FEDERAL REGULATION OF FAMILY SETTLEMENTS*

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WHEN the constitutionality of the federal inheritance tax act of 1898¹ came before the Supreme Court in *Knowlton v. Moore*,² the first question considered by Mr. Justice White (after his historical survey of this form of taxation) was:

Can the Congress of the United States levy a tax of that character? The proposition that it cannot rests upon the assumption that, since the transmission of property by death is exclusively subject to the regulating authority of the several states, therefore the levy by Congress of a tax on inheritances or legacies, in any form, is beyond the power of Congress, and is an interference by the national government with a matter which falls alone within the reach of State legislation.³

Mr. Justice White concluded that the point was without merit:

Under our constitutional system both the National and the State governments, moving in their respective orbits, have a common authority to tax many and diverse objects, but this does not cause the exercise of its lawful attributes by one to be a curtailment of the powers of government of the other, for if it did there would practically be an end of the dual system of government which the Constitution established.⁴

A similar question was raised as to the 1916 law,⁵ the first of the current series of federal taxes on transfers at death. The 1916 law differed from the 1898 law in imposing an estate tax rather than an inheritance tax,⁶ and it was urged that the "tax is cast upon a transfer while it is being effectuated by the State itself and therefore is an intrusion upon its processes, whereas a legacy tax is not imposed until the process was complete." The Court again upheld the federal taxing power, saying that this kind of a tax "has ever been treated as a duty or excise, because of the par-

* This article is a revision of an address delivered before the New York State Society of Certified Public Accountants. It is also being published in the *Journal of Accountancy*.

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¹ 30 Stat. 448 (1898).

² 178 U.S. 41 (1900).

⁴ *Id.* at 60.

³ *Id.* at 56.

⁵ 39 Stat. 765, 777 (1916).

⁶ "A tax upon the exercise of the legal power of transmission of property by will or descent," rather than a tax upon "the legal privilege of taking property by devise or descent." See *Stebbins v. Riley*, 268 U.S. 137 (1925).

ticular occasion which gives rise to its levy' . . . Upon this point a page of history is worth a volume of logic."⁷

Thus was established, on sound doctrinal grounds, the power of Congress to tax successions. Since at its renaissance in 1916, the tax was levied at low rates, the highest bracket being ten per cent of the net estate in excess of \$5,000,000,⁸ and its provisions were not very inclusive, it cannot have had much effect upon the form of successions. But it had great potential power in this respect; if the rates were raised and the definitions of the transfers included within the gross estate elaborated, as has now been done, the tax could have quite as much (or more) force in determining the time and the character of large dispositions of property, as any state regulatory statute. The Treasury, however, does not seem to have extended its studies of the tax beyond its revenue potentialities; and great as these may be, they are secondary to its social and economic consequences. For these reasons, a study of the probable effects of the present tax upon the legal forms of dispositions of estates is pertinent, now that the rates are at their peak in our fiscal history, and the tax is effectively supplemented by a gift tax.

I. ELABORATION OF THE TAXING PROVISIONS

The estate tax imposed by the 1916 law was a comparatively simple affair, the definition of the gross estate occupying three subdivisions of section 202 and half a page. Property of the decedent subject to the payment of charges against his estate and administration expenses; property transferred in contemplation of death, and transfers intended to take effect in possession or enjoyment, at or after death; and property held in joint tenancy or in a tenancy in the entirety, was included. The first provision, taxing property actually passing at death, was found to permit a leak of revenue, since in some states real estate of the decedent is not subject to the payment of expenses of administration, and hence was not included in the gross estate under the original statutory wording.⁹ It was accordingly amended to include all property of the decedent to the extent

⁷ *New York Trust Co. v. Eisner*, 256 U.S. 345, 349 (1921), quoting from *Knowlton v. Moore*, 178 U.S. 41, 81 (1900).

⁸ The tax yielded \$6,076,575.26 in the fiscal year 1917; receipts reached a peak of \$154,043,260.39 in 1921; and thereafter declined with lowered rates to \$34,309,724 in 1933. In 1934, \$113,138,364 was collected; in 1935, \$140,440,682.34; and in 1936, \$218,780,753.53, plus \$160,058,761.47 from the gift tax. The full impact of the present estate tax rates, raised to their present peak August 30, 1935, has not yet been recorded in the revenues, since the tax is payable fifteen months after death.

⁹ See *Crooks v. Harrelson*, 282 U.S. 55 (1930).

of his interest therein at the time of his death.¹⁰ In addition, any interest in the decedent's property surviving in his spouse in the form of dower, curtesy, or statutory substitutes therefor, was included in the measure of the tax.¹¹

More far-reaching changes were made in the course of the twenty years after 1916, in greatly increasing the detail and the scope of the subdivisions which subjected designated *inter vivos* transfers to the estate tax. Congress successively plugged various loopholes, which permitted various forms of quasi-testamentary transfers to go tax-free, and was in fact so diligent in this work, that, with the addition of the gift tax, many loopholes were plugged twice. To the original four categories of *inter vivos* transfers subjected to the estate tax were added three more, plus a sweeping subdivision intended to make the previous provisions applicable retroactively to prior completed transfers. These specifically included in the gross estate assets transferred by the decedent subject to a power in himself either alone or in conjunction with another to alter, amend or revoke;¹² property passing under a general power of appointment exer-

¹⁰ "The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—except real property situated outside the United States. . . .

