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## FEDERAL TAX PROBLEMS IN COMMUNITY PROPERTY\*

*Oliver W. Hammonds and George E. Ray\*\**

## INTRODUCTION

**I**N NO area of estate planning is the complexity of local law a more determinative factor than that pertaining to the disposition of community property. That complexity is doubly compounded (if not confounded) when the impact of the federal tax structure is correlated to the disposition of such property.

Basic, and prior, to an understanding of the intrinsic problems pertaining to the disposition of community property is a complete comprehension of the scope and nature of the community property system. With that background, one can then begin intelligently to comprehend the relation of that system to the federal tax structure. Let us turn first, then, to a review of the community property system, a review which must at best be cursory.

## I. THE COMMUNITY PROPERTY SYSTEM

Eight of our American states have the community property system, which system originated with the Spanish settlements in this country. Spain had the system in effect for many centuries. The Roman law had no such system. In France it is first found in the Napoleonic Code. The system was first introduced into Louisiana territory by the Spanish and French colonizers.

The community property system was recognized by the territories acquired by the United States which were carved from the

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former Spanish possessions. Those property concepts were incorporated into their laws when those territories became states; in some instances as a part of their constitutions, as in the cases of California, Nevada and Texas. The system was "continued" after statehood in California, Louisiana, New Mexico and Texas.<sup>1</sup> In Arizona, Idaho, Nevada and Washington it was "adopted."

While the laws of no two states are precisely alike,<sup>2</sup> and different theories of ownership have been noted within the framework of the system,<sup>3</sup> a number of broad generalizations may be made. Community property law includes two classes of ownership: (1) separate property, and (2) community property. The first class includes property owned by each spouse at the time of marriage and its income yield,<sup>4</sup> and all acquisitions during marriage by gift, devise, bequest or inheritance.<sup>5</sup> Community property has been defined as all property other than separate property.<sup>6</sup> Stated conversely, community property is composed of earnings and acquisitions flowing from the economic activities of husband and wife, and the income and profits derived from

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<sup>1</sup> For an excellent resumé of the community property system of Texas, see Huie, *The Community Property Law of Texas*, 13 VERNON'S TEX. CIV. STAT. ANN. (1951) VII. For a general, authoritative treatise discussion of the entire system throughout the United States, see DE FUNIAK, *PRINCIPLES OF COMMUNITY PROPERTY* (1943).

<sup>2</sup> See 3 VERNIER, *AMERICAN FAMILY LAWS* (1935) 208 *et seq.*; Daggett, *The Modern Problem of the Nature of the Wife's Interest in Community Property*, 19 Calif. L. Rev. 567 (1931); Labovitz, *The Community Property System—Its Relation to Income, Estate, and Inheritance Taxation*, 9 Tax Mag. 286, 287 (1931).

<sup>3</sup> See Evans, *The Ownership of Community Property*, 35 Harv. L. Rev. 47 (1921). The author outlines four concepts: (1) California or single ownership theory; (2) Washington or entity theory; (3) Idaho or double ownership theory; (4) Texas or trust theory.

<sup>4</sup> "The Spanish law which sent the fruits of separate property into the community has been retained" in varying degree in the states of Texas, Idaho and Louisiana. 3 VERNIER, *AMERICAN FAMILY LAWS* (1935) 210. See also 2 TIFFANY, *REAL PROPERTY* (3d ed. 1939) 239, 240.

<sup>5</sup> 3 VERNIER, *AMERICAN FAMILY LAWS* (1935) 209; Evans, *The Ownership of Community Property*, 35 Harv. L. Rev. (1921).

<sup>6</sup> Evans, *The Ownership of Community Property*, 35 Harv. L. Rev. 47 (1921); Maggs, *Community Property and the Federal Income Tax*, 14 Calif. L. Rev. 351, 355 (1926).

community property.<sup>7</sup> Community ownership attaches only to the marital status and dissolves upon the termination of that status.

