such converted community property is treated the same as the property from which it is descended.

72 Treas. Reg. 105, §81.47d (b) (i).

73 Talcott v. United States, (9th Cir. 1928) 23 F. (2d) 897 at 901, cert. den. 277 U.S. 604, 48 S.Ct. 601 (1928); T.D. 3891, V-2 Cum. Bul. 232 (1926). California has since amended her statutes to grant a wife "a present, existing and equal interest" in community property during her lifetime. Cal. Civ. Code (West, 1954) §161a.

74 S. Rep. 1013, 80th Cong., 2d sess., 1948-1 Cum. Bul. 285 at 345.

From the viewpoint of equalization, we cannot quarrel with this result. This particular type of community property is treated in the same manner as property in common law states both for the purpose of inclusion in the gross estate and of qualifying for the marital deduction.

The other side of the coin presents the other basic exception to these community property rules. Suppose the wife dies first in a state in which her community interest is a mere expectancy. She forfeits her interest on death. Hence no part of the community estate is taxable in her gross estate. And, naturally, no part of the property would qualify for the marital deduction.[75]

Again we cannot quarrel with the result; it seems entirely consistent with the treatment of common law property. On the other hand, what we said in criticism of the equalization between common law and community property systems when the wife dies first applies equally well here. As to "pre-'23" California and as to New Mexico community property, the death of the wife causes no tax liability to accrue. Contrast this with the case of ordinary community property; on the wife's death, one-half of the community estate is taxable in her gross estate.

But other complications may also ensue. It is even possible for conflicting results to obtain in one community property state as to the same property. For example, in 1923, California wives were given a power of disposition over their half interests in the community estate.[76] This power was sufficient to require the inclusion of a wife's community interest in her estate if she died first. But if her husband died first, the entire community estate was included in his gross estate.[77]

The application of the principles of the reduction clauses may lead to the curious result that certain property will qualify for the marital deduction in one spouse's estate, but not in the other's! These cross-currents in the community property system create

[75] This apparently is the situation in New Mexico. Hernandez v. Becker, (10th Cir. 1931) 54 F. (2d) 542. But see the acidulous comments of Robert Emmet Clark in "Another Community Property Anomaly," 11 TAX L. REV. 76 at 82 (1955) on this decision. Until recently, it was the rule in Nevada. In 1955, however, the Commissioner reversed his original ruling to take the position that one-half of the community estate is taxable on the wife's death. Rev. Rul. 55-605, Int. Rev. Bul. 1955-40, 10. And prior to 1923, when the wife was granted a power of disposition over her half, it must have been the rule in California.

[76] 1923 Stat. L. (California), c. 18, p. 29.

[77] See authorities cited in note 73 supra.

situations where there is no more equalization among the community property states themselves than there is between community property and common law property.

4. *Conclusion.* By and large the rules relating to the treatment of community property under the marital deduction have achieved the result of preventing a double deduction. To that extent at least, these rules have accomplished equalization. But other aspects of this treatment leave us more dubious. The rules relating to separate property result in equating separate property with common law property under the deduction. Thus, the same types of discrimination that exist between common law and community property are extended to community and separate property. On the other hand, nothing is done to lessen or to eliminate these disparities as to community property itself.

In other words, we can sum up the community property provisions of the marital deduction by saying that they eliminate the possibility of reducing the first spouse's estate to one-quarter of the total. The same possibility has not, however, been eliminated in common law states. There a spouse may confidently give away half his estate before death and still qualify for the full marital deduction when he dies. These provisions obviously leave much to be desired.

D. *Problems of Planning for Administration*

1. *Introduction.* Several problems arise in the planning of an estate for administration on the death of the testator that may give rise to inequalities between the two property systems. Among these problems are the questions (1) of how the estate tax is to be apportioned among the beneficiaries of the estate, (2) of the manner in which the surviving spouse's share will be treated under concepts of local probate administration, (3) of the local death duties payable on the surviving spouse's share, and (4) of the property to be selected for transfer to the surviving spouse for her enjoyment after the testator's death.

