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Federal and Colorado Death and Gift Taxes - A Comparison

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FEDERAL AND COLORADO DEATH AND GIFT TAXES A COMPARISON

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I. INTRODUCTION

In a comparison of the federal estate tax law with the Colorado inheritance tax law, a basic distinction should be kept in mind. An estate tax is levied on the transfer of property *from* a decedent to his estate, while an inheritance tax is imposed on the transfer *to* a beneficiary of a decedent. Since the main function of gift taxes is to supplement and prevent the avoidance of death taxes, this distinction also should be remembered in comparing the federal and Colorado gift tax laws.

Many of the differences between federal and Colorado law in this area spring from the above distinction. Other differences arise from the fact that, although Colorado attempts to follow the federal law in many respects, it is often several years behind a tax-conscious Congress. Of course, some variations are accounted for by policy considerations upon which the two legislative bodies involved do not agree, while others stem from the fact that certain provisions necessary in a federal law would not apply to an individual state, and vice versa.

This article will not cover all the possible variations involved, but will be concerned only with the principal distinctions, mainly substantive, in order that a guide may be provided with regard to problems in the death and gift tax fields in Colorado.

II. FEDERAL ESTATE TAX AND COLORADO INHERITANCE TAX

THE TRANSFERS TAXED

Property Passing by Will or Intestate Succession. Both federal and Colorado laws tax the transfer of property by will or intestate succession.

The former[1] provides that the gross estate shall include all property to the extent of the decedent's interest therein at the time of his death, while the latter[2] states that a transfer is taxable if made by will or by statutes regulating the descent and distribution of property.

These sections thus cover the common garden-variety case where a person dies owning property and the transfer of such property is taxed. There are no important variations between federal and Colorado law here. There is, of course, a difference in the manner of reporting the transfer and paying the tax, due to the above mentioned distinction between an estate tax and an inheritance tax. This will be covered later in the article, since it applies to all taxable transfers, not just those occurring at death.

Transfers in Contemplation of Death. In order to prevent the avoidance of death taxes through the medium of lifetime transfers motivated by, or taking effect at, death, certain provisions have been inserted in both federal and Colorado law taxing such transactions as if they were actually death transfers. One such provision, common to both laws,[3] pertains to transfers "in contemplation of death."

For federal estate tax purposes there is a rebuttable presumption that any transfer of property made within three years of death is made in contemplation of death, while Colorado designates two years as the crucial period. However, the federal law goes on to say that a transfer made *more* than three years prior to death is conclusively *not* in contemplation of death, while Colorado law is silent as to transfers before its two-year period, so such transfers could also be included.

The two jurisdictions are in complete agreement on the meaning of the phrase "contemplation of death." The federal definition stems from the 1931 Supreme Court case *United States v. Wells;*[4] while Colorado spells out its interpretation in Rule 8 of its Inheritance Tax Regulations. The language used in this rule was apparently taken from the *Wells* case. The test in each case is one of motive—whether the purpose of the transfer was one associated with death.

Transfers with Retained Life Estate. Originally the federal estate tax law used only the general language "transfer . . . intended to take effect in possession or enjoyment at or after . . . death" to cover all lifetime transfers (other than those in contemplation of death) includible in the gross estate. The difficulty which courts had in the interpretation of this phrase, particularly in the rather startling *May v. Heiner*[5] decision, led to more detailed provisions in this area and, finally, as more and more specific types of such transfers were covered by the statute, the phrase disappeared entirely from the law.

One of the federal provisions spawned by this phrase is section 2036.[6] Briefly stated, it sweeps into the gross estate any lifetime transfer made by the decedent wherein he retained the possession of or income from the property (or the right to designate who should possess it or receive its income) for his life, for any period not ascertainable without refer-

[1] Int. Rev. Code of 1954, § 2033.
[2] Colo. Rev. Stat. § 138-4-7(1) and (2) (1953).
[3] Int. Rev. Code of 1954, § 2035; Colo. Rev. Stat. § 138-4-7(3) (1953).
[4] 283 U.S. 102 (1931).
[5] 281 U.S. 238 (1931).
[6] Int. Rev. Code of 1954, § 2036.

ence to his death, or for any period which does not in fact end before his death.