The essential fact to be noted is that the fruits of the husband's pursuit of gain constitute community property.<sup>8</sup> It has been stated, loosely perhaps, that "[c]ommunity property consists of things in which substantial interests of two persons (husband and wife) simultaneously exist and demand protection."<sup>9</sup> If divorced the property rights of each are set off and lose their community character.

At the death of the husband one-half of the community estate becomes the separate property of the wife, and the other half is subject to the testamentary disposition of the husband. In most of the community property states the wife is similarly given a right to dispose of one-half by will.<sup>10</sup>

It has been observed that "community is a partnership which begins only at its end,"<sup>11</sup> that is, upon dissolution of the marriage. This observation upon the realities of the system refers to the actual position of the wife during coverture in comparison with her formal co-ownership of the community wealth. During the joint lives of the spouses the husband controls, manages and

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<sup>7</sup> See *Hammonds v. Comm.*, 106 F. 2d 420, 422 (10th Cir. 1939). Cf. *Powell, Community Property—A Critique of its Regulation of Intra-Family Relations*, 11 Wash. L. Rev. 12, 27 (1936). But see *Beals v. Fontenot*, 111 F. 2d 956 (5th Cir. 1940).

<sup>8</sup> Like all generalizations, this one also has its limitations. Property is not acquired by the community unless the spouse making the acquisition has title or color of title. The fruits of a husband's embezzlement may not be attributed to the community. *Estate of Thomas Spruance*, 43 B.T.A. 221. Cf. *Lee v. Lee*, 112 Tex. 392, 401-404, 247 S.W. 828, 832, 833 (1923); *McKAY, COMMUNITY PROPERTY* (2d ed. 1925) c. 21. As to the date of acquisition, compare *Wrightsmen v. Comm.*, 111 F. 2d 227 (5th Cir. 1940) with *Edwin C. F. Knowles*, 40 B.T.A. 861 (1939).

<sup>9</sup> *Powell, Community Property—A Critique of its Regulation of Intra-Family Relations*, 11 Wash. L. Rev. 12, 32 (1936).

<sup>10</sup> Only Nevada and New Mexico discriminate against the wife in regard to a power of testamentary disposition upon her prior death. See 3 *VERNIER, AMERICAN FAMILY LAWS* (1935) 221.

<sup>11</sup> See *Arnett v. Reade*, 220 U. S. 311, 319 (1911). Cf. 3 *VERNIER, AMERICAN FAMILY LAWS* (1935) 221, 226; *Altman, Community Property; Avoiding Avoidance by Adoption in the Revenue Act*, 16 *Tax Mag.* 138, 140 (1938); *Sebree, Federal Taxation of Community Property*, 12 *Tex. L. Rev.* 273, 280 (1934).

disposes of the community property.<sup>12</sup> This "nexus of powers"<sup>13</sup> is not regarded as contradicting the fact of community ownership, for "the very foundation of the community and its efficacious existence depend on the power of the husband, during the marriage, over the community, and his right, in the absence of fraud or express legislative restriction, to deal with the community and its assets as the owner thereof."<sup>14</sup>

The only real limitation upon the husband's powers is that he may not give the property away or dispose of it in fraud of his wife's rights.<sup>15</sup> The restrictions have been more tightly drawn with respect to real property, for generally the husband may not convey such property or encumber it without the written consent of his wife.<sup>16</sup> But the husband may dissipate the proceeds derived from the sale of real property.<sup>17</sup>

It seems to be generally established in all the community states, with the exception of Washington and Arizona, that the community property is liable for the husband's obligations.<sup>18</sup> The community property may be resorted to by creditors who furnish necessaries to the wife, but this liability seems to derive

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<sup>12</sup> Garrozi v. Dastas, 204 U. S. 64 (1907) (nontax); Warburton v. White, 176 U. S. 484 (1900) (nontax). Cf. Arnett v. Reade, 220 U. S. 311 (1911) (nontax). See 3 VERNIER, AMERICAN FAMILY LAWS (1935) 218.

<sup>13</sup> Cf. Helvering v. Achelis, 112 F. 2d 929 (2d Cir. 1940).