2. *Who Pays the Tax?* One anomaly that has appeared in the administration of the marital deduction is the problem of who bears the burden of the estate tax on the decedent's estate: all of the beneficiaries of his estate? Or all beneficiaries other than the surviving spouse if her legacy is tax deductible?

Naturally this is no problem under community property concepts. The surviving spouse takes her one-half share undiminished by a levy for any share of the estate tax on her husband's half interest. She owned her community interest prior to the decedent's death and her interest does not fall into his gross estate.[78]

But in common law states the problem is a perennial one. It arises out of the statutory language of the marital deduction itself. Section 2056 specifically requires that "there shall be taken into account the effect which the (federal estate tax) . . . or any estate, succession, legacy, or inheritance tax, has on the net value of the surviving spouse of . . . (the interests passing to her and qualifying for the deduction)."[79]

As a matter of basic interpretation, what this proviso does is to reduce the amount of any marital transfer by the amount of any federal or state tax chargeable to the property passing from the decedent to his spouse. Naturally, if the amount of property transferred to the spouse exceeds the maximum marital deduction by the amount of the tax, this subsection makes no difference; the amount of the marital transfer, even after reduction for taxes, still exceeds the maximum amount deductible. Hence the full marital deduction, equal to one-half the adjusted gross estate, is deductible.

But in any case in which the property transferred to the surviving spouse is about equal to, or is less than, the maximum deductible, the amount of federal and state taxes apportioned to the spouse's share of the estate will reduce her share; consequently, the amount deductible is also reduced. An example may make this clear: suppose *H* dies leaving a taxable estate of $500,000, passing $250,000 to *W*, all of which qualifies for the marital deduction. But a state inheritance tax of $10,000 is levied against the transfer to her. Under this subsection, the amount of the marital deduction is reduced from $250,000 to $240,000, which is equal to the net amount passed to her.

In the case of the federal estate tax, which is a tax payable out of the entire estate, not a charge against a specific legacy, the testa-

[78] This result occurs even in the case where the surviving spouse elects to have her community interest administered in her spouse's estate for probate purposes. Estate of Buckhantz, 120 Cal. App. (2d) 92, 260 P. (2d) 794 (1953). Compare Estate of Cushing, 113 Cal. App. (2d) 319, 248 P. (2d) 482 (1952), which dealt with the analogous problem of computing the state inheritance tax on the decedent's community estate if he leaves his entire community interest to his surviving spouse.

[79] I.R.C., §2056 (b) (4) (A). See S. Rep. 1013, 80th Cong., 2d sess., 1948-1 Cum. Bul. 285 at 335.

tor may control its payment by will. He can, if he wishes, have property other than that passing to his spouse bear the primary responsibility for the tax. The effect will be to protect the marital legacy from reduction for taxes; consequently, the marital deduction available to his estate will not be reduced for any share of the taxes.

If he fails to provide expressly for the payment of taxes, the general rule, in the absence of a state statute, is that the federal estate tax is payable out of the residual estate.[80] Where the marital transfer is made a part of the residuary share, the marital deduction may be reduced by the entire amount of the estate tax payable on the entire estate; and because the marital deduction is decreased, the amount of estate tax liability incurred will be increased.[81] This result occurs whenever the amount of the surviving spouse's residual share is less than the maximum marital deduction plus estate taxes. To prevent this result, the testator must either provide for apportionment of the tax liability in his will or forego the use of a residual bequest to his spouse.[82]

In certain jurisdictions we find that specific apportionment statutes have been enacted. These statutes direct that the federal estate tax burden be apportioned among the beneficiaries of the estate according to their respective shares in the estate, "except that in making such proration allowances shall be made for any exemption granted by the act imposing the tax and for any deductions allowed by such act for the purpose of arriving at the value of the net estate. . . ."[83]

