Notre Dame Law Review

Volume 30 | Issue 1 Article 2

12-1-1954

Estate Planning and the Internal Revenue Code of 1954

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NOTRE DAME LAWYER

A Quarterly Law Review

VOL. XXX | DECEMBER 1954 | No. 1

ESTATE PLANNING AND THE INTERNAL REVENUE CODE OF 1954

PROLOGUE

It was exactly 9:46 a.m. on August 16, 1954, that our third effort at steering the discussion toward the consideration of planning the estate of Phil Brown was successful. It was raining outside, the clouds showed no signs of breaking, so Phil sensed that any golf before midafternoon was out of the question. So he agreed to spend ten or fifteen minutes talking about the ultimate disposition of the property he had spent a lifetime accumulating. Actually, the President had just signed the fabulous INTERNAL REVENUE CODE OF 1954, and was at that moment handing out, as souvenirs, the pens he had used, or reasonable facsimiles. But while this new Code made substantial changes in almost all areas of our taxing system, including taxes levied on the passing of property by gift, or by death, and the taxing of income of estates and trusts, we knew that no new law would make unnecessary the assembling of all the facts about a man's property and his family in order to carry out his wishes at a minimum cost.

So we whipped out the nine page questionnaire we had prepared for such contingencies and began going over it with him. Our main job was to sell him the idea that it is necessary for us to know the answers to all of those questions, in order to do a decent job of planning his estate, and also to give him some idea as to the reasons for the questions so that he could add other facts we had not asked for, if they seemed relevant.

These questionnaires, or *Confidential Estate Worksheets,* as we call them, have been lifesavers in keeping us reminded of the essential facts we have to have, and also in getting the data accurate so that at the last minute we do not have to retype a page because the middle initial of a grandchild had been misunderstood. We ask the client, himself, to fill in his own name, his wife's name, the names of children and grandchildren, and of both his and his wife's parents, and some estimate of property owned by each of them and the income available to them. Then we go through a federal estate tax return, and ask the questions that will someday have to be filled out by the executor, but the answers to which can best be obtained from the man involved. Most important, we ask him to bring in the actual deeds to the real estate owned by him, the actual policies of insurance on his life, the gift tax returns he has filed, his federal income tax returns for the past three years, and any wills or trusts he may have previously executed or be a beneficiary under.

It will take Phil at least a week to assemble the data we want, as well as to give some thought to how he wants his property to go if his wife does not survive him, and even what he wants done with the property if none of his family survives him, a situation no man likes to think about. So we arrange a conference for the following week, and then firmly resolve to make up a list of all of the changes in the new Code that might have any possible bearing on estate planning for Phil and others. This we resolve to do as soon as we have learned if the bill has actually become law, for no lawyer has been known really to devote himself to the study of something when there was even a remote chance that such disciplinary action might not be necessary.

The evening paper took away our last excuse,[1] and left us confronted with the absolute necessity of studying the new Code to see what provisions would have an effect on estate planning. We were gratified to learn that there were only seventeen changes listed in the report of the Senate Finance Committee directly relating to estate taxes and gift taxes.[2] Of the eight hundred and forty-nine million dollars revenue loss attributable to individual tax changes, only twenty-five million dollars is due to changes made in gift and estate tax laws.[3] But, if even only one of those twenty-five million dollars in tax savings related to one of our clients, we would count the day well spent.

Our elation was short-lived, however, when we came to realize that you cannot just look to the gift and estate tax laws in planning a man's estate. The redemption of stock to pay estate taxes, the basis of property which prior to death was held as tenants by the entirety, the income tax treatment of insurance proceeds, are all vitally connected with estate planning, yet the changes in those provisions are found in Subtitle A, which deals with income tax. The same is true of the taxation of the income of trusts, the five-year throwback rule, and Section 306 stock. So we realized that our list of changes which might materially affect estate planning will continue to grow, but by the time of our next conference with Phil Brown, the tentative list of the important features of the more important changes was as follows:

1 The Internal Revenue Code of 1954 was approved by President Eisenhower at 9:45 a.m. E.D.T., Monday, August 16, 1954. 68A STAT. 3 (1954).

2 SEN. REP. No. 1622, 83d Cong., 2d Sess. 121-8 (1954).

3 *Id.* at 3.

4 68A STAT. 382 (1954).

5 *Id.* at 392

6 *Id.* at 393.

7 *Id.* at 377.

8 *Id.* at 389.

9 *Id.* at 387.

II

IMPORTANT CHANGES IN THE LAW AFFECTING ESTATE PLANNING

A. *Miscellaneous Estate Tax*

1. Gift property cannot be included in the donor's taxable estate as a *transfer to take effect* at death unless he reserves a reversionary interest worth 5% of the property's value. See INT. REV. CODE of 1954 § 2307.[4] Under the prior law, if the transferee gained possession or enjoyment at the transferor's death, the transfer was one to take effect at death even though the transferor had retained no interest in the property. INT. REV. CODE of 1939 § 813 (3) (c), (i.e. *A* to *B* in trust for C with income to be accumulated during *A's* lifetime and at *A's* death accumulated income and corpus to C. Accumulated income and corpus includible in *A's* gross estate under prior law, but not under new Code).

2. *Marital deduction* allowed for *legal life estate* to surviving spouse, with remainder subject to her general power of appointment. [INT. REV. CODE of 1954 § 2056 (b) (5)],[5] while under prior law no deduction was allowed in respect to such an interest passing to the surviving spouse. *Cf.* INT. REV. CODE of 1939 § 812 (e) (1) (F).

3. *Marital deduction* allowed for *specific portion* of trust property from which portion surviving spouse gets income and over which portion she has a general power of appointment. See INT. REV. CODE of 1954 § 2056 (b) (5).[6] Under prior law, deduction for trust property allowed only if spouse received *all* income from trust and had general power over *all* of trust corpus. See INT. REV. CODE of 1939 § 812 (e) (1) (F).

4. *Estate tax previously paid* (in another decedent's estate) on property left to current decedent (within 10 years before or 2 years after the death of the current decedent) is credited against current estate tax whether or not property is traced to estate of current decedent. See

INT. REV. CODE of 1954 § 2014.[7] Prior law required previous transfer to have been within 5 years of current decedent's death and required tracing of previously taxed property into current decedent's estate. See INT. REV. CODE of 1939 § 812 (c).

5. New Code allows *estate tax deduction* of certain expenses in connection with property not in probate estate (*i.e.* trustee's commissions on trust property subject to estate tax but not in probate estate) and does not limit amount of deductible expenses to amount of probate estate (*i.e.* $20,000 in probate estate; $500,000 in insurance and trust; debts and expenses of $30,000 are fully deductible). See INT. REV. CODE of 1954 § 2053.[8] Prior law limited deduction to amounts allowable under state law as claims against the estate. See INT. REV. CODE of 1939 § 812 (b).

B. Life Insurance, Annuities and Other Death Benefits

1. *Life insurance proceeds subjects to estate tax* in insured estate only if (1) payable to his estate, or (2) he owned policy at death. See INT. REV. CODE of 1954 § 2042.[9] Prior law, in addition to either of above grounds, taxed proceeds if insured had paid the premiums on the policy. See INT. REV. CODE of 1939 § 811 (g).

2. Where *insurance proceeds* are taken under one of installment or life *income* options, first $1,000 of interest received annually by surviving spouse of insured is free of income tax. See INT. REV. CODE of 1954 § 101 (d).[10] Prior law excluded all interest received by any beneficiary under such options. See INT. REV. CODE of 1939 § 22 (b) (1).

3. *Proceeds of life insurance* policy are not subject to *income tax* when received by beneficiary even though policy transferred for value, during insured's lifetime, if transfer is to (1) insured, (2) insured's partner, (3)

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[10] *Id.* at 27.

partnership of which insured is a partner, (4) corporation of which insured is a shareholder or officer, or (5) if policy's income tax basis carried over to transferee. See INT. REV. CODE of 1954 § 101 (a) (2).[11] Prior law taxed difference between proceeds and consideration paid by transferee plus subsequent premiums paid by him, except where transfer was (1) to insured, or (2) where policy's basis carried over to transferee. See INT. REV. CODE of 1939 § 22 (b) (2) (A).

4. *Up to $5,000 death benefit* (and no more) can be received by beneficiaries of a deceased employee from his employer or employers, free of income tax. See INT. REV. Code of 1954 § 101 (b).[12] Prior law permitted $5,000 tax-free from each employer (if more than one) and required a contractual obligation calling for the payment. See INT. REV. CODE of 1939 § 22 (b) (1).

5. *Annuity receipts* are taxed as follows: the cost of the annuity is divided by annuitant's life expectancy to determine tax-free portion of annual receipts. Such portion remains tax-free and balance is taxable for each year throughout lifetime of annuitant. See INT. REV. CODE of 1954 § 72 (b).[13] Prior law taxed receipts under "3% rule". See INT. REV. CODE of 1939 § 22 (b) (2) (A).

C. *Gift Tax*

1. The acquisition of the title to real estate as *tenants by the entireties* will no longer result in a gift from the spouse furnishing the consideration, unless he so elects. See INT. REV. CODE of 1954 § 2515.[14] A gift did result under prior law. U.S. Treas. Reg. 108 § 86.2 (a) (6) (1943).

