

# INTEGRATION OF THE ESTATE AND GIFT TAXES<sup>1</sup>

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To give, yet not to give—that is the problem which fear of death taxes has forced down the throats of prospective decedents. Substitutes for testamentary disposition in a hundred different forms have been the nemesis of legislators and tax administrators as far back as death taxes have been levied. A person may desire to leave as much property as possible to his children, and to that end to diminish as far as possible the death taxes that will be imposed; nevertheless, as long as he lives he will want to keep the property for his benefit or at least under his control. Ground between these two desires, decedents have invented all manner of disposition *inter vivos* in which they have attempted to retain control. Often in their eagerness to avoid the death taxes they have added a provision destroying the control which under another provision they essayed to retain, thereby attempting to fool the tax gatherer but in result fooling only themselves, or rather their heirs.

For example, beginning with the 1924 Act the federal estate tax law has contained a specific provision including in the gross estate property transferred subject to a power of revocation, whether the power was exercisable by the decedent alone or in conjunction with any other person; and the Supreme Court had occasion to decide that this provision was applicable and valid even where such other person was the beneficiary.<sup>2</sup> Obviously, a power of revocation exercisable only with the consent of the beneficiary is no power at all. Its inclusion in a trust instrument is but evidence of the absurd lengths to which persons will go in the attempt to avoid death taxes and at the same time retain until death the power and benefit which ownership has meant to them.

That Congress was aware of the use of testamentary substitutes is shown by the fact that in the very first federal estate tax act, that enacted in 1916, it provided for inclusion in the gross estate of transfers made in contemplation of death, and of transfers *inter vivos* intended to take effect in possession or enjoyment at or after death. But Congress was soon to find that testamentary substitutes were of many kinds, and that when one fell under its ax there was always another to take its place. In

<sup>1</sup> The plan presented in this article was first outlined by the author in *Combining the Gift and Estate Taxes* (1938) 16 TAX MAGAZINE 258. It was later developed in an address by him before the National Tax Conference of the National Tax Association in San Francisco, October 18, 1939.

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<sup>2</sup> *Helvering v. City Bank Farmers Trust Co.*, 296 U. S. 85 (1935).

1924 it added inclusion of transfers subject to a power of revocation whether the power was exercisable by the decedent alone or in conjunction with any other person. In 1926 it made conclusive with respect to transfers over \$5,000 to any one person, the presumption contained in earlier acts that transfers made within two years of death were made in contemplation of death; but the Supreme Court ruled this conclusive presumption out as violative of due process.<sup>3</sup> In 1931 the Supreme Court emasculated the provision requiring inclusion in the gross estate of transfers intended to take effect at or after death by holding that it did not apply to irrevocable transfers though the income was reserved by the grantor for life.<sup>4</sup> In consequence Congress added a provision expressly including such transfers in the gross estate. In 1936 the provision with respect to revocable transfers underwent similar elaboration. The Supreme Court indicated that a power to alter, amend or revoke might not include a power to terminate,<sup>5</sup> and so Congress added the word "terminate." The Supreme Court further held that such a power included only a power exercisable by the decedent as settlor, not one exercisable by him as trustee,<sup>6</sup> so that Congress had to add the words, "in whatever capacity exercisable." Again, the Supreme Court opined that the act did not cover a power not reserved in the trust instrument but arising thereafter, as where a trustee resigned and the decedent was elected in his place by the remaining trustees;<sup>7</sup> as a result, Congress added the words, "without regard to when or from what source the decedent acquired such power." Like the heads of the hydra, every time one form of testamentary substitute fell beneath the Congressional knife, there were two others to take its place. Were it not for the recent action of the Supreme Court in holding that the transfer of property subject to reverter on the predecease of the grantee was one intended to take effect in possession or enjoyment at or after the grantor's death,<sup>8</sup> Congress might now be lunging at another hydra head.