80 Harrison v. Northern Trust Co., 317 U.S. 476, 63 S.Ct. 361 (1943).

81 See Miller v. Hammond, 156 Ohio St. 475, 104 N.E. (2d) 9 (1952), where the estate represented to the court that an apportionment of the estate tax burden to the widow's share of the estate would so decrease the marital deduction that the overall federal estate tax burden would be increased $50,000! The court held for the widow on this argument and charged her share with no part of the federal estate tax burden despite the fact that Ohio had no apportionment statute. The case was subsequently overruled in Campbell v. Lloyd, 162 Ohio St. 203, 122 N.E. (2d) 695 (1954), cert. den. 349 U.S. 911, 75 S.Ct. 600 (1955). In Wachovia Bank & Trust Co. v. Green, 236 N.C. 654, 73 S.E. (2d) 879 (1953), the difference in the tax was over $265,000, and In re Uihlein's Will, 264 Wis. 362, 59 N.W. (2d) 641 (1953), about $415,000.

82 See Estate of Rosalie Cahn Morrison, 24 T.C. 965 (1955), where, simply because the transfer was not made in the residuary estate, the Commissioner lost his battle to reduce the marital transfer by a part of the federal estate tax burden. And see Baylor v. Nat. Bank of Commerce, 194 Va. 1, 72 S.E. (2d) 282 (1952), where the testator had made express provision for apportionment in his will.

83 This is the language of §124.1 of the New York Decedent's Estate Law (McKinney, 1949) before the 1950 amendments to it; the pre-1950 language served as the model for most of the other apportionment statutes. The 1950 version of the act was more specific, providing that "any exemption or deduction allowed under the law imposing the tax by

This language has not given the courts any particular compass bearing in reaching a decision as to whether or not the marital transfer should be assigned a portion of the federal levy. The cases under it are conflicting. On the one hand, it has provided sufficient justification for freeing the surviving spouse's share from any part of the estate tax burden; the theory expressed by the courts reaching this result is that because the surviving spouse's share has not contributed to the estate tax burden (it being deductible), it need not contribute to the tax burden levied on the estate.[84]

But, on the other hand, this is not the sole interpretation. Other courts have held that the language requires no more than a straight pro rata apportionment of the net estate tax burden among the various beneficiaries; exemptions and deductions are to be taken into account only to determine the taxable estate; whatever tax results from that determination is made a charge against each beneficiary according to his share in the total estate.[85]

Because of the substantial difference in tax results, litigants in states not having an apportionment statute are urging their courts to adopt a judicially created rule of apportionment. To a very limited extent this approach has succeeded.[86] But by and large the courts have refused to apply any rule of "equitable apportionment." These latter courts reason that the absence of a specific apportionment statute is almost conclusive evidence that the doctrine of apportionment is not the law of the jurisdiction.[87]

reason of the relationship of any person to the decedent . . . shall inure to the benefit of such person bearing such relationship. . . ." N.Y. Decedent's Estate Law (McKinney, 1949; Supp. 1955) §124(3).

84 In re Peter's Will, 88 N.Y.S. (2d) 142 (1949), affd. per curiam 275 App. Div. 950, 89 N.Y.S. (2d) 651, appears to be the grandfather of this theory. *Accord*: In re Wolf's Estate, 307 N.Y. 280, 121 N.E. (2d) 224 (1954); Jerome v. Jerome, 139 Conn. 285, 93 A. (2d) 139 (1952); In re Rosenfield's Estate, 376 Pa. 42, 101 A. (2d) 684 (1954); Estate of Buckhantz, 120 Cal. App. (2d) 92, 260 P. (2d) 794 (1953); In re Fuch's Estate, (Fla. 1952) 60 S. (2d) 539.

85 Weinberg v. Safe Deposit & Trust Co. of Baltimore, 198 Md. 539, 85 A. (2d) 50 (1951); Williamson v. Williamson, (Ark. 1954) 272 S.W. (2d) 72.