"(a) To the extent of the interest therein of the decedent at the time of his death; . . . " Sec. 302, Revenue Act of 1926, as amended by the Revenue Act of 1934.

¹¹ After the opening paragraph quoted in note 10 *supra*:

"(b) To the extent of any interest therein of the surviving spouse, existing at the time of the decedent's death as dower, curtesy, or by virtue of a statute creating an estate in lieu of dower or curtesy; . . . "

¹² An express provision for the inclusion of the corpus of revocable trusts in the gross estate first appeared in federal law in 1924 (43 Stat. 253); but the Supreme Court held in 1929 (*Reinecke v. Northern Trust Co.*, 278 U.S. 339, 348) that a trust revocable by the settlor alone was "intended to take effect in possession or enjoyment at or after his death," and so fell within the gross estate under prior laws. The present subdivision reads:

"(d) (1) To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona-fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished in contemplation of decedent's death.

"(2) For the purpose of this subdivision the power to alter, amend, or revoke shall be considered to exist on the date of the decedent's death even though the exercise of the power is subject to a precedent giving of notice or even though the alteration, amendment, or revocation takes effect only on the expiration of a stated period after the exercise of the power, whether or not on or before the date of the decedent's death notice had been given or the power has been exercised. In such cases proper adjustment shall be made representing the interests which would have been excluded from the power if the decedent had lived, and for such

cised by the decedent;¹³ and the proceeds of life insurance policies taken out by the decedent upon his own life.¹⁴ Although no new categories of transfers have been inserted since 1926, the wording has been frequently extended in later revenue acts, generally to offset court decisions giving an interpretation to existing law which the Treasury regarded as unduly narrow.¹⁵

The increase in estate tax rates did not go along *pari passu* with the extension of the scope of the act. In 1916, the top bracket was ten per cent upon the portion of net estates in excess of \$5,000,000. Even under war pressure, it became in 1919 only twenty-five per cent of the excess

purposes if the notice has not been given or the power has not been exercised on or before the date of his death, such notice shall be considered to have been given, or the power exercised, on the date of his death.

"(3) The relinquishment of any such power, not admitted or shown to have been in contemplation of the decedent's death, made within two years prior to his death without such a consideration and affecting the interest or interests (whether arising from one or more transfers or the creation of one or more trusts) of any one beneficiary of a value or aggregate value, at the time of such death, in excess of \$5,000, then, to the extent of such excess, such relinquishment or relinquishments shall, unless shown to the contrary, be deemed to have been made in contemplation of death within the meaning of this title." Sec. 302 (d), as amended by the Revenue Act of 1936.

¹³ The first specific mention of this form of transfer in the estate tax law appeared in the Revenue Act of 1918 (40 Stat. 1057). The present subdivision reads:

"(f) To the extent of any property passing under a general power of appointment exercised by the decedent (1) by will, or (2) by deed executed in contemplation of, or intended to take effect in possession or enjoyment at or after, his death, or (3) by deed under which he has retained for his life or any period not ascertainable without reference to his death or for any period which does not in fact end before his death (A) the possession or enjoyment of, or the right to the income from, the property, or (B) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom; except in case of a bona fide sale for an adequate and full consideration in money or money's worth." Sec. 302 (f), as amended by the Revenue Act of 1932.

¹⁴ This subdivision came into the federal estate tax law in 1918 (40 Stat. 1057), and has been continued in the same form ever since:

"To the extent of the amount receivable by the executor as insurance under policies taken out by the decedent upon his own life; and to the extent of the excess over \$40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life." Sec. 302 (g).

¹⁵ Most notable are the series of amendments to Section 302 (c). On March 2, 1931, the Supreme Court, by a series of *per curiam* decisions, held that property transferred in trust to pay the settlor the income for his life, with remainders over, need not be included in the gross estate under the existing law. *Burnet v. Northern Trust Co.*, 283 U.S. 782 (1931); *Morsman v. Burnet*, 283 U.S. 783 (1931); *McCormick v. Burnet*, 283 U.S. 784 (1931). Congress amended the law on the following day to include such a transfer (and others) specifically in the gross estate; and further elaborated the provisions in the Revenue Act of 1932, § 803 (a). A similar elaboration has occurred in sec. 302 (d). See also *Surrey and Aronson*, *Inter Vivos Transfers and the Federal Estate Tax*, 32 Col. L. Rev. 1332 (1932).

over \$10,000,000. In 1924, the rate on this latter bracket became forty per cent, but in 1926, was reduced to twenty per cent. In 1932, the rate on this top bracket was again advanced to forty-five per cent, and in 1934, to sixty per cent. In 1935, additional upper brackets were inserted, and the highest rate became seventy per cent upon net estates in excess of \$50,000,000.¹⁶ The exemption, \$50,000 in 1916, was \$100,000 in 1926; and is now \$40,000.¹⁷ Finally, in 1932, the short-lived gift tax of 1924-25 was revived,¹⁸ and has since been continued, with rates numerically three-fourths of the estate tax rates; actually, as will be shown, the effective rates are much lower.