The Colorado law still has the general language "intended to take effect at or after death."[7] The section goes on to say that the reservation of a life interest shall be deemed to be such a transfer. The specific mention of a reserved life estate is not as broad as the above federal rule on such reservations, but presumably the general Colorado language would cover most of the cases embraced in federal section 2036.

Transfers Taking Effect at Death. Another section of the federal code whose origin was the language "taking effect at death" is section 2037.[8] The present requirements of this section were developed only after a painful (for the taxpayer) succession of cases beginning in 1931 with *Klein v. United States*[9] and ending in 1949 with *Estate of Spiegel v. Commissioner.*[10] The trend of these cases seemed to indicate that eventually a lifetime transfer might be included in the gross estate for the sole reason that the decedent's death was the occasion for the shifting of beneficial enjoyment of the property, without any other supporting facts. At this point Congress stepped in and passed a series of amendments to this part of the law, finally resulting in the present section 2037. A transfer of property is now included in the gross estate of the decedent if it is made in such a way that possession or enjoyment of the property can be obtained only by surviving the decedent, and he has retained a reversionary interest in the property exceeding five per cent of its value.

As mentioned above, the Colorado statute still contains the general language "at or after death,"[11] but the regulations[12] are more specific and contain the two elements of survivorship and a reversionary interest found in federal section 2037. However, as to the second element, the wording is *any* interest rather than one exceeding five per cent of the value of the property.

Subsection (5) of the same section of the Colorado statute[13] covers a situation where the decedent entered into a contract, for less than full consideration, under the terms of which his estate was to make payment at or after his death. This type of case would be covered under the general language of section 2033,[14] coupled with section 2053 (c) (1) (A),[15] of the federal law.

Revocable Transfers. Federal law[16] requires a transfer to be included in the gross estate if the decedent had, at the time of his death, the power to alter, amend, revoke, or terminate the transfer. Colorado's comparable section[17] is somewhat more limited, in that it relates only to transfers in trust and applies only where the exercise of the power would revest the property in the decedent. However, transfers not included under this section might still fall within section 138-4-7 (4).

Annuities. Under federal law,[18] the value of an annuity receivable by any beneficiary by reason of surviving the decedent is included in the latter's gross estate to the extent that he contributed to the cost, with

7 Colo. Rev. Stat. § 1938-4-7(4) (1953).
8 Int. Rev. Code of 1954, § 2037.
9 283 U.S. 231 (1931).
10 335 U.S. 701 (1949).
11 Colo. Rev. Stat. § 138-4-7(4) (1953).
12 Colo. Inheritance Tax Comm., Rules and Regulations, Rule 9 (1950).
13 Colo. Rev. Stat. § 138-4-7(5) (1953).
14 Int. Rev. Code of 1954, § 2033.
15 Id. § 2053(c)(1) (A).
16 Id. § 2038.
17 Colo. Rev. Stat. § 138-4-10 (1953).
18 Int. Rev. Code of 1954, § 2039.

certain exceptions and limitations. Apparently in Colorado, annuities would be dealt with as property passing by will or intestate succession[19] or, in the case of joint and survivor annuities, as property held in joint names.[20] No exemption is allowed as is the case with insurance policies.[21]

Joint Interests. The federal law includes the entire value of property held by the decedent and another person as joint tenants, except to the extent that such other person can prove his contribution thereto and that such contribution was not received by him from the decedent for less than a full consideration.[22] If the property was acquired by the joint tenants as a gift or inheritance, then only the decedent's fractional share is included.

Colorado taxes joint tenancies in proportion to the decedent's *interest,* except in the cases of co-ownership of United States government securities and bank accounts, which are taxed in proportion to his *contribution.*[23]

Powers of Appointment. The federal code[24] taxes the value of property with respect to which the decedent had a general power of appointment at the time of his death, meaning a power exercisable in favor of himself or his estate, or the creditors of either.[25] The Colorado provision is similar in that it considers either the exercise or nonexercise of a power of appointment a taxable transfer to the appointee, or to the person taking in lieu of appointment.[26]

Proceeds of Life Insurance. The federal code includes the proceeds of life insurance in the decedent's gross estate, if payable to his estate or, provided he had any of the "incidents of ownership" in the policy, if payable to third parties.[27] Colorado also taxes the proceeds if payable to the estate, or to third parties if the decedent had incidents of ownership. But in the latter case there is a $75,000 exemption. If the decedent had no incidents of ownership and the proceeds were not payable to his estate, then the transfer is not included at all.[28]