86 Lincoln Bank & Trust Co. v. Huber, (Ky. 1951) 240 S.W. (2d) 89; Pitts v. Hamrick, (4th Cir. 1955) 228 F. (2d) 486 (applying a decision of South Carolina probate court); Weyenberg v. United States, (D.C. Wis. 1955) 135 F. Supp. 299 (applying a Wisconsin probate court decision); and see Miller v. Hammond, 156 Ohio St. 475, 104 N.E. (2d) 9 (1952), subsequently overruled.

87 Northern Trust Co. v. Wilson, 344 Ill. App. 508, 101 N.E. (2d) 604 (1951); In re Uihlein's Will, 264 Wis. 362, 59 N.W. (2d) 641 (1953); Moorman v. Moorman, 340 Mich. 636, 66 N.W. (2d) 248 (1954); Wachovia Bank & Trust Co. v. Green, 236 N.C. 654, 73 S.E. (2d) 879 (1953); Campbell v. Lloyd, 162 Ohio St. 203, 122 N.E. (2d) 695 (1954), cert. den. 349 U.S. 911, 75 S.Ct. 600 (1955).

This discussion points to the obvious conclusion that there is no uniformity among the states in regard to the sharing of the estate tax load by the surviving spouse. And, consequently, there is no uniformity in whether or not the available marital deduction is to be reduced for a share of the estate taxes. Uniformity in practice is attainable only by making express provision in the decedent's will.[88]

In one apportionment area, at least, we thought uniformity had been achieved. That area pertains to the right of an executor to obtain contribution for a share of the estate tax burden from beneficiaries who have received property from the decedent outside the probate estate but in such manner that the property falls into the decedent's gross estate for federal estate tax purposes. For instance, in the case of life insurance beneficiaries, the Internal Revenue Code expressly creates a right of contribution, making the insurance beneficiary liable to the estate for a pro rata share of the federal estate burden, except that "this section shall not apply to such proceeds (received by a surviving spouse) except as to the amount thereof in excess of the aggregate amount of the marital deduction allowed. . . ."[89] The same rule of contribution exists in favor of the estate against persons who receive property because of a power held by the decedent in such manner as to include the property in his gross estate.[90]

A fair inference to be drawn from this language is that a surviving spouse's share is exempt from making a contribution to the extent that her share is deductible and therefore did not contribute

[88] This was the answer given by the dissenters in Miller v. Hammond, 156 Ohio St. 475, 104 N.E. (2d) 9 at 19 (1952). If the testator wants equality with community property states he can obtain it merely by so providing in his will; and, the dissenters went on to point out, the testator doesn't have the disadvantage inherent in community property: he is not required to give his surviving spouse as much property as she is entitled to under community property laws! As a matter of estate draftsmanship, we might point out the most advantageous tax apportionment clause is one that would not only protect the marital deduction but also eat into any part of the marital transfer in excess of the deduction. The reason for this conclusion should be obvious: any transfer to the surviving spouse in excess of the amount deductible will be taxed in both the decedent's and the surviving spouse's estates before passing to the second generation beneficiaries. Therefore, rather than have this excess amount transferred to the surviving spouse, you may find it more economical to apply it to the payment of estate taxes on the decedent's estate. In order to achieve this end, you might provide a tax apportionment clause that would apportion the estate tax first to the share of the surviving spouse to the extent, and only to the extent, that it exceeds the maximum marital deduction allowable. The remainder of the estate tax would be apportioned pro rata to all other beneficiaries.

[89] I.R.C., §2206.

[90] I.R.C., §2207; in both cases, the right of contribution may be waived by the decedent in his will.

to the measure of the tax. But this is not the interpretation placed upon the section by one of the probate courts that has ruled on the matter.