In 1924, as the result of complaints directed at the federal government's invasion of this field of taxation, hitherto occupied by the States, a provision was introduced¹⁹ giving a credit for state inheritance and estate taxes paid, in an amount not to exceed twenty-five per cent of the federal tax.²⁰ The amount of the credit was increased in 1926 to eighty per cent, coincident with a reduction in the federal rates.²¹ It appeared that the federal government was about to desert the estate tax field, with only a parting admonition to the states that their estate and inheritance rates should equal but not exceed four-fifths of the low federal rates.²² But the necessities of the depression ended this strategic retreat by Congress. In 1932, the states having largely adjusted their rates to equal the federal credit exactly, an additional federal estate tax was imposed,²³ to which the credit was inapplicable. It is these additional rates which were increased in 1934 and again in 1935. The 1926 rates are in reality left in effect only for the purpose of the determination of the credit for state taxes.²⁴ Although the credit, in the case of sizeable estates, does not now

¹⁶ Sec. 201 (a), Revenue Act of 1935, amending sec. 401 (b) of the Revenue Act of 1932, as amended. The highest rate of the British estate tax is fifty per cent on estates in excess of £2,000,000. There are low additional legacy and succession duties. See Magill, Parker and King, *A Summary of the British Tax System* 26 (1934).

¹⁷ Sec. 201 (b), Revenue Act of 1935, amending sec. 401 (c) of the Revenue Act of 1932.

¹⁸ Revenue Act of 1932, § 501 *et seq.*

¹⁹ Sec. 301 (b), Revenue Act of 1924.

²⁰ The validity of the provision was upheld in *Florida v. Mellon*, 273 U.S. 12 (1927); see *Machen, The Strange Case of Florida v. Mellon*, 13 *Corn. L. Q.* 351 (1928); 16 *Calif. L. Rev.* 447 (1928); 27 *Col. L. Rev.* 462 (1927).

²¹ Sec. 301 (c), Revenue Act of 1926.

²² The Senate Committee on Finance recommended the repeal of the estate tax in 1926 *Sen. Rep. no. 52*, 69th Cong. (1st session), p. 7. The provisions for an estate tax contained in the House bill were restored in conference, with an increase in the exemption from \$50,000 to \$100,000. *House Rep. no. 356*, 69th Cong. (1st session 1926), pp. 49-50.

²³ Sec. 401, Revenue Act of 1932.

²⁴ The conditions and limitations of the credit are described in *Treas. Reg. 80*, art. 9 (b).

exceed twenty-five per cent of the actual federal tax, the state taxes for the most part have been kept within it.

A final preliminary observation is that the sanctions of the present provisions of the estate tax and gift tax operate most notably in the cases of large estates, and relatively slightly in the cases of small estates. It can fairly be said that, in the case of net estates under \$50,000, transfer taxes have little effect upon the form of disposition. The combined federal and New York estate taxes upon a net estate of \$50,000 (before exemptions) will be less than \$400. Even in the case of a net estate of \$100,000 the combined taxes are \$5,200, without any deduction for the state exemptions on bequests to widow or surviving husband, children or parents, etc., which exemptions will normally reduce the tax considerably. On the other hand, the state and federal governments take over one-fifth of a net estate of \$1,000,000, and more than half of a net estate of \$10,000,000—amounts necessitating careful consideration of the best methods of estate disposition.

II. SANCTIONED TRANSFERS

A survey of the present status of estate and gift taxation in this country leads to two general conclusions: first, that federal taxes are a dominant factor in regulating the form of property dispositions by informed persons possessing large wealth; and second, that Congress has strongly encouraged *inter vivos* gifts, and particular kinds of *inter vivos* gifts. Proof of the first proposition lies in the foregoing introduction. Federal rates are several times as high as the state rates. The credit provision has so far operated as a ceiling, above which the state legislatures have not found it politic to push the state rates. Hence the state taxes necessarily occupy a position of subsidiary importance. Moreover, it may be doubted whether any state statutes regulating the form of successions, other than taxes, have so broad an effect upon the transfers of large aggregations of wealth as the present federal estate and gift taxes, with their detailed provisions and high rates. Finally, the facts that the federal gift tax rates are so much less than the estate tax rates, and that the latter are very high, have already caused large dispositions of property by gift,²⁵ and thereby have removed much property from the possible operation of state death duties. So long as the present federal laws continue in force, estates are bound to be whittled down by gifts by their owners during their

²⁵ In 1925, with relatively low rates, the gift tax yielded only \$7,518,129; and in 1926, \$3,175,339. In 1936, the gift tax yielded \$160,058,761.47, only \$60,000,000 less than the estate tax (\$218,780,753.53). When the effect of the 1935 rates appears in the revenues, these figures will be largely increased.

lives; and the yield and importance of state estate and inheritance taxes correspondingly decreased.

More important for present purposes is the consideration of the precise forms of property disposition which Congress has encouraged, and discouraged.