2. No part of a *gift to a trust* for a minor will be a *future interest* if (1) income and corpus can be spent by or for minor before he reaches 21, and (2) to extent not spent

[11] *Id.* at 26.
[12] *Id.* at 27.
[13] *Id.* at 20.
[14] *Id.* at 409.

passes to him at 21, and (3) if he dies before 21, passes to his estate or is subject to his general power of appointment. See INT. REV. CODE of 1954 § 2503 (c).[15] Prior law doubtful as to whether gift to minor's trust was present or future interest. *Cf.* INT. REV. CODE of 1939 § 1003 (b) (3); *Kieckhefer v. Commissioner,* 189 F.2d 118 (2d Cir. 1951); *Stifel v. Commissioner,* 197 F.2d 107 (7th Cir. 1952).

3. The value of *present interest* (such as a life estate in a trust) is to be computed without regard to a *power of termination* in the trustee, if the power of termination can be exercised only in favor of the life tenant. See INT. REV. CODE of 1954 § 2503 (b).[16] Under prior law, even though trustee's power could be exercised only in favor of life tenant, the present interest (life estate) did not qualify for the annual exclusion since it could not be valued due to the unpredictability of the exercise of the power of termination. *Brody v. Commissioner,* 19 T. C. 126 (1952).

4. The value of a taxable *gift made in prior years* upon which statute of limitations has run cannot be reopened in determining gift tax on current year's gifts. See INT. REV. CODE of 1954 § 2504 (c).[17] Prior law was to the contrary. *Cf.* INT. REV. CODE of 1939 § 1001 (a) and (b).

D. Income Taxation of Estates and Trusts

1. The *"conduit theory"* of taxing trusts and estates is retained. Distributions of income previously accumulated are taxed under the *"5-year" throw-back rule.* INT. REV. CODE of 1954 Subchapter J.[18] Under prior law, conduit theory was followed, and distributions of accumulated income were taxed under the "65-day" and "12-month" rules. INT. REV. CODE of 1939 Supplement E.

2. *"Clifford" regulations* adopted into law with minor

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[15] *Id.* at 405.

[16] *Id.* at 404.

[17] *Id.* at 405.

[18] *Id.* at 215.

variations. INT. REV. CODE of 1954 § 671-675.[19] For regulations under prior law, see U.S. Treas. Reg. 118, § 39.22 (a) -21 (1953).

E. Miscellaneous Personal and Corporate Income Tax Changes

1. All property subjected to tax in decedent's estate (with two minor exceptions) acquires a new *income tax basis* equal to its estate tax value. INT. REV. CODE of 1954 § 1014.[20] Under prior law property taxed in decedent's estate as a gift in contemplation of death or to take effect at death, or with income reserved, did not acquire a "stepped-up" basis, nor did jointly held property. *Cf.* INT REV. CODE of 1939 § 113 (a) (5).

2. *Corporate stock* may be *redeemed* at owner's death without proceeds of redemption being taxed as a dividend if (1) amount redeemed does not exceed death taxes and funeral and administration expenses, and (2) if stock comprises 35% of gross or 50% of net estate. Shares in two or more corporations (if estate is owner of 75% or more of stock of each corporation) treated as a single corporation for percentage tests. INT. REV. CODE of 1954 § 303.[21] Prior law permitted redemption only if stock of one corporation comprised 35% of gross estate. INT. REV. CODE of 1939 § 115 (g) (3).

3. A *preferred stock dividend* becomes *"Section 306"* stock subject to the disabilities outlined in that section, (INT. REV. CODE of 1954 § 306)[22] in that a sale by the recipient or his donee results in a tax on entire proceeds at ordinary income rates to the extent of accumulated earnings and profits. Prior law not settled as to effect of disposal of preferred stock received as a dividend. *Cf.* INT. REV. CODE of 1939 § 115 (g); *Chamberlin v. Commissioner*, 207

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19 *Id.* at 226-230.

20 *Id.* at 296.

21 *Id.* at 88.

22 *Id.* at 90.

F.2d 462 (6th Cir. 1953).

We reminded ourselves that the above changes will take effect in various ways and on varying dates, and made a mental note to carefully check the statute itself before recommending any action which involved reliance on any one of the changes.

III

ANALYSIS OF PHIL'S ESTATE

The following is a summary of the information we gleaned from Phil's answers on our Confidential Estate Worksheet.

Phil is fifty-two and his wife, Marjorie, is forty-four. They have a son, Thomas age nineteen, and a daughter, Mary age eleven. Tom is in college studying engineering, and Mary is attending grade school. Phil's assets are these:

Assets	How Owned	Estimated Value
Home	By entireties. (Cost — $22,000 — $10,000 down payment made by Phil in 1946—existing mortgage of $6,000)	$30,000 6,000 less mortgage 24,000 net
All (1000) shares in Acme Structural Steel Company (par value — $50 per share)	Individually by Phil	150,000[23]
Ordinary life insurance on Phil's life	By Phil (all past premiums paid by him)	70,000 death proceeds 21,400 cash value

[23] There have been no sales of this stock. In approximating its value for estate planning purposes, we looked to its book value, earnings history, and the estimated value of the underlying assets of the corporation and arrived at our approximation. INT. REV. CODE of 1954 § 2031, 68A STAT. 380 (1954); U.S. Treas. Reg. 105, § 81.10 (c) (1943). If there had been companies comparable to Acme Structural Steel Company, the stock of which was listed on an exchange, we would have applied their ratios of book value to market price, and average earnings after taxes to market price, to the Acme book value and average earnings after taxes as a more accurate estimate of value. INT. REV. CODE of 1954 § 2031 (b), 68A STAT. 380 (1954).

Series E Bonds	Joint with Marjorie (all consideration paid by Phil)	4,000 3,600	maturity value present value
Listed Stock	Individually by Phil	27,000	
Household Goods, etc.	Joint with Marjorie (paid for by Phil)	5,000	
Miscellaneous tangible personal property, including cars, clothing, etc.	Individually by Phil	5,000	
	Total Present Value	$236,000	
	Total Death Value	$284,600	

(Marjorie has no assets of any substantial value.)

Phil started the business twenty years ago and is its mainspring. He has made no previous gifts of any substantial value to Marjorie or the children. His "dispositive desires," in the order of their importance to him, are these:

(1) To assure Marjorie as much as she needs of his estate, perhaps all of it, for her lifetime;

(2) To preserve the business for the family and as a future for Tom;

(3) To leave everything equally to the children after Marjorie's death; and

(4) To do this with a minimum tax cost.

After reviewing the questionnaire, and what we thought were the relevant parts of the New Code, we wrote Phil as follows:

Phillip Brown, President
Acme Structural Steel Company
Indianapolis, Indiana

Dear Phil:

This letter is for the purpose of alerting you to the questions we will discuss at our next conference, and of giving you our thinking on those questions as of this time. Incidentally, it compels us to organize our thoughts. We are setting out below the main topics we shall discuss, and our present reaction.

Your Home

When you bought your present house in 1946, you took title in your own name at our suggestion in order to avoid gift tax complications. We told you then that the interest which would pass to Marjorie if you took title as tenants by the entirety would be treated as a gift by you and that we would have to obtain from the Commissioner of Internal Revenue a computation of the value of that gift based upon the amount of your payments on the house and your respective ages.[24] Notwithstanding the fact that this would be treated as a gift of an interest to Marjorie, the entire value of the property would be included in your estate at your death[25] with credit for any gift taxes paid,[26] and the basis of computing the gain on any subsequent sale of the property after your death would be the cost basis to you even though it might have been included in your estate at a substantially higher figure.[27]

All of that has been changed in the 1954 Code, and there are no longer any adverse federal gift, estate or income tax consequences to holding title to property as tenants by the entirety. Commencing in 1955 there will be no gift when you purchase the property and take it in your joint names, but only a gift if, upon the sale of the property, Marjorie should receive a greater share of the proceeds of the sale than she contributed to the original cost of the property.[28]

The property would still be included in your estate for federal estate tax purposes,[29] but the basis of the property would become the value at which the property was included for federal estate tax purposes, and would not remain the original cost.[30] The property would not be included in your estate for Indiana inheritance tax purposes.[31] And since the advent of the marital deduction [32] in 1948, the Indiana inheritance tax has usually substantially exceeded the credit allowed against the estate tax for state inheritance taxes in estates of your size, so that the exclusion results in a real tax saving to you. For these tax reasons, but principally for the reason that the holding of title to the home property in the

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24 U.S. Treas. Reg. 108, § 86.2 (a) (6) (1943). If under the law of the jurisdiction governing the rights of tenants by the entireties there was no right by which either of the tenants acting alone could defeat the right of the surviving tenant to all of the property, the exact amount of the gift was not one-half of the value thereof, but depended upon the ages of the two tenants and the possibility of the donee spouse surviving the donor spouse. Since two lives were involved in this computation it was necessary to request from the Commissioner of Internal Revenue the factor to be used in determining the value of the gift based upon this possibility, and upon request, he will furnish this figure provided the gift has been completed. U.S. Treas. Reg. 108, § 86.19 (b) (1943).

name of husband and wife has seemed the most natural thing to do for many many years, we shall recommend that you transfer title to your home to yourself and wife as tenants by the entirety, immediately after January 1, 1955, when there will be no gift tax complications. The gift problem remains with us throughout 1954.[33]

Joint Ownership of Bonds

The new tax law does not affect your series "E" bonds. Even though you paid for them and took title jointly with Marjorie you

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25 INT. REV. CODE of 1939 § 811 (e).