In *Weinberg v. Safe Deposit & Trust Co. of Baltimore,*[91] the court took the position that the federal statute was intended to apply only to insurance proceeds payable to a surviving spouse in excess of the deductible amount. Hence, as to the amount qualifying for the marital deduction, the federal provision did not apply and the local apportionment statute governed. Because the court had already interpreted its own apportionment statute to require contribution of a pro rata share of federal estate taxes from a surviving spouse's share even when deductible, the wife's share of the insurance proceeds was also subject to contribution. The fact that the entire amount had been a deductible amount in the decedent's gross estate was immaterial.

Thus, we are furnished with an example of the projection of local inequalities, arising out of local law, into an area for which Congress had attempted to legislate a uniform rule. It would be hard to find a better example of the extreme difficulties of writing a uniform rule of equalization for application among the several states and their varied property systems.

3. *Double Probate Expenses and Death Duties.* As those who practice in common law states know, the marital deduction is not an unmixed blessing. In practice the theoretical saving provided by the use of the maximum deduction is often not realized in full measure. One reason for this is the presence of local fees, taxes and expenses that are levied on the probate of an estate. Compare, for example, these charges on a marital deduction type of settlement versus a life estate remainder over settlement. At the time of the decedent's death probate fees and death duties are incurred on the entire estate. If the property is given outright to the surviving spouse, a second round of probate fees and death duties will be levied on the property on her death.

On the other hand, had the testator foregone the saving of a marital deduction transfer, he might have saved the second levy of fees and taxes by creating only a life estate in the surviving spouse; hence, on her death there would be no property in her estate to administer because the remainder interest in the property has al-

91 198 Md. 539, 85 A. (2d) 50 (1951).

ready been transferred directly to the second generation beneficiaries.[92] Thus the saving in fees and taxes must, in many cases, be considered as an offset to the saving of the marital deduction and must be borne in mind in determining how desirable the deduction actually is.

A number of states have eliminated this problem in regard to taxes by providing for a marital deduction modeled upon the federal prototype.[93] In such a jurisdiction there would be no doubling of state taxes because presumably a transfer that qualifies for the federal deduction would also qualify for the state marital deduction. The problem of double costs of administration would still exist even in these jurisdictions, however.

What we have said about the possible offsetting loss for double taxes and expenses under a marital deduction transfer does not apply to community property estates. In the latter case each spouse's community interest bears its own taxes and costs of administration. Each spouse's interest is treated as his own estate on his death; the interest of the surviving spouse is not administered in the estate of the decedent and suffers no diminution for taxes and expenses until it is probated on the subsequent death of its owner.[94]

To this extent, then, a saving in costs and local taxes is available to community property spouses that may be denied to their counterparts under the common law system. So long as the terminable interest rule forces the decedent to leave his property to the surviving spouse in such fashion that it will fall into her estate on her death, this disparity will exist.

92 This statement is not intended to imply that the price for escaping a second round of costs of administration and death duties is the loss of the marital deduction. An astute estate planner working within the framework of a given jurisdiction can frequently figure out transfers that will accomplish both results. We are also ignoring the costs of terminating a life tenancy of record under local procedure.

93 Without attempting to be all-inclusive, we find that at least two states (New York and North Dakota) have made provision for a marital deduction: N.Y. Tax Law (McKinney, 1954) §249-s; N.D. Rev. Code (Supp. 1953) §57-3711 (2). Similarly, California exempts 50% of the decedent's separate property, if that amount is transferred to his surviving spouse. Cal. Revenue and Taxation Code (Deering, 1952) §13805.

94 Invariably, it seems we must recognize an exception. In many community property states, as in the case of the widow's election discussed above, the surviving spouse may elect to have her community interest administered in her husband's estate. In this case, it would bear a pro rata share of the costs of administration, but not of taxes. However, on her subsequent death, a separate administration of her community interest would not be necessary.