1. *Small annual gifts.*—Small annual gifts of not to exceed \$5,000 to any one person are markedly encouraged by a complete exemption from gift taxation.²⁶ By the same token gifts to several members of the family, rather than to one, are favored. The father with several children is by this means stimulated gradually to build up small estates for each of them, whether he makes use of trusts or insurance for their benefit, or of outright gifts. It is a curious example of legislative and Treasury failure to adopt a single philosophy of transfer taxation that, while the gift tax in this limited way encourages the distribution of property among many beneficiaries, the estate tax offers no such incentive.²⁷ An estate passing to a single beneficiary is taxed no more by the federal government than an estate passing to a dozen or a hundred beneficiaries.

2. *Inter vivos gifts.*—Secondly, the Treasury and Congress quite strongly urge the owner of an estate to give away the greater part of it during his life; the amount he is urged to give away varies with the size of his estate. Unless he gives some of his property while he lives, he throws away the benefit of the \$40,000 cumulative gift tax exemption,²⁸ as well as the \$5,000 annual exemption for individual gifts just referred to. Instead of transferring at least \$45,000 of property tax free (and possibly much more, if his gifts to individual beneficiaries are spread over a number of years), he transfers it subject to the highest bracket of the estate tax applicable to his estate; and even with a moderate net estate of \$500,000, the additional estate taxes due to the failure to make the gift are \$10,800. Moreover, by making some sizeable gifts while he lives, the donor obtains the full benefit of the lower brackets of the progressive rate schedules of the two taxes. But additional and more powerful

²⁶ Sec. 504 (b), Revenue Act of 1932: "In the case of gifts (other than of future interests in property) made to any person by the donor during the calendar year, the first \$5000 of such gifts to such person shall not, for the purposes of subsection (a), be included in the total amount of gifts made during such year."

²⁷ President Roosevelt in 1935 urged the adoption of an inheritance tax in addition to the existing estate tax. Message to Congress, June 19, 1935, House Doc. no. 229, 74th Cong. (1st session, June 19, 1935) p. 1. The Senate substituted increased rates in the additional estate tax, because of the numerous obstacles "encountered in designing an inheritance tax even reasonably free from serious administrative difficulties." Sen. Rep. no. 1240, 74th Cong. (1st session 1935) p. 8. The bill as finally passed adopted the Senate's plan.

²⁸ See sec. 505 (a) (1) of the 1932 law as amended by sec. 301 (b), Revenue Act of 1935.

stimuli are provided by the fixing of the gift tax rates at markedly lower percentages than the estate tax rates; and by the opportunity to reduce greatly the income taxes payable by the family as a group, by means of a division of income-producing property among its members. Although the gift tax rates are numerically three-fourths of the estate tax rates in the respective brackets, the actual differential is much greater, due to the fact that the estate tax is measured by the entire estate, including the amount which is used to pay the tax, whereas the gift tax is measured by the net gift. Thus, an estate of \$2,000,000 is subject to total federal and New York estate taxes of approximately \$570,540 and the beneficiaries therefore receive only \$1,429,460 net. The gift tax on \$1,429,460, given to only one person, is \$259,220.40, much less than half of the estate taxes.²⁹

The Government also strongly encourages *inter vivos* gifts, through the steeply graduated income tax rates, and the provisions for separate returns by husband, wife, and children of the income from individually owned property.³⁰ An individual owning \$2,000,000 of property producing \$60,000 per year income pays annually \$12,385 federal income taxes, and has \$47,615 left to spend. If he gave \$1,000,000 to his wife or his son, the total federal income taxes on the same income would be reduced to \$7,250, and the two parties would have \$5,000 more for themselves. Even if property has to be sold to pay the gift tax, the combined net incomes after taxes (\$48,900) will exceed the previous net income (\$47,615). Obviously considerations other than rates of taxation will be taken into account, but Congress has provided a powerful incentive toward the adoption of its philosophy that large estates should be distributed while their original owner lives.

Another incentive toward *inter vivos* gifts of property is the practical impossibility of accumulating in the estate an amount of cash and liquid assets sufficient to preserve intact a sizeable business or aggregate of other

²⁹ In other words, if this individual gave to the members of his family while he lived the entire amount which they would otherwise receive upon his death, and paid the gift tax, he would still have left \$311,319.60 for his own purposes. Or to put it another way, the donor can transfer to his beneficiaries about \$250,000 more by gift than by bequest, he paying the tax in both cases.

³⁰ There is a similar incentive toward residence in one of the eight community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington), since in these states the wife may return one-half her husband's salary for income tax purposes; and upon his death, only one-half of the community property need be included in his estate. See *Poe v. Seaborn*, 282 U.S. 101 (1930); cf. *Silverberg v. Comm'r*, 20 B.T.A. 716 (1930). In these states, the local community property laws take a dominant position in determining the form of property disposition; and automatically accomplish, at least in part, what a citizen of one of the other forty states can accomplish for himself only by taxable transfers.

property. To protect a business worth \$5,000,000 from the estate tax, so that it can be transferred intact to beneficiaries, requires a liquid fund of \$4,818,857, almost as large as the business itself. To protect a \$50,000,000 business, the owner would require the staggering amount of \$107,782,000. The reason for these results is, of course, that the gross estate includes the fund, as well as the business property; and the estate tax must be paid out of the gross estate which is taxed. Hence, if a business man wishes to pass his business to his son intact, the tax laws cause him to arrange to transfer at least some of it while he lives; and in some manner, to arrange for a fund outside of his estate designed to be used to purchase assets from the executor for the benefit of the son.³¹