26 INT. REV. CODE of 1939 § 813 (a).

27 INT. REV. CODE of 1939 § 113 (a) (5); Lang v. Commissioner, 289 U.S. 109 (1933).

28 INT. REV. CODE of 1954 § 2515, 68A STAT. 409 (1954). It seems proper that such an acquisition should not be a taxable gift. The gift tax was not enacted as a revenue producing measure in its own right. In its report on the 1932 Revenue bill which contained the gift tax law as a part of it, the Committee on Ways and Means of the House of Representatives stated that the purpose of the gift tax was to assist in the collection of the income and the estate tax and ". . . prevent their avoidance through the splitting up of estates during the lifetime of a taxpayer. . . ." H. R. REP. No. 708, 72d Cong., 1st Sess. 8 (1932), and to:

> . . . reduce the incentive to make gifts in order that distribution of future income from the donated property may be made to a number of persons with the result that the taxes imposed by the higher brackets of the income tax law are avoided. It will also tend to discourage transfers for the purpose of avoiding the estate tax. H. R. REP. No. 708, *supra* at 28.

Neither of the reasons set out in the committee reports was applicable to the case of the acquisition of property as tenants by the entirety. Since the Revenue Act of 1948 which permitted income splitting between husband and wife there was no income tax advantage to be gained by the owning of property by tenants by the entirety; nor did the imposition of the gift tax upon the acquisition of property by the entireties aid in the collection of the estate tax, since an estate tax is imposed upon the death of the spouse who furnishes the consideration even though a previous gift tax was paid. Since a credit for the gift tax paid is given at the time the property is subjected to an estate tax it would seem that no revenue was realized by the provision. The only possible revenue gain from the provision would have been because (a) of the difference in the exemption under the estate and gift taxes and (b) the inclusion of such transfers as gifts increases the gift tax rate applicable to other gifts. *Cf.* INT. REV. CODE of 1954 § 2502, 68A STAT. 403 (1954).

29 INT. REV. CODE of 1954 § 2040, 68A STAT. 385 (1954).

30 INT. REV. CODE of 1954 § 1014, 68A STAT. 296 (1954).

31 IND. ANN. STAT. tit. 7, c. 24, § 7-2401 (Burns 1953).

32 INT. REV. CODE of 1954 § 2056 (a), 68A STAT. 392 (1954).

33 INT. REV. CODE of 1954 § 7851 (a) (2) (B), 68A STAT. 920 (1954).

made no taxable gift to her since either of you can cash them at any time without the consent of the other. If Marjorie ever cashes any of the bonds you will be making a taxable gift to her at that time, of the amount cashed.[34] The value of the bonds will be taxed in your estate at your death,[35] but that would be true of any property owned by you so that is no special disadvantage. The income from the bonds will be taxed to Marjorie if she cashes them after your death,[36] but a credit against her income tax on the interest income will be allowed in respect to the estate tax paid on account of interest accrued at your death.[37] In view of the fact that these bonds will serve as a ready source of cash for Marjorie if she survives you and since they present no tax difficulties, we recommend that the existing form of ownership be continued.

Your Life Insurance

We have been telling you for this long time that there is no way of getting insurance out of your estate, as Marjorie has no independent income out of which to pay the premiums, and all of the devices suggested to you by enterprising salesmen were just devices. Now, however, it is possible to get the insurance out of your estate if you wish to, but that is not because someone has found a new device, but because Congress has said so. In the past, insurance was included in the estate of the insured if any one of the following conditions existed:[38]

1. Insurance was payable to the estate of the insured.
2. Insurance was owned by the insured at the time of his death, even though payable to a named beneficiary other than the estate of the insured.
3. The insured had paid the premiums either directly or indirectly regardless of who owned the policy, and regardless of who was named beneficiary.

The new Code has eliminated #3 above, so that now insurance is included in your estate only if you own the policy at the time of your death, or if the insurance is payable to your estate.[39] If, for example, Marjorie were named beneficiary, and you were to give her the policies outright, vesting in her all rights exercisable under the policies, then the insurance would not be included in your estate even though you went on paying the premiums as you

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34 U.S. Treas. Reg 108, § 86.2 (a) (4) (1943).

35 Int. Rev. Code of 1954 § 2040, 68A Stat. 385 (1954).

36 Int. Rev. Code of 1954 § 691 (a), 68A Stat. 235 (1954).

37 Int. Rev. Code of 1954 § 691 (c), 68A Stat. 237 (1954).

38 Int. Rev. Code of 1939 § 811 (g).

39 Int. Rev. Code of 1954 § 2042, 68A Stat. 387 (1954).

now do. You would have made a gift to Marjorie that would have to be accounted for for gift tax purposes,[40] but that would be relatively inconsequential, compared to the estate tax on the insurance if it is left in your estate.[41]

Before moving too swiftly along this line, we should consider the lifetime function that insurance performs, apart from furnishing death protection and giving your estate liquid assets with which to meet liabilities. Your policies have by this time built up a cash value of $21,400, and we can remember the time when it was quite a source of satisfaction to you to have this type of liquid asset available in the event you needed it. Also, insurance in many instances is counted upon for retirement income, and you should not count upon giving it away, and keeping it for retirement income, too. Here are some alternatives we would like to suggest:

1. You could obtain paid-up insurance in the amount of $34,000 on your present policies, remain the owner of those policies, and have the cash surrender value available to you at all times, with the privilege of converting the policies into retirement income at your election. The net difference to your estate between that amount of paid-up insurance and the $70,000 present face value of your policies could be covered by having Marjorie take out policies on your life in the amount of $29,200, retaining full ownership of those policies, but with you paying the premiums. The new policy taken out by Marjorie would not be taxed at your death. The elimination of the estimated 27% estate tax on this new insurance would result in the same net insurance after taxes going to your estate as under your present set up.[42] The total net premium outlay per year, would then be approximately $980, as compared with $1,180 which you are now paying. Thus, under this arrangement under the new Code, you would make available to your estate the same net protection which you have at the present time at a saving of $200 in premiums each year.

[40] The gift would be of the replacement cost of the policies. This is somewhat more than the cash value. U.S. Treas. Reg. 108, § 86.19 (i) (1943).

[41] Assuming Phil's estate to be valued at $284,600, the top $14,800 of his net estate would be taxed at 27.2% if he obtained the maximum marital deduction. If he did not leave a spouse surviving him and obtain the maximum marital deduction, the top $69,600 would be taxed at 27.6%. INT. REV. CODE of 1954 § 2001, 68A STAT. 373 (1954) (Both figures are after the credit for state inheritance taxes).

[42] A full 27% tax on the insurance removed from the gross estate is not saved since had the insurance remained in the gross estate, only one-half of it would have been taxed. This is due to the fact that, in effect, one-half of it would have been deductible under the marital deduction.

2. Or, since you have become accustomed to the annual outlay of approximately $1,180 you could take out $34,000 of additional insurance through Marjorie for the same net annual premium (considering dividends on the paid-up policy and the new policy), and have your family $4,800 richer at no greater outlay in yearly insurance premiums.

Both of the foregoing alternatives have these advantages: (1) They involve no gift [43] from you to your wife, aside from future insurance premiums; (2) You retain personal control over your existing cash values; and (3) The new insurance will not be taxed in your estate.[44]

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[43] Since Phil will never have owned the new policy and since there will be no transfer of the new policy from the insured (Phil), the proposed plan would have the added advantage of making it extremely difficult to sustain any argument based upon one time ownership of the policy by Phil. Should the other facts requisite to a contemplation of death transfer be present, it could be argued by the government that Phil "transferred" the new policy to Marjorie in "contemplation of death". To sustain this argument, it would have to be concluded that in *substance* Phil *transferred* the new policy to Marjorie, in view of the over-all plan of taking paid-up insurance and new insurance to equal the previous net protection or to equal the previous total premiums, and in view of the fact that Phil will continue to pay the premiums as he has in the past. The conclusion seems impossible to draw since Phil will never have possessed any of the incidents of ownership in the new policy, and the new statute taxes insurance only if the insured "possessed any incidents of ownership" (or having possessed any, transferred them in contemplation of death). Furthermore, the conclusion, if drawn, would in effect, amount to the taxation of the proceeds of the new insurance in Phil's estate partly because he paid the premiums on the new policy; yet Congress has specifically eliminated premium payments as a ground for taxation.

The contemplation of death argument would, however, have to be faced in the gift of any existing policies unless the insured lives at least three years from the date of the gift. U.S. Treas. Reg. § 105, 81.25 (1942).

[44] Care must be taken in the case of new insurance purchased by someone other than the insured, and in the case of existing insurance transferred from the insured to someone else, to make certain the insured or his estate does not have more than one chance in twenty of receiving the ownership of, or the proceeds from the policy. Section 2042 (2) specifically defines "incident of ownership" as including a:

> ... reversionary interest (whether arising by the express terms of the policy or other instrument or by operation of law) ... if the value of such reversionary interest exceeded 5 percent of the value of the policy immediately before the death of the decedent. As used in this paragraph, the term "reversionary interest" includes a possibility that the policy or the proceeds of the policy, may return to the decedent or his estate, or may be subject to a power of disposition by him. 68A STAT. 387-8 (1954).