4. *Choice of Assets.* As we have pointed out previously, the community interests of husband and wife are equal undivided interests in all the property held by them in community ownership. Neither spouse can pick and choose which specific community assets he wishes to own for himself; if he makes an effort to do so and obtains his spouse's consent to his sole ownership, he effects a conversion of the community ownership of the property into separate ownership. This conversion would be accomplished either by way of gift or exchange, depending upon the circumstances.

But their counterparts under the common law system labor in no such strait jacket.[95] In framing a marital deduction bequest, a spouse at common law is fairly free in his will to make whatever selection of assets he wishes between his marital bequest and other settlements. The proper use of this power to select is an important function of the estate planner in framing a marital deduction bequest most advantageously for his clients. A short discussion of these points will make this advantage clear.

First, as a general rule the testator should segregate his wasting assets and place them in the marital deduction transfer. By "wasting assets" is meant such properties as annuities, patents, copyrights, mineral leases, leaseholds, life estates (per autre vie), estates for years, insurance renewal commissions, etc., none of which are technically terminable interests in themselves.[96] These assets will be deductible in the decedent's gross estate at their full value as of the date of death or the date of optional valuation, whichever is selected. But because these assets are wasting, they may have disappeared completely on the death of the surviving spouse or else have become substantially depreciated in value. Hence little or nothing will be included in her estate and the family unit may escape estate taxation on them. What greater advantage could one desire?

Second, in the process of selecting assets for the marital bequest, the testator should keep in mind the income tax consequences of his

[95] Again we must point out a possible area of disagreement with the statement in the text. In most states a surviving widow is given an election to take against the will if she feels her husband has not treated her generously in his will. And her interests in his estate, assertable by her under such an election, would be analogous to a community spouse's interest in the community estate. It would reach all the assets equally and be an undivided interest therein until the date of partition by order of the probate court setting aside specific assets in satisfaction of her statutory interest.

[96] See discussion, Part B, 1 supra.

selection. For example, if his surviving spouse already possesses sufficient income to take care of her needs, he should refrain from giving her additional high income-producing properties. The tax rate on the income from these properties may virtually nullify the benefit of the bequest to her. Hence he may be well advised to select assets that produce little or no income for transfer to her. Among these would be works of art, personal objects, personal automobiles, the family home (none of which produces income), or income properties that produce high deductions to offset income, such as oil investments (depletion) or hotels (depreciation).

Third, assets should be selected with an eye to their treatment under state inheritance tax laws. If exemptions or exclusions are provided for certain types of properties, such as insurance proceeds, assets of this nature, such as insurance policies, should be transferred to the surviving spouse; on her subsequent death, these assets will then qualify for the exemption and not suffer diminution through a second levy of inheritance taxes.

These are advantages available to an estate planner that he may properly make use of in framing an estate plan in the best interests of his clients. Such planning has become, for obvious reasons, an integral part of marital deduction planning. It has, however, no counterpart in community property planning and to that extent represents a substantial advantage over the concepts of community estates.

II. EQUALIZATION UNDER THE FEDERAL GIFT TAX

A. *Statutory Framework*

The federal gift tax imposes a tax upon all gifts made by a person to another; the rate of tax imposed is progressive, rising from 2¼ percent on the first $5,000 of taxable gifts to a maximum rate of 57¾ percent. The rate is roughly three-quarters of the estate tax rate for the equivalent brackets.

Provision was made in the Revenue Act of 1948 to permit spouses to elect to split gifts made by one of them to a third party between themselves for the purpose of computing the tax on the gifts; this provision was introduced for the purpose of equalizing the tax treatment of gifts made from a spouse's separate property with that accorded to gifts made from community property.[97]

[97] I.R.C., §2513. See H. Rep. 1274, 80th Cong., 2d sess., 1948-1 Cum. Bul. 241 at 260-261.

Provision was also made for gifts inter spouse. In community property states each spouse is presumed to have contributed equally to the acquisition of community property; hence the creation of equal undivided interests in community property is not created as a taxable gift by one spouse to another. Consequently, the Revenue Act of 1948 attempted to duplicate in common law states this tax-free splitting of community property by providing for a tax-deductible method of transferring interests between spouses.[98] The device used was to write the concept of a marital deduction into the federal gift tax.