Because of this hopeless battle with testamentary substitutes Congress imposed the gift tax, a tax on pure gifts *inter vivos*, as a fortifying complement to the estate tax. It was first imposed under the Revenue Act of 1924, repealed in the Revenue Act of 1926, and then restored under the Revenue Act of 1932. Since then it has been continuously in force, the rates being approximately 75% of those imposed by the estate tax.<sup>9</sup> The states, which like the federal government have had to endure the battle with testamentary substitutes, have begun to follow the federal government in the adoption of gift taxes. So far gift taxes have made their appearance in Oregon, Wisconsin, Virginia, Colorado, Minnesota, North Carolina, Tennessee and California.

<sup>3</sup> Heiner v. Donnan, 285 U. S. 312 (1932).

<sup>4</sup> Burnet v. Northern Trust Co., 283 U. S. 782 (1931).

<sup>5</sup> Helvering v. Helmholz, 296 U. S. 93 (1935).

<sup>6</sup> White v. Poor, 296 U. S. 98 (1935).

<sup>7</sup> White v. Poor, *supra* note 6.

<sup>8</sup> Helvering v. Hallock, 60 Sup. Ct. 444 (1940), overruling Helvering v. St. Louis Union Trust Co., 296 U. S. 39 (1935), and Becker v. St. Louis Union Trust Co., 296 U. S. 48 (1935).

<sup>9</sup> Actually, because the estate tax is imposed on the entire estate without deducting the tax, while the gift tax is imposed on the amount actually passing to the donees, the rates of the latter tax are less than 75% of the former. Thus, for an estate of \$10,040,000 the gift tax is about 50% of the estate tax. MONTGOMERY, FEDERAL TAXES ON ESTATES, TRUSTS AND GIFTS, 1938-39, pp. 370-371.

The federal gift tax, and those of several of the states, are cumulative, that is, the rate brackets applicable to the gifts made in any year are determined by setting such gifts on top of the aggregate of gifts made in prior years since the start of the continuous imposition of the tax.<sup>10</sup> Thus, in effect, the gifts made throughout the various years are treated as if made at one time. By this method there is prevented avoidance of the gift tax by a spread of gifts over many years, and thereby the gift tax, with respect to gifts *inter vivos*, is given all of the efficacy of the estate tax. Even so, the gift-tax falls far short of the mark, for the grantor can, by evenly dividing his gifts between gifts *inter vivos* and transfers at death, bring his transfers down into much lower brackets than would be applicable if he made all of his transfers either as gifts *inter vivos* or as transfers at death.<sup>11</sup> It is the same result as that accomplished under the income tax by dividing the income equally between husband and wife. As a result, the prospective decedent still has the problem of making transfers *inter vivos* without wholly removing his fingers from the property transferred, and yet without leaving it within the reach of death taxes.

The suggestion is almost immediate that the gift tax and death tax be combined into a single cumulative transfer tax. The scheme of the federal gift tax could be used, with the transfers in the year of death, both *inter vivos* and at death, regarded as the final transfers. The rate brackets applicable to the year of death would be determined, as under the present federal gift tax, by superimposing the transfers made in that year, both *inter vivos* and at death, upon the aggregate of transfers made in prior years.

Validity of such a scheme of transfer tax, combining pure gifts *inter vivos* with transfers at death under one tax, is now clear.<sup>12</sup> Moreover, if such a tax is enacted, there is nothing to prevent inclusion of gifts made prior to the date of enactment in determining the rate brackets applicable to transfers made after the date of enactment. It has been held, for example, that property otherwise beyond the reach of a state inheritance tax because beyond the borders of the taxing state could be included for the purpose of determining the rate,<sup>13</sup> and likewise that stores otherwise beyond the reach of a chain store tax because beyond the borders of the taxing state could be included for the purpose of determining the rate.<sup>14</sup> It should follow that transfers otherwise beyond the reach of the taxing act because made before enactment of the act could be included for the purpose of determining the rate brackets applicable to transfers made after enactment of the act. From the standpoint of practical administration, however, the gifts to be included for this purpose could include only those made since the enactment of the gift tax. Discovery of gifts made prior to that time

<sup>10</sup> This feature was not present in the federal gift tax adopted in 1924.

<sup>11</sup> It is possible to calculate the respective portions of an estate which should be given away during the owner's life and retained until his death in order to produce the minimum combined gift and estate tax. For a table illustrating these proportions for estates of various sizes, see MONTGOMERY, *FEDERAL TAXES ON ESTATES, TRUSTS AND GIFTS*, 1938-39, p. 427. In an estate of \$5,000,000, the minimum rate is reached when the owner retains \$640,000. The minimum combined rate is then 19.5% as against the estate tax rate on the entire estate of 38%. *Id.* at 426.