There may be doubt about just what a reversionary interest is. If the policy contained a clause providing that it was to revert to the insured if the owner predeceases him that would be the most obvious kind of reversionary interest arising by the terms of the policy itself, or if a policy were given by the insured

We see no reason for changing the present beneficiary designation on your insurance, and it would probably be wise for Marjorie to make the same designation on the new insurance to be taken out on your life by her. All of the insurance on your life would then be payable to your wife in a single sum with Marjorie having the right to elect to receive the proceeds under any of the optional methods of settlement such as the interest, installment,

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to a trust for the lifetime of the insured's spouse, without any remainder gift, the insured would clearly have a reversion by operation of law. The doubt, as expressed to the authors by persons active in the insurance field, arises in the case where, for example, the insured's wife is the owner of the policy, they have no children, and she has no will. The insured is the sole heir of the owner of the policy. Thus, even though the spouse has complete and untrammeled ownership of the policy, there would be a "possibility . . . that the policy . . . may be subject to a power of disposition by (the insured)," since he would stand to inherit it if his wife predeceased him. Certainly this expectancy of inheritance would not be a reversionary interest in the normal property law sense of the term since the insured (even if the policy were one which he had previously owned and given to his spouse) did not transfer "less than his entire interest" in the policy. *Cf.* RESTATEMENT, PROPERTY § 154, comment *a* (1936). The property law definition would, however, necessarily give way to the definition contained in the statute itself which is frighteningly broad in its literal language. The Senate Finance Committee Report, however, gives the answer as to the intended meaning of this language when it states:

> To place life insurance policies in an analogous position to other property, however, it is necessary to make the 5 per cent reversionary interest rule, applicable to other property, also applicable to life insurance. SEN. REP. No. 1622, 83d Cong., 2d Sess. 124 (1954).

It is clear that in respect to other property a mere possibility of inheritance is not a reserved interest of the type to which Congress intends, or has ever intended, to attach estate tax liability. U. S. Treas. Reg. 105 § 81.17 (1942) and Spiegel's Estate v. Commissioner, 335 U.S. 703 (1947). It is believed, therefore, that an outright gift of an existing policy from the insured to another person, or the purchase of a new policy on the insured by another person with full ownership in the other person, cannot result in the insured's having a "reversionary interest" in the policy, even though he may stand to inherit the policy from the owner.

This is not to say, however, that care should not be taken to prevent the actual passing of ownership of a policy to the insured should the first owner die prior to the insured. The ownership of the policy would cause taxation of the proceeds in the insured's estate at his subsequent death. Either the owner's will or the policy itself should contain successor ownership provisions to prevent the ownership of the policy from passing to the insured. This assumes that the insured will still want to keep the proceeds out of his estate should the first owner die before the insured. It is possible when there are no children and the wife is the owner, that the insured husband will not particularly care what his estate tax liability is if his wife predeceases him, and would actually want to receive the policy from his wife if he survived her.

An interesting aspect of the "reversionary interest" problem is presented by a standard clause in some insurance policies which provides that the retirement income option can be elected only by the first owner of the policy or successor owners whose successive ownership is provided for by the or life income options. Should you die, Marjorie can then decide how much of the insurance will be needed for settlement costs and can leave the balance on one of the options, keeping in mind that if she chooses one of the installment or life income options, the interest paid to her on the principal amount of insurance left with the company will, to the extent of the first one thousand dollars of interest received each year be free of income tax.[45]

Gifts to Your Children

From a tax standpoint, you have considerable to gain by making gifts to your children. The property given would not be taxed in your estate [46] and the income subsequently earned on the gift property would be taxed to the children instead of to you at your high rates. The fact that your children are both minors complicates the picture however, since a guardian would have to be appointed by court for the children before they could take any effective action in respect to reinvesting the property, [47] and even after a guardian was appointed the income from the property could not be used for the children's needs so long as you are able

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policy itself. Suppose a situation in which the wife takes out new insurance on her husband, (they are childless) upon which he pays the premiums, with the thought that when the husband reaches retirement age she will exercise the retirement income option. This will work out fine if the wife is living when the time for election arrives. But the possibility of her predeceasing him presents an impasse. The husband cannot be designated as a successor owner of the policy since that would result in his having a "reversionary interest"; nor can the desired end be accomplished by her leaving the policy to him by will or by intestacy since in such event, he could not exercise the retirement option due to the restriction in the contract. Two possible solutions of the impasse appear: (1) the companies may be persuaded to eliminate the troublesome clause from their policies; or, if not, (2) the wife can take out low premium "death" insurance, with no particular retirement values, while the husband can continue to own the high value insurance with the potential retirement income values.

[45] This exclusion applies only in favor of the surviving spouse. It does not apply to interest paid on the straight interest option. INT. REV. CODE of 1954 § 101 (b) and (c), 68A STAT. 27 (1954). Regulations and tables are to be issued by the Secretary of the Treasury for use in determining the proportion of interest and returning principal in each year's payments. Interest received on proceeds where the death of the insured occurred before August 16, 1954, will continue to be taxed under the old rule which exempted all interest, regardless of who the beneficiary was, in installment or life income optional payments, and taxed all interest paid on the straight interest option. *Ibid.*, U.S. Treas. Reg. 118, § 39.22 (b) (1)-1 (1953).

[46] Assuming Phil lived three years beyond the date of the gift. If he died within three years after making the gift, it would be presumed to have been made in contemplation of death for estate tax purposes. INT. REV. CODE of 1954 § 2035, 68A STAT. 381 (1954).

[47] *Cf.* 2 HENRY, PROBATE LAW AND PRACTICE 1747 (Grimes ed. 1954).

to supply those needs.[48] The essential difficulty then with a minor owning property under a guardianship is the loss of flexibility in the use of those funds. Flexibility in the use of the gift property can be attained if you establish a trust for your children, to which gifts could be made, with the trustee having broad powers over the management and use of the property for the benefit of the children. In the past, however, we could not have advised you to make gifts to a trust for your children without running a substantial risk that the gifts would not have qualified for the $3,000 annual exclusion allowed under the gift tax law.[49] That risk has been eliminated, however, by an entirely new provision in the 1954 Revenue Code. In this new section[50] of the law, Congress has

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[48] 2 HENRY, *op. cit. supra* note 47 at 1729.

[49] INT. REV. CODE of 1954 § 2503 (b), 68A STAT. 404 (1954), provides the annual exclusion of $3,000 on gifts to any one donee of present interests in property. Future interests in property, however, are not excludable. Under the prior law, it was not possible to establish a trust for a minor to which a gift could be made with absolute assurance that no part of it would be a future interest. Where a competent adult was the beneficiary, a donee could be relatively sure that no future interest was involved if the beneficiary received all the income and had the right to withdraw all of the principal at any time, since the essential requirement that the donee have the right to the present enjoyment of the income and corpus would be satisfied. *Cf.* Kieckhefer v. Commissioner, 189 F.2d 118 (7th Cir. 1951); *Cf.* 2 PAUL, FEDERAL ESTATE AND GIFT TAXATION, § 15.11 (1942). However, because of the legal disabilities of a minor, the Commissioner argued that as a beneficiary of such a trust, a minor could not effectively exercise his power of withdrawal and hence did not have the right to the present enjoyment of the corpus. In the *Kieckhefer* case, *supra*, a majority of the Court of Appeals of the Seventh Circuit disagreed with the Commissioner holding that the entire trust gift was a present interest. The court felt that by such a gift in trust the minor was given as much as he could be given by an outright gift of property since he would be under disabilities in respect to the use of the property in either event. It was influenced by a feeling that if the gift in trust were held to be of a future interest, the conclusion would logically follow that even an outright gift to a minor would involve a future interest. The court drew a distinction between restrictions upon the enjoyment of property arising under the gift instrument and those arising by law. On the other hand, the Court of Appeals for the Seventh Circuit unanimously held in Stifel v. Commissioner, 197 F.2d 107, 110 (2d Cir. 1952) that a gift to a similar trust for a minor by his father involved a future interest since (1) the minor could exercise his right of termination only through a guardian, and (2) the father had purposely refrained from having a guardian appointed at the time the trust was drawn since he didn't want the power exercised; and (3) no guardian was appointed during the period between the gift and the trial. The court went on to say that even if a guardian had been appointed, it would then be proper to "consider the actual facts as to the father's influence on the guardian appointed."

The unsettled state of the law made it impossible to make gifts to a minor's trust, regardless of its provisions, with any assurance that the $3,000 exclusion was available.

[50] INT. REV. CODE of 1954 §2503 (c), 68A STAT. 404 (1954).

said that no part of a gift to a trust for a minor will be a future interest if all the following conditions are satisfied:

1) the corpus and income may be expended by or for the benefit of the minor beneficiary while he is under twenty-one;
2) to the extent not so expended, all of the trust fund will pass to the minor when he reaches twenty-one; and
3) if the minor dies before reaching twenty-one, the trust fund will be payable to the estate of the minor or as he may appoint under a general power of appointment exercisable by deed or will.[51]

You could establish a trust for each of your children[52] and give the trustee complete discretion[53] over the use of the income and principal during the child's minority, which would afford the desired flexibility in the use of the gift property, without losing your annual exclusion on any property given to the trust. As each child reaches twenty-one, his trust will terminate and the property will be distributed to him. Although the possibility is exceedingly remote, if either child should die before reaching twenty-one, the trust property will pass to the estate of the child unless he has previously directed where he wants the property to go.[54] In that

[51] For the definition of a general power of appointment see INT. REV. CODE of 1954 § 2514 (c), 68A STAT. 407 (1954).