Section 2523 of the code permits a person who makes a gift to his spouse to deduct half its value from the measure of the amount of the gift for tax purposes. In other words, if a husband transfers $100,000 to his wife by gift, in a common law state he need treat only $50,000 of it as a taxable gift.

The section also contains a disqualification provision for terminable interests; the marital deduction allowable on a gift is forfeited if the donee's interest is one that may shift from her to another on the occurrence of a condition. Exceptions to the terminable interest disqualification are provided for property transfers that are substantially the equivalent of a fee interest. And, finally, gifts of community property are excluded from the benefits of the deduction.[99] All of these qualifying sections bear marked resemblance to their counterparts under the estate tax marital deduction and, in large part, our discussion concerning the estate tax provisions is applicable equally as well to the gift tax marital deduction.

B. *Lifetime Splitting Under the Gift Tax Marital Deduction*

That this formula for equalizing the two property systems under the gift tax is unsuccessful should be apparent. There is a tremendous pressure on an estate planner in a common law state to suggest a program of inter vivos gifts between the spouses in any case in which one spouse owns considerably more property than the other. If the richer spouse dies first, the estate planner can turn to the estate tax marital deduction and thus split the estate between the spouses for estate tax purposes. But if the poorer spouse dies first, the estate planner finds that the bulk of the estate

98 S. Rep. 1013, 80th Cong., 2d sess., 1948-1 Cum. Bul. 285 at 351.

99 I.R.C., §2523 (b), (e), and (f).

is in the hands of the surviving spouse who has now forfeited the opportunity of utilizing the marital deduction unless he remarries. And so, if he could, the estate planner would like to transfer part of the richer spouse's estate to the poorer prior to death in order to split the estate for estate tax purposes regardless of which spouse dies first.

But the price for making these gifts is a gift tax. The marital deduction under the gift tax is available only for half the property given to the poorer spouse; the other half is a taxable transfer. And weighing in the scales against these proposed lifetime gifts is the knowledge that the richer spouse can transfer one-half of his net estate to the poorer spouse completely tax-free on his death. Any gift tax previously paid on a transfer to the poorer spouse becomes an unnecessary expenditure if the richer spouse dies first.[100]

If lifetime splitting cannot be accomplished between spouses without incurring a tax liability, there is obviously no equality between the common law and community property systems under the federal gift tax.

C. *Gifts to Others*

Faced with this situation, the estate planner usually finds his solution to lie in encouraging gifts by the richer spouse directly to the secondary beneficiaries, by-passing his spouse. By such a program, the richer spouse can reduce the discrepancy between his own and his spouse's estates. The loss of the marital deduction to him will thus be much less severe if the poorer spouse dies first.

And here, unlike the situation under the gift tax marital deduction, the richer spouse may take advantage of the split-gift provisions without forfeiting other advantages he may have under the estate tax marital deduction. In this situation he is treated just like his counterpart in a community property state who makes gifts from the community property.[101]

III. CONCLUSION

We believe it is abundantly clear that the marital deduction has fallen short of its goal of equalization. On the quantitative side,

[100] See the discussion in Part I, B, 4 supra. Neither the credit for gift taxes (§2012) nor the credit for prior transfers (§2013) would be available to the estate of the poorer spouse on her subsequent death because she is the donee of the gifts. Nor are these credits available to the richer spouse, unless, in the case of the former, the gifts fall into the richer spouse's gross estate for estate tax purposes.

[101] See the discussion in Part I, B, 5 supra.

the major disparity grows out of the fact that the marital deduction is a function of only one spouse's estate, not of the total estate of both spouses (as in the case of community property splitting). And from the qualitative viewpoint, we find that even more discrepancies exist, brought about in part by the ingenuity of estate planners. A technical rule of disqualification, such as the terminable interest rule, is an open invitation for the design of plans that fall just outside the proscribed limits but within the rule's purpose.