<sup>12</sup> *Helvering v. Bullard*, 303 U. S. 297 (1938).

<sup>13</sup> *Maxwell v. Bugbee*, 250 U. S. 525 (1919).

<sup>14</sup> *Great Atlantic & Pacific Tea Co. v. Grosjean*, 301 U. S. 412 (1937).

would be impracticable. Considering both validity and practical administration, then, the gifts to be included for the purpose of determining the rate brackets applicable under such a combined gift and estate tax could include the gifts made in prior years from the beginning of the continuous imposition of the gift tax which, together with the estate tax, it supersedes.

For example, suppose Congress enacted such a tax applicable to decedents dying after December 31, 1940, and that a certain decedent died December 1, 1941. Suppose further that the schedule of rates under the new transfer tax was the same as the schedule of rates under the present federal gift tax law, and that the other provisions of the present gift tax law were also embodied in the new law. Suppose also that this particular decedent had made gifts in prior years totaling, after deducting the \$4,000 exclusion applicable to each donee in any one year (\$5,000 with respect to gifts made before 1939), and after deducting gifts to charities, and so forth, but before deducting the so-called specific exemption of \$40,000—totaling, with these deductions, \$400,000. Now suppose that in 1941 he made gifts totaling, with similar deductions, \$200,000 up to the date of death, and \$400,000 in transfers at death. His transfer tax for the year of death would be computed as follows:

Transfers at death.....	\$ 400,000	
Gifts <i>inter vivos</i> in 1941, the year of death.....	200,000	
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Total transfers in year of death.....	\$ 600,000	
Transfers in prior years.....	400,000	
		<hr/>
Total transfers.....	\$1,000,000	
Deduct specific exemption.....	40,000	
		<hr/>
Net transfers.....	\$ 960,000	
		<hr/>
Tax on this amount under schedule adopted.....		\$158,250
<i>Deduct</i>		
Tax under same schedule on total of gifts made in prior years:		
Total of gifts made in prior years.....	\$ 400,000	
Less specific exemption.....	40,000	
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Net gifts made in prior years.....	360,000	
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Tax as computed under same schedule.....		43,950
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Tax payable on transfers in year of death.....		\$114,300

The same integrating scheme could be applied, with slight variation, to the state gift and inheritance taxes, the rates of which vary according to the relation of the donee or legatee to the donor or decedent. Under this scheme it is obvious that a prospective decedent would have nothing to gain, as far as taxes on gifts and transfers at death are concerned, by making gifts during his lifetime. It might, in fact, be said that he would tend to defer gifts in order to defer the payment of the taxes and

thereby to save the interest for the period of deferment on the amount of taxes involved. This tendency could be counteracted by allowance of a credit against the tax payable for the final year, of an amount computed like interest, at say 3 or 4% on the taxes paid for prior years from the dates of payment to the date of death. The saving, however, that gifts *inter vivos* ordinarily effect in income taxes, by dividing the income-producing capital and thus bringing the donor's income down into lower brackets, might be expected to counteract any tendency to defer gifts merely to save the interest on the tax amounts for the period of deferment. Perhaps, then, any credit against the final tax on account of such interest lost where transfer taxes have been paid in prior years might be disregarded.

In any case, it is obvious that with replacement of the separate gift and death taxes by a single transfer tax the reason for all testamentary substitutes, at least as far as taxes are concerned, will have disappeared. Transfers in contemplation of death, transfers to take effect in possession or enjoyment at or after death, and transfers with a power reserved, in all of their motley forms, with all of their gossamer distinctions, that have fed for a generation the fires of battle between tax lawyers on the one hand and tax administrators and legislative bodies on the other, that have evoked from the courts a type of reasoning reminiscent of the seminars of the middle ages, that have kept the fingers of prospective decedents quivering with the faint caress of property transferred but still theirs, yet not theirs—all these will vanish when the separation between the gift and death taxes is borne to its final resting place.