VALUATION

The transfers taxed are valued as of the date of the decedent's death

19 Colo. Rev. Stat. § 138-4-7(1) and (2) (1953).
20 Id. § 138-4-8 (1953).
21 Id. § 138-4-9 (1953).
22 Int. Rev. Code of 1954, § 2040.
23 Colo. Rev. Stat. § 138-4-8 (1953).
24 Int. Rev. Code of 1954, § 2041.
25 Id. § 2041(b)(1).
26 Colo. Rev. Stat. § 138-4-12 (1953).
27 Int. Rev. Code of 1954, § 2042.
28 Colo. Rev. Stat. § 138-4-9 (1953).

under both federal[29] and Colorado[30] law, but both laws provide for an optional valuation date one year after death.[31]

EXEMPTIONS

Federal law[32] allows an exemption of $60,000 in computing the taxable estate. Due to the different nature of an inheritance tax, the Colorado exemptions are allowed to the *beneficiaries* and depend upon their respective degrees of relationship to the decedent.[33]

DEDUCTIONS

Expenses, Indebtedness, and Taxes. Under federal law,[34] there may be deducted from the gross estate funeral expenses, administration expenses and claims against the estate. State inheritance taxes are not usually deductible, although they may qualify for a *credit.*[35]

Colorado law[36] allows deductions in a similar fashion, but restricts expenses for a monument or memorial to $500. The federal estate tax is not deductible, nor is there any provision for a credit with respect to it.

Losses. Federal section 2054[37] allows a deduction for casualty and theft losses incurred during the settlement of estates, but Colorado makes no such specific provision.

Charitable Deduction. Both the federal[38] and the Colorado[39] laws allow deductions for transfers to qualifying charities.

Marital Deduction. Section 2056 of the federal code permits a deduction for the value of property passing to the surviving spouse (not a "terminable interest"), to the extent such property is included in the gross estate, not to exceed fifty per cent of the adjusted gross estate. The

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[29] Int. Rev. Code of 1954, § 2031.
[30] Colo. Rev. Stat. §§ 138-4-14 and 138-4-32 (1953).
[31] Int. Rev. Code of 1954, § 2032 and Colo. Rev. Stat. § 138-4-6 (1953).
[32] Id. § 2052.
[33] Colo. Rev. Stat. § 138-4-14 (1953) provides as follows: "The following beneficiaries shall be included in:
"Class A. Father, mother, husband, wife, child, or any child or children legally adopted as such, or to any lineal descendant of such decedent born in lawful wedlock; provided that for the purpose of this article no person shall be considered legally adopted unless the adoption decree was entered prior to such person reaching the age of twenty-one years.
"Class B. Wife or widow of the son, or the husband or widower of the daughter, or the grandfather or grandmother, or any brother or sister, or any person to whom the deceased, for not less than ten years prior to death, stood in the mutually acknowledged relation of a parent; provided such relationship began at or before said person's fifteenth birthday and was continuous for ten years thereafter; and, provided that except in the case of a stepchild, the parents of such person so standing in such relation shall be deceased when such relationship commenced.
"Class C. Any uncle, aunt, niece, or nephew, or any lineal descendant of the same.
"Class D. All other persons and corporations not exempt from taxation under this article.
"Collateral relatives of the half-blood shall be entitled to the same exemptions, and shall pay the same rates of tax, as corresponding relatives of the whole blood."
Colo. Rev. Stat. § 138-4-15(2) (1953) then provides:
"Transfers to a wife shall be taxable only to the extent that the value of the property transferred exceeds twenty thousand dollars; and transfers to any other person in class A shall be taxable only to the extent that the value of the property exceeds ten thousand dollars, provided that in the event the statutory allowance to widow or children is claimed and allowed such allowance shall not constitute an exemption in excess of that provided in this section; and transfers to any person in class B shall be taxable only to the extent that the property exceeds two thousand dollars. No transfer to any person or corporation in classes C and D shall be taxable unless the value of the property exceeds five hundred dollars, in which case the entire transfer shall be taxable. If the decedent be not a resident of this state then the exemption allowable shall be the proportion of the allowable exemption in the case of residents that the net property taxable by this state bears to the whole net property transferred by the decedent to the transferee."
[34] Int. Rev. Code of 1954, § 2053.
[35] Id. § 2011.
[36] Colo. Rev. Stat. § 138-4-16 (1953).
[37] Int. Rev. Code of 1954, § 2054.
[38] Id. § 2055.
[39] Colo. Rev. Stat. § 138-4-15 (1953).

principal purpose of this section is to equalize noncommunity with community property states. There is no such deduction allowed in Colorado, of course, although there is an exemption for a surviving spouse, as previously discussed.