Since the gift tax is payable in the present, and the estate tax in the future, it may be urged that their rates cannot accurately be compared without the calculation of compound interest on the amount of the gift tax for period of the donor's expectancy, and that, with this necessary correction, the discrepancy in rates tends to disappear. Nevertheless, the actual incentive toward gifts seems to remain, as the Treasury's receipts show.³² The gifts are apt to be made to members of the family; and the income from the donated property may very well be used for expenditures which the donor would otherwise meet. The capital used to pay the gift tax may or may not have been income-producing. In any event, the loss of income to the donor will be restored in large part by savings in income taxes, and in the estate taxes which would apply to any accumulations of income added to the estate. Hence the comparison of the effective rates, without interest, probably indicates the extent of the encouragement of gifts, nearly if not quite as well, as the comparison in which interest is taken into account.

3. *Trusts.*—Although the law tends to encourage gifts as contrasted with testamentary transfers, it also strongly encourages transfers in trust as contrasted with outright gifts. This is an interesting development to a legal historian who has observed the numerous devices hitherto adopted to remove or at least loosen the grip of the dead hand upon transferred property. Hitherto, husbands and wives have frequently made mutual wills, each merely transferring his property to the other, and leaving the other free to dispose of the entire estate as he might see fit. Under the present estate tax laws, unless the two spouses die within five years of

³¹ Cf. *Wilson v. Bowers*, 57 F. (2d) 682 (C.C.A. 2d 1932); and *Lomb v. Sugden*, 82 F. (2d) 166 (C.C.A. 2d 1936) in both of which cross-options to purchase were given during life by the owners of corporate shares. The court held, in substance, that the shares must be valued in the estate at the option prices.

³² See the figures in note 25 *supra*.

each other³³ estates of \$1,000,000 and upwards will be reduced from thirty-six to eighty-five per cent by the taxes payable at the two successive deaths under this form of disposition. There is, therefore, the strongest incentive to the creation of an *inter vivos* trust, the income to be paid to the other spouse, for example, for her life, remainders to designated beneficiaries. The longer the ultimate transfer in fee can be postponed, the greater the saving in death duties.

The Supreme Court held, in *Helvering v. Schweitzer*³⁴ and *Helvering v. Stokes*,³⁵ that the income of a trust created for the education and support of the settlor's children is taxable to the settlor to the extent so used. Since both decisions were rendered without opinion, upon the authority of *Douglas v. Willcuts*,³⁶ their precise limitations are not wholly clear, but the accepted philosophy seems to be that the settlor is taxable upon income actually used for the discharge of his legal obligation to support his wife or his children.³⁷ If the settlor must expend a similar amount of income for a like purpose, these decisions (and section 167 of the income tax law, upon which they are a commentary) offer no strong discouragement to the settlor's setting up trusts for the same end, since the settlor can conveniently retain various managerial powers over the trust corpus. Indirectly, however, other forms of settlement are encouraged, since their tax consequences are less. If the trust is created by one who owes no legal duty of support, as the wife's father or the minor children's mother or grandfather, the income is taxable to the trustee or the recipient, not to the settlor or to the husband and father.³⁸ Since the latter's income will often be taxable at a higher rate than his wife's or his children's, income taxes will be saved and more income will be available for family expenditure. Again, if the income of a trust is to be accumulated during the minority of the beneficiaries, it is apparently taxable to the trustee, not to the settlor.³⁹

All of these legal consequences of the present income tax on estates and trusts strongly point toward an era of settled property in this country, a condition of things similar to that now common in England among large

³³ In which event, the value of the property identified as having been received from the prior decedent, or as having been acquired in exchange therefor, is deducted from the gross estate of the second decedent, but subject to a number of limitations. See sec. 303 (a) (2) of the Revenue Act of 1926, as amended; Treas. Reg. 80, art. 41.

³⁴ 296 U.S. 551 (1935).

³⁵ 296 U.S. 551 (1935).

³⁶ 296 U.S. 1 (1935).

³⁷ See Magill, *Taxable Income* 242 ff. (1936).

³⁸ *Id.* at 247; *Comm'r v. Yeiser*, 75 F. (2d) 956 (C.C.A. 6th 1935).

³⁹ It was so decided by the lower courts in the Stokes case, note 35 *supra*, and this point was not taken to the Supreme Court by *certiorari*. See 28 B.T.A. 1243 (1933); 79 F. (2d) 256 (C.C.A. 3d 1935).

property owners.⁴⁰ The desire to save wealth for the family, rather than pay it over to the Treasury, will find its expression in settlements of property in trust for as long a term as the rules against perpetuities will permit; and as the time for ultimate distribution approaches, the prospective recipient will be urged to create a new long-term trust of the corpus. We have customarily cared for our children during their minority, and then have sent them out to make their own way, without property settlements, unlike the English. This condition of affairs is apt to change, notably in the case of large property-owners.