[52] A trust for each minor is recommended. There appears to be nothing in the statute which literally requires a separate trust for each minor, so one trust for several minor beneficiaries would probably be satisfactory if each minor was given a definite interest in a fraction of the income and corpus. Of course, the trustee could not be given discretion to use all or any part of the entire trust income or corpus for any of the beneficiaries. All of the income and all of the corpus of each minor's undivided interest would have to be sharply segregated for him. However, it would seem safer in view of the newness of the provision to have individual trusts for each donee until there is some definite pronouncement of its meaning. For an interesting analogy, consider the original estate tax marital deduction trust provision which allowed the deduction only if all of the income from the trust went to the surviving spouse and all of the corpus went to her estate or was subject to her general power of appointment [INT. REV. CODE of 1939 § 812 (e) (1) (F)] which however was changed by INT. REV. CODE of 1954 § 2056 (b) (5), 68A STAT. 393 (1954) to permit the deduction for an undivided interest in trust property, all the income of which goes to the surviving spouse and the corpus of which passes to her estate or is subject to her general power of appointment.

[53] Under the House version of the bill, this was not true. *Cf.* SEN. REP. No. 1622, 83d Cong., 2d Sess., 479 (1954).

[54] From an estate planning standpoint, it would probably be more desirable to give the child a power of appointment only, with the property passing in default of the exercise of the power to the surviving spouse and/or issue of the deceased child, if any, or if none to the other child's trust. Thus, Phil and Marjorie would not run the risk of inheriting the gift property. Section 2503(c)(2)(B) appears to provide alternative

connection, if the property should pass to the estate of one of your children, assuming he left no children of his own, you, Marjorie, and the other child would each inherit one-third of the property.[55] Since one of your aims in making any gifts would be to remove the gift property from your estate for estate tax purposes, you and Marjorie would not want to receive this property back. Therefore, we would recommend, assuming you do decide to establish such trusts, that each child execute what is called a 'power of appointment',[56] under which each will direct that if he dies before

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grounds for qualifying a trust under the provision, i.e., the property must pass to the minor's estate if he dies before twenty-one or it must be subject to a general power of appointment. However, until definite assurance is available that the use of either clause will qualify a trust, and both are not necessary, it would seem wise to draft such a trust with both provisions satisfied. If Congress' intent was to declare that the gift property will not be a future interest if the property would be included in the minor beneficiary's estate at his death before twenty-one, then the use of only one of the grounds would be sufficient since either should cause the property to be taxed in the beneficiary's estate. INT. REV. CODE of 1954 §§ 2033 and 2041 (a) (2), 68A STAT. 381 and 386 (1954). An analogy to the marital deduction section of the estate tax might be drawn, since there Congress authorized the deduction for property left to an "estate" trust, (the terminable interest rule is not violated since no interest in the property passes to any other person than the spouse) INT. REV. CODE of 1954 § 2056 (b) (1) (5), 68A STAT. 392 (1954) or to a "power of appointment" trust. INT. REV. CODE of 1939 § 812 (b) (5). The deduction was apparently allowed in either instance in view of the fact that the property would be subject to estate tax in the surviving spouse's estate. However, it is not true that a gift will be a present interest merely because it will be taxed in the donee's estate, 14 P-H 1945 T.C. MEM. DEC. 45,243 (1945), so that the analogy does not remove the doubt, however slight it may be.

There is however a second reason for not relying solely on a power of appointment. If the minor cannot under local law effectively exercise a power of appointment, the requirement of Section 2503 (c) (2) (B) that the property pass "as he may appoint" would not be satisfied. In Indiana, it is clear that a minor cannot exercise a power of appointment by will since he cannot execute a valid will. IND. ANN. STAT. tit. 6, c.5, § 6-501 (Burns 1953). Furthermore, a minor can, upon reaching twenty-one disaffirm his previous inter-vivos conveyances, *Cf.* Long v. Williams, 74 Ind. 115 (1881); Shroyer v. Pittenger, 31 Ind. App. 158, 67 N. E. 475 (1903) and an inter-vivos exercise of a power of appointment would be treated as any other conveyance. *Cf.* RESTATEMENT, PROPERTY § 345 (1936). Of course, if the infant exercises the power by deed, and then dies before reaching twenty-one, the reason for allowing disaffirmance no longer exists (the infant's welfare). There is authority, however, that an infant's heirs can disaffirm his deed after his death. Gillenwaters v. Campbell, 142 Ind. 529 (1890).

Even though it be true that the infant could effectively exercise his power by an inter-vivos deed, the risk of a contrary result would seem too great to justify reliance solely on the power of appointment provision.

[55] IND. ANN. STAT. tit. 6, c. 2, § 6-201 (c) (3) (Burns 1953).

[56] Even though there may be some doubt as to whether the exercise of the power will be effective, there is no reason not to attempt it.

twenty-one his trust property is to go to his surviving spouse and children, if any, or if none, to the trust for your other child.

This kind of trust will be fine during the minority of your children. The only objection to it is that it will require distribution of the property as each child reaches twenty-one. That is satisfactory for more modest gifts, but where large amounts are involved it might be better for the trustee to hold the property until the child reaches a more advanced age. You and Marjorie do not at this time have a sufficiently large estate to warrant large gifts for your children. If the time comes when you can make larger gifts, the importance of having the property held until the children are capable of receiving it would outweigh the desirability of getting the annual exclusion, so a more appropriate trust could then be drafted. In the meantime, however, we recommend that you consider making gifts, perhaps of $3,000 annually[57] to a trust, of the type previously described, for each of your children.

Your Business

There are three important estate planning problems in respect to your business:

1. Your business is a valuable asset only so long as it is being properly operated, and it is our understanding that there is no one presently in the business who could carry on after your death. Marjorie has no knowledge of, or particular interest in, its operation. If Tom continues to develop and shows an interest in the business, he may be able to eventually carry the load, and we know that you would like to preserve the business, if possible, until he has demonstrated his capabilities and interests. If he does work into the company and is successful with it, it will be much more valuable to your family than the proceeds from a quick sale at your death. In view of these considerations, we recommend that you consider leaving your interest in the business to a corporate trustee during Marjorie's lifetime. Your executor and the trustee would have power, with Marjorie's consent, to sell it at any time should it appear advisable. Marjorie would be given power to vote the stock in the trust. The trustee would have to hire competent management for a while which would be expensive, but this plan would result in the preservation of the company as a going concern until Tom reached the point where he could take over.

2. The second problem is a corollary of the first; it is an additional aspect of the overall problem of how to handle the stock during Marjorie's lifetime.

[57] Phil could give $6,000 annually to each trust and not exceed the annual allowable exclusions, because of the gift splitting provisions. INT. REV. CODE of 1954 § 2513 (a), 68A STAT. 406 (1954).

It would be possible to leave all of the stock in the trust during Marjorie's entire lifetime. But this procedure would not give due regard to the possibility that Marjorie might live long after the children reach maturity. In such event, would it be right to delay the receipt by the children of any interest in the business until after her death, particularly in view of the fact that Tom may be the backbone of the business during that period? This problem can be obviated by a provision in the trust that a portion of the stock be turned over to the children, perhaps at age thirty, even though Marjorie is then living. This portion should not be so great as to disturb Marjorie's voting control, yet it should be large enough to give the children, particularly Tom, a sense of close identification with the business. We will give you our recommendation on the exact proportions involved in the following paragraph.

3. The third problem arises from the fact that you will want the stock ultimately to be divided between Tom and Mary. The possible solution to this problem will also assist in determining the solution to the second problem. Since you do want the business interest divided equally between the children after Marjorie's death (or at your death if she should predecease you), this desire could be achieved simply by leaving the existing common stock to them equally upon termination of the trust. However, if Tom becomes active in the business, as you hope, his efforts will "make or break it," while Mary will play no active part. Would it be fair to Tom for Mary to have fifty per cent of the equity (common) stock which will increase in value, if it does, through Tom's efforts? Or would it be fair to Mary if she had only common stock which, from an income standpoint, could be worth little, while Tom will be drawing a substantial salary? We think you will agree with us that this would not be fair to either of them. This dilemma can be solved by the issuance of a stock dividend on your existing 1,000 common shares, of 1,000 shares of \$100 par, 5% preferred stock[58] which would absorb the present \$100,000 surplus of the \$150,000 value of the business.[59] The preferred would carry annual dividends of \$5,000 and would be non-

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[58] The preferred dividend would be tax-free. INT. REV. CODE of 1954 § 305 (a), 68A STAT. 90 (1954).