TAX RATES

Federal estate tax rates[40] range in a graduated table from three per cent to seventy-seven per cent of the "taxable estate" (gross estate, less exemption and deductions), while Colorado inheritance tax rates[41] depend upon the class in which the beneficiary falls[42] and vary from a low of two per cent to a high of sixteen per cent. There is also an old-age pension tax in Colorado equal to ten per cent of the inheritance tax.[43]

CREDITS AGAINST THE TAX

State Death Taxes. Internal Revenue Code section 2011 allows a certain credit, a deduction directly from the tax, for state death taxes paid where the taxable estate exceeds $40,000. The credit is subject to several minor limitations.

As previously mentioned, Colorado allows no deduction or credit for federal estate taxes paid. It does, however, impose an additional "estate" tax to take full advantage of the federal credit![44] The purpose is obvious—to collect the maximum revenue for Colorado, since to the extent the credit is unused, it represents a diversion to the United States Treasury, dollar for dollar.

[40] Int. Rev. Code of 1954, § 2001.
[41] Colo. Rev. Stat. § 138-4-14 (1953).
[42] See note 33 supra.
[43] Colo. Rev. Stat. 101-2-2 (1953).
[44] Id. §§ 138-4-25 and 138-4-26 (1953).

Gift Tax Credit. Both federal[45] and Colorado[46] laws allow a credit for gift taxes paid with respect to property later subject to death taxes in the estate of the donor.

Prior Transfers. The federal law[47] allows a sliding-scale credit for estate taxes paid with respect to transfers from another decedent to the present decedent which are included in the latter's gross estate. Roughly speaking, the amount of the credit is that part of the former estate tax required to be paid because of the inclusion of the property in question in the former estate. The purpose, of course, is to soften the blow of successive estate taxes on the same property within a short period of time. One hundred per cent of the credit is allowed if the prior decedent died within two years before the death of the present decedent (or two years after, which could arise where the other decedent made a lifetime transfer to the present decedent, which was required to be included in the gross estate of both). The credit is eighty per cent if the prior decedent died from two to four years before the present decedent, and so on down to twenty per cent, if between eight and ten years.

Colorado also allows a credit for prior transfers, but a shorter period is specified (three years) and no sliding-scale feature is included.[48]

III. FEDERAL GIFT TAX AND COLORADO GIFT TAX

Gift taxes are not important revenue-raising measures. Their main function is to supplement, and discourage the avoidance of, death taxes. The principal differences between the federal gift tax and the Colorado gift tax arise for the same reasons as set out in the beginning of this article with regard to death taxes.

THE TRANSFERS TAXED

Federal law[49] and Colorado law[50] are substantially the same; each imposes a tax on the transfer of property by gift by an individual. Colorado, however, by statute requires a donative intent,[51] while the federal law does not.[52]

VALUATION

The property transferred is valued as of the date of the gift.[53]

EXCLUSIONS

The federal law allows a donor to exclude up to $3,000 per donee per year from the amount of his taxable gifts, except where the gift is of a future interest in property.[54]

Colorado permits a similar annual exclusion,[55] the amount depending on the degree of relationship to the donor. As to Class *A* donees, the exclusion is $2,500, Class *B*—$1,500, and Classes *C* and *D*—$1,000.[56]

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45 Int. Rev. Code of 1954, § 2012.
46 Colo. Rev. Stat. § 138-5-12(1) (1953).
47 Int. Rev. Code of 1954, § 2013.
48 Colo. Rev. Stat. § 138-4-18 (1953).
49 Int. Rev. Code of 1954, § 2501.
50 Colo. Rev. Stat. § 138-5-1 (1953).
51 Id. § 138-5-7 (1953).
52 Int. Rev. Code of 1954, § 2512(b); Commissioner v. Wemyss, 324 U.S. 303 (1945).
53 Int. Rev. Code of 1954, § 2512; Colo. Rev. Stat. § 138-5-6 (1953).
54 Int. Rev. Code of 1954, § 2503.
55 Colo. Rev. Stat. § 138-5-5 (1953).
56 See note 33 supra.