Because the approach may have been unwise does not mean that the policy underlying the marital deduction is erroneous. But the marital deduction formula needs much greater revision than it received in 1954.

As a matter of ultimate social policy, we believe that it is hard to quarrel with the thesis that a man's estate and his earnings ought to be available to his spouse after his death without diminution for estate taxes. Perhaps this belief is an outgrowth and natural product of the community property system itself. A wife shares and contributes to the building up of her husband's accumulations equally as much in a common law jurisdiction as under community property rules. And, if this is true, it seems unfair to reduce the amount of these accumulations to which she has contributed by way of a tax on her husband's death. For these reasons the policy of the marital deduction has much to commend it.

But can such a policy be implemented by a statutory framework that will achieve equalization? Perhaps. One method would be to provide a complete exemption from estate and gift tax for all interspousal transfers. This is a suggestion that has been made frequently in the past and its adoption appears to be as remote as ever.[102]

Another suggestion for improvement would be to adopt a series of amendments to the present marital deduction formula. The first of these, we believe, ought to be to get rid of the qualitative restrictions on the types of transfer that qualify for the deduction. In other words, the terminable interest rule, which has caused so much grief and misunderstanding, should be eliminated, if for no other reason than the fact that its restrictions can readily be avoided both in common law and community property jurisdictions.

102 Surrey, "Federal Taxation of the Family—The Revenue Act of 1948," 61 HARV. L. REV. 1097 at 1161 (1948).

Coupled with this relief must obviously be a provision designed to catch the property in the surviving spouse's estate if it is deductible in the decedent's estate. Under the existing rule which exempts a remainder interest from taxation in the life tenant's estate, the terminable interest rule is essential in order to prevent wholesale tax avoidance. But if the rule is revised, or if a condition is attached to the deduction that the surviving spouse agree to report the value of the remainder in her estate, this difficulty would be eliminated. At any rate, an amendment of the rules relating to the taxation of life tenants must go hand in hand with any relaxation of the terminable interest rule.

Turning to the quantitative inequalities that presently exist under the marital deduction formula, we believe that the best hope for equality lies in the correlation of the estate and gift taxes into one over-all transfer tax pattern. In other words, gifts by living persons should be treated as part of a person's ultimate estate plan, which in many cases they really are. A tax would be levied on these gifts as a prepayment of the ultimate estate tax due.

Basically, what we are trying to do is to permit an owner of common law property to transfer one-half of it to his spouse tax-free, whether the transfers are during life or at death. The available marital deduction would be exhausted either by inter vivos gifts or by bequests at death. To the extent that gifts during life had been made under the deduction, the amount of the deduction allowable at death would be correspondingly reduced.

And, finally, to accomplish complete equality, we would find it necessary to make the deduction a function of the total estate of both spouses.[103] The amount of the deduction would no longer be one-half of the decedent's adjusted gross estate, but it would be one-half of the total of the decedent's estate plus his spouse's property. Any property owned by his spouse would reduce the amount of the deduction dollar for dollar, regardless of the source from which the property came. As we have pointed out in some detail earlier,[104] only a formula based on the total holdings of both spouses can approach the philosophy behind the community system.

Whether or not these suggestions are of value and would provide a feasible and workable solution to the dilemma of equaliza-

[103] Cf. Sugarman, "Estate and Gift Tax Equalization—The Marital Deduction," 36 CALIF. L. REV. 223 at 280 (1948).

[104] See Part I, A, 2 supra.

tion will depend upon the thought and criticism that can be brought to bear upon them. Perhaps the changes brought forward here would only serve to complicate even more an already complicated problem. But, on the other hand, these suggestions may ultimately prove to be an acceptable solution to our present difficulties and complexities. Only further study and criticism can give the answer.