[59] The condensed balance sheet after the dividend would be as follows:

Assets	
Net value of assets =	\$150,000
Liabilities	
1,000 shares 5% pfd, \$100 par value =	\$100,000
1,000 shares common \$50 par value =	\$ 50,000
Total	\$150,000

voting. The common would continue to carry the voting rights and its $50,000 value would increase or decrease according to the company's fortunes. This preferred dividend, which is really nothing more than a division between two classes of stock of the rights which the existing common stock has, will permit a solution of both the second and third problems. Your will can leave all of both classes of stock to the trust and the preferred would remain in trust throughout Marjorie's lifetime to assure her, as the sole income beneficiary, an income. One-half of the common will also remain in trust for her lifetime, but the other half will be distributed equally to the children, each child receiving his portion at thirty even though Marjorie is then living. This would give Tom and Mary the interest in the business which we believe to be desirable without sacrificing Marjorie's income. After Marjorie's death, the stock will go equally to the children with Mary's half being made up of preferred insofar as possible, and Tom's one-half being made up of common to the extent possible. If we assume that the total value of the business has increased to $200,000 at the time of Marjorie's death so that the common is worth $100,000 (its $50,000 par value would not determine its actual value), an example of the result achieved would be that $100,000 of preferred (all) and $50,000 of common (one-half) would have remained in trust for Marjorie's lifetime. Marjorie, voting through the trust one-half of the common stock, would always be in practical control of the company. The other $50,000 of the common (one-half) would have gone $25,000 (one-fourth) to Tom at thirty and $25,000 (one-fourth) to Mary at thirty. At Marjorie's death, the total stock values in trust would be $150,000, which would be divided equally between the children with Mary receiving $75,000 of preferred and Tom receiving $25,000 of preferred and $50,000 of common.

Mary then would own one-fourth of the outstanding common ($25,000), which would permit her to share partially in the future growth of the business, and $75,000 of preferred which would draw dividends of $3,750 yearly. Tom would be in control of the company, owning three-fourths of the voting common ($75,000), as well as $25,000 of the preferred. Tom's heavy interest in common would afford him the opportunity of sharing heavily in any increase in value of the business due to his efforts.

This plan for the business seems to us, at this time, to be a good one. However, it might in later years after your death turn out to be entirely wrong because of changes in the family or business situation. As a kind of safety valve against this possibility, Marjorie should be given the power, exercisable during her lifetime or in her will, to adjust the plan by providing for different distribution dates and divisions of the stock between Mary and Tom.[60] She would have the power to require the trustee to turn over either class of stock in such proportion or proportions as she deems proper to Tom or Mary, or both. Although she would not be able to prevent the distribution of one-fourth of the common to each child at thirty, this will permit her to take a "second-look" at the rest of the plan for disposition of the business and to change it if the facts justify a change.

From a mechanical standpoint, the proposed preferred stock dividend we have been discussing could be issued either now, or at your death, or at Marjorie's subsequent death. This type of preferred stock, however, carries certain income tax disadvantages under the new Revenue Code, [61] which are removed once the stock passes through an estate. These disadvantages only come into play upon certain sales of the stock which should not seriously affect you, but they might have an adverse affect on

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[60] As will be discussed later in this article, Marjorie will be given a general power of appointment exercisable by deed or will over the portion of the trust which is to qualify for the marital deduction. This will permit her to make adjustments in a portion of the stock in trust. Of course to the extent that she exercises the power by requiring distribution under the power during her lifetime she will be making a taxable gift [INT. REV. CODE of 1954 § 2514 (b), 68A STAT. 407 (1954)], and to the extent it is unexercised the property will be taxed in her estate but that is necessary in order to get the marital deduction. This is discussed later in the article.

She can be given a non-general power of appointment over the portion of the trust property that is not to qualify for the marital deduction, exercisable only in favor of the children or their issue. This will not cause the property subject to that power to be taxed at her death. INT. REV. CODE of 1954 § 2041 (b) (1), 68A STAT. 386 (1954) although should she exercise the power by directing a distribution during her lifetime she would be making a taxable gift by the release of the present value of her life estate in the property subject to the exercise of the power. *Cf.* U.S. Treas. Reg. 108, § 86.2 (b) (2) (1943); E.T. 23, 1950-1 CUM. BULL. 130.

[61] The preferred stock would, prior to Phil's death, be "306 stock". Sec. 306 of the new Code is directed at the preferred stock "bail out" of the type found in Chamberlin v. Commissioner, 207 F.2d 462 (6th Cir. 1953), and would not interfere with a legitimate preferred stock dividend or recapitalization for the purpose proposed. It would prevent Phil from selling the preferred stock, unless he simultaneously disposed of all of his common stock, in that he would have ordinary income on the sale of the preferred to the extent of the preferred's allocable share of the corporation's earning and profits. INT. REV. CODE of 1954 § 306 (a) (1), 68A STAT. 91 (1954). However, if he subsequently decided that he wanted to sell a part of his interest in the corporation, he could retrace his steps, causing the corporation to redeem the preferred for common, and the gain from the sale of the new common would be capital gain. INT. REV. CODE of 1954 § 306 (b) (3), *ibid.* The transfer of the preferred stock through his estate at his death would not give rise to any income tax to him or the estate and would relieve the stock of its "306" qualities so that Mary, as the ultimate recipient, could sell all or any part of it with the gain, if any, being taxed at the capital gains rate. INT. REV. CODE of 1954 §§ 306 (b) (3) and 306 (c), *ibid.*

Mary after your death should she want to sell a part of the shares. Therefore, it would be well to declare the dividend now so that the stock will have passed through your estate, thus eliminating the undesirable qualities by the time Mary gets the stock.

If brevity is the sole of wit this letter is dour beyond doubt, but justifiably dour we believe. The property that a man spends a lifetime in acquiring should not be relinquished without full consideration and thought. When you and Marjorie have had an opportunity to think over the problems involved, please give us a call so that we can set a time for another conference at which we should be able to reach some definite conclusions.

Cordially yours,
Merle H. Miller

After a couple of weeks passed, Phil called for an appointment. When he and Marjorie came in, Phil said that although "dour" not merely beyond doubt but beyond belief, the letter had brought to his attention the various problems and had given him an idea of the decisions he would have to make. He said he intended to take our advice in respect to the home, the "E" bonds, and the life insurance. He had been thinking a good deal about gifts to the children, and the handling of the business, and wondered why it wouldn't be possible to go through with the preferred stock dividend, and then establish trusts for Tom and Mary. He could then give a little preferred to Mary's trust and a little common to Tom's trust. He felt that if Tom received some personal financial interest in the business upon reaching twenty-one, he would be encouraged to come into the business after graduation. Even though there would be some income tax disadvantages[62] if gifts of this stock were made, we were constrained not to advise against them because of the satisfaction they would give Phil and Marjorie, and the incentive Tom would be given to become actively interested in the company.

Due to Marjorie's lack of business experience Phil wanted her to have the assistance of a trustee in handling the portion of his estate that would pass under his will.

When this conference had concluded we advised Phil that we could now draft wills for him and Marjorie and that we would write him soon summarizing the estate plan that had now been decided upon.

IV

GENERAL ESTATE PLAN

Our summary letter to Phil, with which we enclosed copies of his and Marjorie's wills, was as follows:

Phillip Brown, President
Acme Structural Steel Company
Indianapolis, Indiana

Dear Phil:

In view of our discussions we have drafted wills for you and Marjorie, copies of which are enclosed, which together with your nontestamentary dispositions of property, achieve the following general estate plan:

(1) On January 2, 1955, you will convert the title to your home to a tenancy by the entireties with Marjorie. Should you die thereafter, title to the house will pass directly to Marjorie.

(2) Your jointly owned "E" bonds will be left as they are. These will pass directly to Marjorie at your death.

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[62] The stock of both classes would have Phil's low income tax basis, which would carry over on a gift [INT. REV. CODE of 1954 § 1015 (b), 68A STAT. 298 (1954)] while if Tom retained the stock until death it would acquire a new basis equal to its fair market value at that time [INT. REV. CODE of 1954 § 1014 (a), 68A STAT. 296 (1954)]. The gift of preferred to Mary's trust would present an additional problem. If Phil gave the preferred or any part of it to a trust for Mary, he would not at that time realize any income on account of the "306" character (there is perhaps a question under the statute as to whether a gift is a prohibited disposal under 306 (a) but it is understood that the regulations to be issued will hold that it is not). In the event of its gift, however, "306" stock remains "306" stock, and should the trustee or Mary subsequently sell all or any part of it during Phil's lifetime, she would be taxed just as Phil would have been taxed if he had sold it, [INT. REV. CODE of 1954 § 306 (c) (1) (C); § 318 (a) (1); § 318 (a) (2) (B), 68A STAT. 92 and 100 (1954)] unless Phil at the same time sold all of the remaining stock which he had in which case the gain to both Phil and Mary would be capital gain. INT. REV. CODE of 1954 § 306 (b) (1) (A), 68A STAT. 91 (1954). After Phil's death, and the termination of the trust to be established under Phil's will, Mary could sell all of the preferred, including the gift preferred, provided she sold her common at the same time, without the proceeds from any part of the sale being taxed as ordinary income. The important thing to remember about section 306 is that it is directed at the proceeds from the sale of dividend preferred stock by the recipient or his donee and will not interfere with the use of preference stock for estate planning purposes where no sale of the stock is involved until after it has passed through an estate.

(3) You will take paid-up life insurance of $34,000 for your existing insurance, with Marjorie named as the primary beneficiary. She will have the right to take the proceeds in a lump sum or under any of the options. Your children will be named as the contingent beneficiaries under an appropriate installment option. The cash value of this insurance will always be available to you should you need it for any purpose, including as a source of retirement income.

(4) Marjorie will take out new insurance on your life in the face amount of $34,000, upon which you will pay the premiums. The annual net premium on this policy should be approximately equal to the net premiums you have been paying on your existing policies. The trusts to be established by you for the children are to be the contingent owners of this policy (should Marjorie predecease you) unless the trusts have terminated, in which event the children will be the contingent owners. The beneficiary designation will be identical with that on your existing policies. This insurance will not be taxed in your estate.