EXEMPTIONS

Each donor is allowed a lifetime exemption of $30,000 under federal law,[57] while Colorado[58] permits exemptions in accordance with the class of donee, which are the same amounts as under the inheritance tax law, that is, $20,000 for gifts to the wife of the donor, $10,000 for gifts to others in Class *A*, $2,000 to Class *B*, and $500 to Classes *C* and *D*.[59]

DEDUCTIONS

Both federal[60] and Colorado[61] statutes permit deductions for the value of gifts to qualifying charities. Unlike Colorado, the United States allows a marital deduction of one-half the value of gifts to a spouse, with certain limitations, [62] and also allows a husband and wife to split their gifts to third parties.[63]

TAX RATES

The federal gift tax rates[64] are three-fourths of the estate tax rates and range from a low of 2¼ per cent of taxable gifts in any one year to a high of 57¾ per cent. The tax is cumulative in the sense that, roughly speaking, it is first computed as if all the gifts were made in the current year and a credit is then given for taxes paid on prior years' gifts. The effect is that the more taxable gifts a donor makes in his lifetime, the higher brackets he reaches. The Colorado gift tax is also cumulative and the rates are the same as in the inheritance tax law.[65]

MISCELLANEOUS PROVISIONS

Creation of Joint Tenancies. Federal section 2515 permits a husband and wife to elect whether or not to treat the creation of a joint tenancy in real estate with the funds of one, as a gift to the other. No such election is permitted in Colorado, and such transaction would be treated as a gift at the time of creation.

Certain Property Settlements. Internal Revenue Code section 2516 in effect exempts certain property settlements between husband and wife from the gift tax. The same result would probably be reached in Colorado without express statutory provision.

IV. CONCLUSION

Basically, both federal and Colorado law are attempting to accomplish the same objectives in this field. The primary purpose, of course, is the raising of revenue, but coupled with this is the accomplishment of certain objectives, such as preventing the concentration of wealth, encouraging wide and frequent distribution of property, stimulating gifts and bequests to charity, and so on.

Historically, most state death taxes have been of the inheritance type, rather than the estate type, although some states, for example, New York, have switched to an estate tax. An inheritance tax does

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57 Int. Rev. Code of 1954, § 2521.
58 Colo. Rev. Stat. § 138-5-4(2) (1953).
59 See note 33 supra.
60 Int. Rev. Code of 1954, § 2522.
61 Colo. Rev. Stat. § 138-5-4(1) (1953).
62 Int. Rev. Code of 1954, § 2523.
63 Id. § 2513.
64 Id. § 2502.
65 Colo. Rev. Stat. § 138-5-3 (1953).

have the advantage that it can be graduated to fit the degree of relationship of the beneficiary to the decedent and the amount received. Thus the tax is computed separately as to each beneficiary and his share of the tax (unless the will provides otherwise) is withheld from his distributive share by the personal representative of the decedent, and paid to the state.

An estate tax, on the other hand, is probably easier to administer, because it is levied on a single sum, the "taxable estate," the amount of which can be ascertained as of the date of death, and does not depend, as does the inheritance tax, on possible contingent future interests, where the persons who will take, and their respective shares, may be unknown for years to come. This problem has led to a number of special sections in the Colorado law[66] for which, of course, there are no comparable provisions in the Internal Revenue Code.

In spite of the basic difference between the two types of taxes, it would seem that more uniformity could be accomplished by the Colorado Legislature without the sacrifice of revenue. Just as in the income tax law, many of the distinctions between federal and Colorado law are not based on any legitimate purpose, and only serve to complicate the administration of both laws. It would appear that an overhauling of the Colorado inheritance and gift tax laws, and the issuance of up-to-date rules and regulations would be in order.

[66] See, e.g., Colo. Rev. Stat. §§ 138-4-19 to 138-4-23 (1953).