Some of the supposedly tax-saving trusts of the last decade have been markedly discouraged by Congress, through the imposition both of a gift tax and an estate tax in respect of the transfer of the property. Although in such cases a credit for the gift tax is granted against the estate tax,⁴¹ the credit reduces the possible credit for state inheritance taxes, so that in the end the total transfer taxes paid are greater than if there had been a single taxable transfer. If the settlor reserves a power to revest the trust corpus in some one other than himself;⁴² or reserves a power to revoke jointly with a beneficiary of the trust, it seems that he will be subject to a gift tax when he creates the trust, and that the corpus will be included in his estate when he dies.⁴³ As an alternative, Congress has sanctioned a trust subject to a power to revoke in a beneficiary alone; the creation of such a trust by gift will be subject to a gift tax,⁴⁴ but the corpus will apparently not be included in the settlor's gross estate.⁴⁵ Finally, the familiar revocable trust of the simplest kind—the power being reserved by the settlor alone—is mildly⁴⁶ discouraged by the fact

⁴⁰ For an excellent discussion of the provisions of the English form of will, developed through 300 years experience, see Kales, *The Will of an English Gentleman of Moderate Fortune*, 19 *Green Bag* 214 (1907). These provisions were dictated by the experiments and mistakes of the past, not by taxes; but present necessities, including taxes, dictate a remarkably similar disposition of the estate.

⁴¹ Sec. 301 (b), Revenue Act of 1926, added by sec. 801, Revenue Act of 1932.

⁴² As to the gift tax, see the Treasury ruling cited in Sutter and Owen, *Federal Taxation of Settlers of Trusts*, 33 *Mich. L. Rev.* 1193, 1195 (1935); as to the estate tax, *Porter v. Comm'r*, 288 U.S. 436 (1933).

⁴³ As to the gift tax, *Treas. Reg.* 79, art. 3; as to the estate tax, *Helvering v. City Bank Farmers Trust Co.*, 296 U.S. 85 (1935).

⁴⁴ *Treas. Reg.* 79, art. 3.

⁴⁵ Sec. 302 (d), Revenue Act of 1926 as amended, refers to powers which may be exercised "either by the decedent alone or in conjunction with any person, to alter, amend, or revoke." The subdivision is quoted in note 12 *supra*.

⁴⁶ Mildly, because the income will frequently be made payable to persons to whom the settlor would otherwise make similar payments for support, which payments would not reduce his taxable net income.

that the settlor will be subject to an income tax upon its income,⁴⁷ though he does not receive it; and the corpus falls within his gross estate.⁴⁸

A familiar but rather recent creation is the funded insurance trust, irrevocable by the settlor, under which he has assigned to a trustee insurance policies upon his own life, irrevocably payable to designated beneficiaries; together with securities yielding income sufficient to pay the insurance premiums. Apparently the transfer of property to such a trust is a taxable gift by the settlor, even though the income is to be used to discharge what Mr. Justice Cardozo called a "pressing social duty";⁴⁹ but the income remains taxable to the settlor under the express provisions of section 167 of the income tax law. Thus this form of settlement has been effectively discouraged. Unfunded insurance trusts, or trusts created by beneficiaries rather than by the insured seem to be the likely forms of provision.⁵⁰

4. *Powers of appointment.*—Property passing subject to a power of appointment in the legatee or devisee is taxable in the estate of the donor of the power. If the power is general, its exercise by the donee by will subjects the property to a second estate tax.⁵¹ The exercise of a special power of appointment is not subject to the estate tax. Although the distinction is perhaps a logical one in the case of an estate tax (as opposed to an inheritance tax)⁵² the form of the provision strongly discourages the grant or the exercise by will of general powers, and encourages the use

⁴⁷ Sec. 166, Revenue Act of 1936.

⁴⁸ Sec. 302 (d), Revenue Act of 1926, as amended, quoted in note 12 *supra*.

⁴⁹ See Treas. Reg. 79, arts. 2, 3.

⁵⁰ Sec. 167 of the Revenue Act of 1936 provides in part: "Where any part of the income of a trust . . . is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, applied to the payment of premiums upon policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for the purposes and in the manner specified in section 23 (o), relating to the so-called 'charitable contribution' deduction); then such part of the income of the trust shall be included in computing the net income of the grantor."

Hence the income of a trust created by a wife to pay the premiums on insurance policies on her husband's life is not in terms taxable to the settlor. If, however, the wife is the beneficiary, and possesses the incidents of ownership, *quaere* whether the income may not be taxable to her, as being used at her direction for her benefit. Cf. *Helvering v. Blumenthal*, 30 B.T.A. 591 (1934), rev'd 76 F. (2d) 507 (C.C.A. 2d 1935), rev'd 296 U.S. 552 (1935).

⁵¹ See the provisions quoted in note 13 *supra*.

⁵² Generally the state inheritance tax acts do not distinguish between the exercise of general and special powers, imposing the tax in both cases. See 4 C.C.H. *Inheritance, Estate and Gift Tax Service* ¶ 1540B (1936). See also, Bentley, *Inheritance Taxation on Powers of Appointment*, 23 Ill. L. Rev. 446 (1929); Simes, *The Devolution of Title to Appointed Property*, 22 Ill. L. Rev. 480, 508 (1928).

of special powers instead.⁵³ Congress may very well change this situation as time goes on.