(5) You will have your corporation, the Acme Structural Steel Company, issue, against its present surplus, a stock dividend of 1,000 shares of $100 par value 5% preferred stock.

(6) We will draft a trust for each of your children to which you can make yearly gifts of either class of your stock. These gifts will qualify for the annual gift tax exclusion. The trustee will be authorized to use the income and principal for the children or not as it sees fit, during their minority. As each child reaches twenty-one, his trust will terminate and the trust property will be distributed to him.

(7) Your will leaves the household goods, your miscellaneous personal property and the home (if you should die before converting it to a tenancy by the entireties), outright to Marjorie if she survives you. The rest of your estate is left to the trust established by the will. If Marjorie predeceases you, all of your estate (except the life insurance which will go as previously mentioned) will pass to the trust.

Your executor, with Marjorie's consent, is empowered to sell the company stock although not directed to. Marjorie is given the power to vote the stock during the period of administration.

(8) The trust established by your will accomplishes these results:

(a) The net income is paid to Marjorie during her lifetime.

(b) Marjorie will be adviser to the trustee with veto power over any major investment decisions, including a sale of the company stock. She will also have the right to vote the common stock in the trust.

(c) Marjorie will have the right to appoint the exact amount of the values in the trust, to anyone of her choosing, including herself or her estate, during her lifetime or by her will, so that your estate will be insured the maximum marital deduction.[63]

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[63] A single trust would not have been possible in this situation under prior law which did not allow the marital deduction for an undivided interest in trust property [INT. REV. CODE of 1939 § 812 (e) (1) (F)] even though all of the income from that interest went to the surviving spouse and the interest was subject to her general power of appointment. The law required all of the income from the entire trust to go to the spouse and all of the corpus to be subject to her general power before any part of the trust property qualified for the marital deduction. Thus in order to accomplish Phil's desires of having the bulk of his property in trust for Marjorie, two trusts would have been needed, one a marital deduction trust to which enough property would have been left to assure qualification of one-half of the adjusted gross estate for the deduction and a second trust to which the balance of the estate would have been left. Marjorie would have received all of the income from this second trust but would have had no general power over the principal so that its corpus would not have been subjected to a second tax at her death.

The use of a single trust is made possible by INT. REV. CODE of 1954 § 2056 (b), 68A STAT. 392 (1954) which allows the marital deduction for a "specific portion" of trust property. The provisions of such a trust must be carefully drafted. Where the entire residue of an estate is left to such a trust and the taxes and costs of administration are to be paid from the residue, it will not be possible to predict how much of the estate values will finally be distributed to the trust due to the impossibility of accurately predicting the costs and taxes. Therefore, it would not be completely satisfactory to give the surviving spouse the income from and a general power of appointment over a *fractional* part of such a residuary trust with any assurance that exactly one-half of the adjusted gross estate would qualify for the marital deduction. Another possibility would be to give the surviving spouse the income from, and a power of appointment over, a dollar amount of values in the trust. Thus, if an additional $50,000 (when added to life insurance proceeds and jointly owned property which qualify for the deduction) is needed to get the full advantage of the marital deduction, the surviving spouse would be given a general power of appointment over the first $50,000 of property in this trust. One difficulty with the use of such a clause is that it could be argued by the government that a "dollar amount" of values in the trust is not a "specific portion" of the trust property; the theory being that the use of the term "portion" in the statute requires some kind of fractional determination of the amount to qualify for the marital deduction. The Regulations may shed some light on what "specific portion" means. Another possibility would be a

The portion of the trust corpus subject to this power will qualify for the marital deduction and when it is added to the property Marjorie will receive outright (home, household goods, miscellaneous personal property, and life insurance owned by you), one-half of your adjusted gross estate will qualify for the marital deduction.

(d) Marjorie will have a non-general power of appointment over the rest of the trust property. This will permit her to direct the trustee, either during her lifetime or at her death, to turn over all or part of this portion of the trust property to the children or their issue. The portion of the trust subject to this power will not be subject to a "second estate tax" at Marjorie's subsequent death.

By virtue of her two powers of appointment Marjorie will be able to make changes in your estate plan insofar as the children are concerned, after your death without any substantial additional cost in gift or estate taxes. This will be particularly useful in connection with the ultimate division of the company stock between the children.

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trust income and power of appointment provision akin to the "formula clause" now used by many draftsmen in bequeathing exactly one-half of the adjusted gross estate to the surviving spouse. In such a clause, the surviving spouse would be given the income from, and a general power of appointment over, the exact portion of the trust which would be needed in order to give the deceased spouse's estate the exact marital deduction. For a discussion of the formula type clause, see Casner, *Estate Planning—Marital Deduction Provisions of Trusts,* 64 HARV. L. REV. 582 (1951).

Another factor should be carefully considered before deciding to use one trust instead of two. Assume a single trust is used to which $150,000 in property values are left, over $50,000 of which the surviving spouse is given a general power of appointment in order to leave one-half of the adjusted gross estate, and no more, so that it qualifies for the marital deduction. The non-qualifying portion of the trust will not be taxed at the spouse's later death. Further assume a general decrease in the value of the property in that trust between the deaths of the spouses, from $150,000 to $100,000. The taxable estate of the second spouse would not get the benefit of any of that decrease since in order to get the exact marital deduction she was given a power of appointment over a specific amount of the trust corpus. The reduction, for tax purposes, would come out of the part of the trust which would be tax-free at the second spouse's death. Of course, if there is an increase in values between the deaths of the spouses, the increase would be in the tax-free portion, which would be to the taxpayer's advantage.

This possibility can be avoided by the use of two trusts, which would presumably suffer a decrease, or gain an increase, in equal amounts or nearly so. It could also be avoided even though one trust were used if the surviving spouse's power of appointment was over a fractional part of the trust corpus.

(e) In order to give the children a "stake" in the business as soon as practicable, while Marjorie is living, each of them will receive one-fourth of the company's common stock at the age of thirty. Marjorie's powers of appointment will not permit her to delay this distribution.

(f) If Marjorie should die while either child is under thirty, that child's portion of the trust will be held in trust for him. If he is under twenty-one the trustee will have discretion in the use of his share of the income for him.[64] After he reaches twenty-

[64] In the event Phil and Marjorie should both die while either of the children were minors, the trustee is to have discretion over the use of the income for the minor child's needs. The income accumulated, by virtue of the exercise of this discretion, is to be added to corpus and distributed at the corpus distribution ages. In any trust providing for income accumulations, careful attention should be given to the provisions in the new Code dealing with the taxation of trusts and their beneficiaries. INT. REV. CODE of 1954 §§ 641-668, 68A STAT. 215-226 (1954).

The "conduit" theory of the old law is retained so that generally speaking the trust gets a deduction for income which it distributes to beneficiaries, which income is in turn taxed to the beneficiaries. Income that is not distributed, but accumulated, is within certain limitations taxed to the trust. This has always presented an opportunity for tax avoidance in that income could be accumulated and added to corpus, then subsequently distributed to the beneficiaries, the effort being to divide the *taxable* income between the trust and the beneficiaries, yet have it all go to the beneficiaries eventually. The old law attempted to make this practice less attractive by providing that any distribution by a trust of income accumulated in a prior taxable year, within 65 days after the end of that prior taxable year would be treated as if distributed from the prior year's income. INT. REV. CODE of 1939 § 162 (d) (3). If made more than 65 days after the end of the prior taxable year, the distribution was considered as distributed in the current taxable year, but only to the extent of the actual income of the trust for the preceding 12 months. For example: A trust began its existence on January 1, 1950, which provided for the accumulation of all income until July 1, 1951. It had $500 of monthly income for the 18 months prior to July 1, 1951, all of which was distributed on that date. It had $500 of monthly income for the remaining six months of 1951. In its 1950 return, the trust would have paid tax on $6,000 ($500 monthly for 12 months). The July 1 distribution of $9,000 would be taxed to the beneficiary, *but* only to the extent of the trust's income for the preceding 12 months. Since the income for the preceding 12 months was only $6,000, the other $3,000 would not be taxed to the beneficiary. Thus it was possible to divide taxable income between a trust and its beneficiaries even though all of the income was regularly (at appropriately spaced intervals) paid out to the beneficiary. In an effort to further close this "loophole" the 1954 Code adopts what will be known as the "five year throw-back rule", the effect of which is that any distribution by a trust (with certain specified exceptions hereinafter mentioned) in excess of the distributable net income for its current year shall be "thrown back" first to the preceding year to the extent there was undistributed net income (*i.e.*, accumulated income) in that year, and then to each preceding year as to the extent of undistributed net income in those years, for no more than five previous years in total.

one each child will receive his share of the income from the trust property.

(g) Each child will receive his entire half of the trust property at the age of thirty or at Marjorie's death, whichever is later. Mary's half will consist of preferred stock and Tom's half will be made up of common stock, to the extent consistent with an equal division. This will give Tom who persumably will be active in the business the bulk of the common stock, which will carry voting control, and the value of which will depend on his

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INT. REV. CODE of 1954 §§ 665-668, 68A STAT. 223-6 (1954). To the extent undistributed net income exists in those five previous years, the beneficiary is taxed in the current year on the amount he receives. (There are relief provisions designed to prevent the total income taxes exceeding what they would have been if the income had been distributed in the 5 prior years instead of having been accumulated.) Thus in the previous example $3,000 would be treated as if distributed in 1951 while the other $6,000 of the $9,000 distributed on July 1, 1951, would be "thrown back" to 1950, and since there was $6,000 of accumulated income in 1950, that amount would be taxed to the beneficiary in 1951.