5. *Joint estates*.—The time-honored joint tenancy and tenancy by the entirety, created by gift, have also been given a body-blow. The donor is subject to a gift tax upon the value of the interest transferred at the time he creates it;⁵⁴ and if he dies before the donee, the entire value of the property is included in his gross estate.⁵⁵ A credit for the gift tax may be obtained, but, for reasons already given, this credit is inadequate. The successive impositions of a gift tax and an estate tax are based on theories somewhat if not wholly inconsistent; if an individual has disposed of property during his life, it ought not to form part of his estate. But until Congress sees fit to change the estate tax law, the creation of these joint tenancies is discouraged.

6. *Insurance*.—Congress has urged decedents to carry insurance for named beneficiaries (other than the executor) through the device of an additional estate tax exemption of \$40,000;⁵⁶ though it has not yet seen

⁵³ By a slight limitation upon the class of persons to whom the donee may appoint (apparently by the exclusion of a single person), the power may be converted into a special one, without in fact limiting the donee in designating any one of the natural objects of his bounty. *Cf. Kendrick v. Comm'r*, 34 B.T.A. 162 (1936) (one person and his descendants excluded as appointees; he died before the exercise of the power and there was no proof that he left issue; power held general).

The will of Mr. Kales' English gentleman contains a special power. *Kales, op. cit. supra* note 40, at 218.

⁵⁴ As to the valuation of this interest, see *Treas. Reg. 79, art. 19 (8)*: "Tenancies by the entirety.—Should either a husband or his wife purchase property and cause the title thereto to be conveyed to themselves as tenants by the entirety, or should either cause to be created such a tenancy in property already owned by him or her, and under the law of the jurisdiction governing the rights of the spouses with respect to the property neither of them may, acting alone, defeat the right of the survivor of them to the whole of the property, the transfer effects a gift from the spouse owning the property at the time of the creation of the tenancy or who furnished the consideration in the purchase of the property. The value of the gift is the sum of (1) the value of the right, if any, of the donee spouse to a share of the income or other enjoyment of the property during the joint lives of the spouses, and, (2) the value of the right of the donee spouse to the whole of the property should he or she be the survivor of them. The value of each of such rights is to be determined in accordance with the Actuaries' or Combined Experience Table of Mortality, as extended.

"A case involving the value of the right of survivorship (provided the gift is completed and not merely proposed or hypothetical) may be submitted to the Commissioner, who will, in accordance with recognized actuarial principles, compute the applicable factor to be used in determining such value, and will advise the donor of the factor."

See also *Treas. Reg. 79, art. 2, examples (7) and (8)*.

⁵⁵ See sec. 302 (e) of the Revenue Act of 1926; *Treas. Reg. 80, art. 23*.

⁵⁶ Sec. 302 (g), Revenue Act of 1926, quoted in note 14 *supra*.

fit to encourage insurance to pay estate taxes.⁵⁷ Amounts in excess of that sum can preferably be carried by one of the beneficiaries personally, since in such an event, the insurance is not taxable upon the insured's death. The courts have added the suggestion that if the insured takes out the policies, he should not retain incidents of ownership—the power to change the beneficiary, to borrow on the policy, or to surrender it for cash; if he does not, probably the insurance is not taxable in his estate.⁵⁸ If he does not retain these powers, his premium payments constitute annual gifts,⁵⁹ taxable only if (with any other gifts) they amount to more than \$5,000 per year per beneficiary. A sizeable estate in insurance can be purchased for this sum. If the power to change the beneficiary has previously been reserved, it will often be desirable to surrender it during life. A gift tax will then be payable upon the present value of the policy,⁶⁰ but its amount will ordinarily be less than the estate tax, since the base and the rates are less.

7. *Charitable gifts.*—Congress has also subsidized gifts *inter vivos* to charities, educational and religious institutions, and certain public organizations, by allowing a deduction for income tax purposes⁶¹ as well as for gift tax purposes.⁶² This encouragement is no doubt a conscious development of the general policy of increasing expenditures for public purposes. Bequests to the designated organizations are free from estate tax,⁶³ but do not affect the income tax either of the decedent or of his estate. A gift, on the other hand, in the case of a wealthy donor, will largely consist of funds which would otherwise go to the Treasury. Thus, a gift of \$150,000 by a single man with a net income of \$1,001,000 (before the deduction for this gift) will reduce his income tax from \$681,000 to \$567,000. In other words, the \$150,000 gift costs him \$36,000 net. Moreover, if the individual in question has a net estate of \$25,000,000, the federal government will take 69 per cent of the \$150,000, if it is left to individual beneficiaries at

⁵⁷ Indeed, Congress has rather effectively discouraged such insurance by the provision whereby insurance receivable by the executor under policies taken out by the decedent upon his own life is all included within the gross estate, without the exemption, granted in the case of insurance payable to other beneficiaries. See sec. 302 (g), quoted in note 14 *supra*.

⁵⁸ See *Chase Nat'l Bank v. United States*, 278 U.S. 327 (1929); *Bingham v. United States*, 296 U.S. 211 (1935); 44 Yale L. J. 1409 (1935); 34 Mich. L. Rev. 1207 (1936).