There are five exceptions to the application of this rule to a trust and its beneficiaries (it does not apply to estates):

1. Accumulations paid to a beneficiary upon his reaching 21 are not "thrown back."

2. Distributions of accumulations "to meet the emergency needs" of a beneficiary are not "thrown back".

3. Accumulations paid upon a beneficiary's reaching a specified age or ages if (a) the total distributions to a beneficiary do not exceed four in number, and, (b) the period between each distribution is four years or more, are not "thrown back."

4. Final distributions which include accumulations if made more than nine years after the date the last property was transferred to the trust are not "thrown back".

5. Distributions which include accumulations not exceeding the current year's distributable income by more than $2,000 are not "thrown back".

Since it is customary to provide for accumulations, particularly during the minority of trust beneficiaries, it will be important to make sure that all provisions under which accumulations may be distributed come within one of the five exceptions if it is desired to have the accumulation taxed to the trust instead of the beneficiary. In Phil's trust, the trustee is to have discretion over income payments to the children during minority (after Marjorie's death) and any amounts so accumulated because of the exercise of its discretion are to be distributed at age 30. By virtue of the fourth exception above, the accumulations will not be "thrown back", since they will be distributed at a single specific age.

The first exception for distribution at 21 is clear and will be sufficient in the case of many trusts. For instance, if Phil's trust provided for distribution of all income accumulated for each child to that child at 21, this exception would be satisfied.

efforts. He should also receive a small portion of the preferred. Mary will have some common stock (one-fourth of the common) in order to permit her to partially share in the fortunes of the business, but the bulk of her interest will be in preferred stock which should give her a relatively secure income.

(9) Marjorie's will leaves her estate to you if you survive her and if not to the trust established by your will. If either

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The regulations will probably elaborate on the second exception, specifying more particularly to what the term "emergency needs" is intended to apply. The Senate substituted this language for "maintenance support or education of the beneficiary" contained in the House bill, and the Finance Committee Stated that the exception as provided in the House Bill was:

> . . . too broad and, that the revision was made in order to prevent employment of this provision as an escape from the application of the rule. . ." SEN. REP. No. 1622, 83d Cong., 2d Sess. 85 (1954).

The Senate went on to say in the detailed discussion of its report that:

> Whether or not a distribution falls within this paragraph depends upon the facts and circumstances causing such a distribution. A distribution based upon an unforseen or unforseeable combination of circumstances requiring immediate help to the beneficiary would qualify. However, the beneficiary must be in actual need of the distribution. The fact that a beneficiary has other sufficient resources would tend to negate the conclusion that a distribution was to meet his emergency needs. *Id.* at 357.

It is apparent that this exception is intended to have a fairly limited effect. Therefore, until the regulations are issued, it would seem unwise to draft a provision providing for emergency distributions which provided for anything more than distributions "to meet the emergency needs" of the beneficiaries, using the language of the statute.

The third exception can be tied into most estate plans without the necessity of distorting any of the testator's distributive desires. It is the unusual trust which provides for more than four separate distributions of principal or separates the principal distribution dates by less than four years.

The fourth exception would be one which the intelligent planner would leave to chance, for it would seem unwise to specifically delay final distribution for nine years after the last assets were transferred to the trust (which in the case of Phil's trust would be nine years after his death) in order to get this income tax benefit, assuming that the beneficiaries would have already reached the desired age or ages for distribution before the nine year period has elapsed.

The fifth exception is apparently a kind of "de minimus" approach by Congress and should completely free many small trusts from the "throw back" rule.

Although the careful planner should, where reasonable, draft a trust so as to come within the exceptions, it would seem on the other hand that any distortion of his client's desires and the needs of the family, merely to come within the exceptions, would be permitting "the tax tail to wag the dog" to an unreasonable extent.

child is thirty or over at Marjorie's death that child will receive his one-half of her estate outright instead of it going into the trust.

To give you and Marjorie a more comprehensive picture of your estate plan we are enclosing an Estate Flow Chart*** to graphically portray the passage of your property if Marjorie survives you.[65]

Cordially yours,
Merle H. Miller

*Merle H. Miller**
*H. Gene Emery***

[65] Similar charts were prepared to cover the situation at Marjorie's subsequent death, and to cover both estates if Marjorie should predecease Phil. Footnotes 66 and 67 are references to the chart which appears on the pages following the main text of this article.

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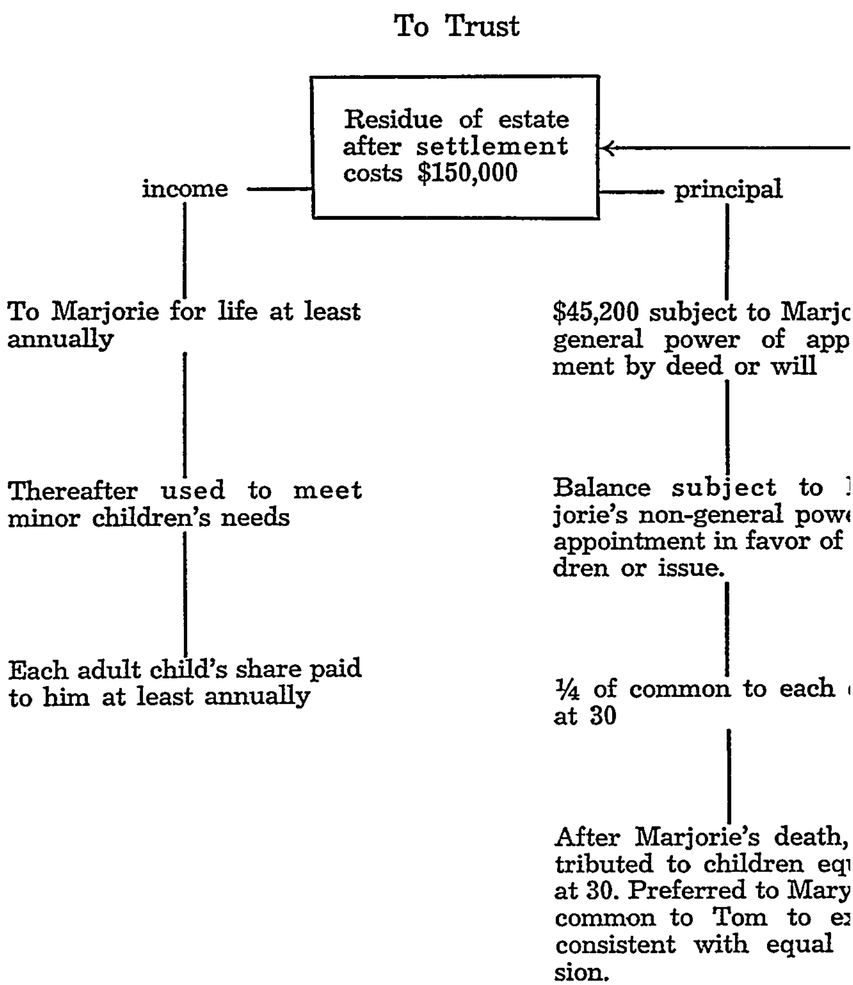
ESTATE FLOW CHART 1***

How Phil's Estate Will Pass if Marjorie Survives H

Based on Estimated Values



Assets

Home (joint)	$ 24,000
Stock in Acme Steel Co.	
1000 shs. $100, 5% pfd.	100,000
1000 shs. common	50,000
Life insurance (paid up)	34,000
"E" Bonds (joint)	3,600
Listed stock	27,000
Household goods (joint)	5,000
Misc. personalty	5,000
	$248,600

To Marjorie

Home	$24,000
Life insurance	
(Owned by Phil)	34,000
"E" bonds	3,600
Household goods	5,000
Misc. personalty	5,000
	$71,600
Life insurance[66] Owned by Marjorie on Phil's life	$34,000

Less Estimated Settlement Costs[67]

Last expenses	$ 3,000
Probate expenses	9,000
Accrued taxes and debts	3,000
Indiana inheritance tax	3,400
Federal estate tax	8,600
Total	$27,000

[66] The $34,000 in tax-free insurance proceeds which Marjorie will receive will be added to the one-half of Phil's adjusted gross estate, received by her at his death, in determining her gross estate at her subsequent death for estate tax purpose (to the extent she has not consumed the proceeds during her lifetime). Since the estate tax is a progressive tax, this means that the minimum combined estate taxes in Phil's and Marjorie's estates would be achieved if Phil left Marjorie slightly less than one-half of his adjusted gross estate so that one-half of all property involved would be taxed at Phil's death, and one-half would be taxed at Marjorie's death.

[67] Phil's estate will have sufficient liquid assets to pay his settlement costs without using any of the company stock. However, if it were thought desirable to redeem a part of such stock, even though not necessary to pay death costs, it could be done without the proceeds of the redemption being taxed as a dividend. Section 303 (a) of the new Code permits, as did the previous law, a redemption of stock in an amount not exceeding the death taxes and allowable funeral and administration expenses (the funeral and administration expenses were added in the 1954 Code). There is no statutory requirement that the proceeds of the redemption be needed to meet the taxes and costs. Of course the necessary percentage requirements must be satisfied, for which see page 10 herein.