⁵⁹ Treas. Reg. 79, art. 2, examples (5) and (6).

⁶⁰ *Ibid.*

⁶¹ Subject to a limitation to fifteen per cent of the net income, before the charitable deduction. Sec. 23 (o), Revenue Act of 1936. Prior acts contain similar provisions.

⁶² Sec. 505 (a) (2), Revenue Act of 1932.

⁶³ The estate tax deduction is worded somewhat less broadly than the gift tax deduction. See sec. 303 (a) (3), Revenue Act of 1926, as amended.

death. Taking into account the estate tax as well, the gift of \$150,000 to the designated educational, religious, and charitable institutions actually costs the donor and his family only \$11,160. The balance of the gift is really made by the Treasury.

The present laws operate to discourage gifts to charities, subject to an annuity charged on the gift. It appears that the present value of such a gift will be free from the gift tax, but the full value of the property might be included in the estate as a form of transfer intended to take effect in possession or enjoyment at or after death.⁶⁴ If the donor wishes to preserve his income, he would be wiser to make an outright gift to the charity of his choice, reserving sufficient funds to purchase a life annuity from an insurance company for himself. Thus, the owner of a \$5,000,000 estate, with \$150,000 income therefrom, pays an income tax of \$63,450. If he gives \$20,000 to charity, he saves \$12,400 in income taxes but may lose \$600 per year income (assuming that he needs all his income for his personal expenses, and hence has to make the gift out of capital). With the net amount of income saved, or \$11,800, he can at age 55 buy a life annuity of \$815 per annum, only \$354 of which will constitute taxable, income. Thus he reduces his income tax greatly in the year of the gift and very slightly in succeeding years; and if he lives out his expectancy, his estate will be little impaired.

Charitable and educational gifts (rather than bequests) receive another form of indirect but effective encouragement from the usual state decisions to the effect that bequests to extra-state charities or educational institutions are not deductible for purposes of the state inheritance tax.⁶⁵ The Dartmouth alumnus resident in Illinois who plans to add to the college endowment should exercise his bounty during his life, thereby reducing his federal income taxes, and also his state inheritance taxes. The latter may otherwise be a sizeable sum, since a bequest outside the family takes the highest rate.

CONCLUSION

Mr. Mellon, writing in 1924, inveighed against the proposal to increase the top bracket of estate tax rates from twenty-five to forty per cent.⁶⁶ His main argument was that wealthy persons by their savings preserve

⁶⁴ See sec. 302 (c), Revenue Act of 1926, as amended; and decisions by state courts relative to the similar provisions of inheritance tax acts; e.g., *In re Honeyman's Estate*, 98 N. J. Eq. 638, 129 Atl. 393 (1925).

⁶⁵ See, e.g., *People v. O'Donnell*, 327 Ill. 474 (1927); cf. *People v. First Nat'l Bank of Chicago*, 364 Ill. 262, 4 N. E. (2d) 378 (1936).

⁶⁶ Mellon, *Taxation: The People's Business* 111 (1924).

the liquid capital for underwriting the business expansion of the nation. Out of their hoards, new industries can be financed, and hazardous ventures authorized, to an extent impossible if wealth were more evenly divided. Again, he said, estate taxes devoted to the current expenditures of government deplete the total wealth of the country; they are paid out of capital, and when currently spent, the capital is gone.

Eleven years later, President Roosevelt, in the message which put in motion the legislative machinery for the enactment of the 1935 increase in estate tax rates to a top bracket of seventy per cent, said:

.... The transmission from generation to generation of vast fortunes by will, inheritance, or gift is not consistent with the ideals and sentiments of the American people.

The desire to provide security for one's self and one's family is natural and wholesome, but it is adequately served by a reasonable inheritance. Great accumulations of wealth cannot be justified on the basis of personal and family security. In the last analysis such accumulations amount to the perpetuation of great and undesirable concentration of control in a relatively few individuals over the employment and welfare of many, many others.⁶⁷

Whatever the merits of Mr. Mellon's arguments, it is evident that Congress has turned its back upon them in the succeeding twelve years. Congress has done what it can to encourage the breaking up of large fortunes, by income tax and estate tax rates of exceptional severity in the upper brackets. The necessary saving for investment will presumably come from the upper middle class, from those with incomes from \$10,000 to \$50,000 who are not yet severely taxed. Congress has so far, moreover, strongly encouraged *inter vivos* gifts and gifts in trust by much lighter effective rates of taxation. Capital distributed at an earlier date among children may well yield satisfactory social results. If children must be given large funds while their fathers live, if they are to have large funds at all, fathers will give more thought to the education of children to their responsibilities. The ultimate result of a generation of gifts in trusts is not clear. Trust funds are not venturesome; they sit by the fire and warm themselves with three per cent, or less, and safety. A nation of trust beneficiaries would not be the nation of the roaring twenties, but it will be a nation of more equally distributed wealth. And so long as the inventor or organizer can preserve for his family more than fifty per cent of the estate he builds up, individual initiative will hardly perish.

⁶⁷ Message to Congress, House Doc. no. 229, 74th Cong. (1st session, June 19, 1935).