<sup>14</sup> Mr. Justice White, in Garrozi v. Dastas, 204 U. S. 64, 79 (1907) (nontax). Compare the opinion of the same Justice in Warburton v. White, 176 U. S. 484 (1900) (nontax). See also Bek v. Miller, 8 F. 2d 797 (D. C. Cir. 1925).

<sup>15</sup> There are a "variety of views" in regard to the husband's power to give away community property. See Huie, *Community Property Laws as Applied to Life Insurance*, 18 Tex. L. Rev. 121 (1940). See also 3 VERNIER, AMERICAN FAMILY LAWS (1935) 219; Daggett, *The Civil-Law Concept of the Wife's Position in the Family*, 15 Ore. L. Rev. 291, 298 (1936); Evans, *The Ownership of Community Property*, 35 Harv. L. Rev. 47, 64 (1921). For a definition of fraud see Garrozi v. Dastas, 204 U. S. 64, 82 (1907) (nontax). For an example of fraud see Moore v. California-Western States Life Insurance Co., 67 S. W. 2d 932 (Tex. Civ. App. 1934) *er. disp.*

<sup>16</sup> See 3 VERNIER, AMERICAN FAMILY LAWS (1935) 220; 2 TIFFANY, REAL PROPERTY (3d ed. 1939) 243, 244. The husband's sole power over real property is still practically complete in Nevada, Texas and Louisiana.

<sup>17</sup> 3 VERNIER, AMERICAN FAMILY LAWS (1935) 220.

<sup>18</sup> *Id.* at 223.

from the husband's obligation of support.<sup>19</sup> Despite limitations in favor of the wife, the powers of management, control and disposition are still in the husband, and the wife's role is essentially that of a back-seat driver who may carp and criticize but may not take the wheel.<sup>20</sup>

The precise nature of the wife's interest under the community system of shared ownership and unitary control has been a source of considerable speculation, some fruitful and some otherwise. Lawyers, like others, must work with categories.<sup>21</sup> It is not strange, therefore, that the community has been compared to a partnership, a trust, an estate by the entirety, an inchoate dower right, and an heir's expectancy. It has been frankly concluded that the wife's interest is *sui generis*, defying common law criteria.<sup>22</sup> When confronted with something alien to their way of thinking, lawyers and judges, raised on common law terminology, have, as a way out of their difficulties, seized upon the concepts of "vested interest" and "expectancy" in order to deal with the wife's property right.<sup>23</sup> It would appear to have made little difference which of these two concepts was employed in describing the wife's interest.<sup>24</sup>

It is not surprising that this dichotomy, which has prevailed in the private law of community property, has been carried over

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<sup>19</sup> *Ibid.*

<sup>20</sup> Cf. Daggett, *The Modern Problem of the Nature of the Wife's Interest in Community Property*, 19 Calif. L. Rev. 567, 600 (1931); Seabee, *Federal Taxation of Community Property*, 12 Tex. L. Rev. 273, 279 (1934).

<sup>21</sup> Compare the debate between Mr. Justice Frankfurter and Mr. Justice Roberts in *Wisconsin v. J. C. Penney Co.*, 311 U. S. 435 (1940) (state tax).

<sup>22</sup> See Daggett, *The Modern Problem of the Nature of the Wife's Interest in Community Property*, 19 Calif. L. Rev. 567, 572 (1931).

<sup>23</sup> See *Sampson v. Welch*, 23 F. Supp. 271, 279 (S. D. Calif. 1938); Bruton, *The Taxation of Family Income*, 41 Yale L. J. 1172, 1173 (1932); Daggett, *The Modern Problem of the Nature of the Wife's Interest in Community Property*, 19 Calif. L. Rev. 567, 573 (1931); Hooker, *Nature of Wife's Interest in Community Property in California*, 15 Calif. L. Rev. 302 (1927).

<sup>24</sup> See 3 VERNIER, *AMERICAN FAMILY LAWS* (1935) 234, 235; cf. Note, 39 Harv. L. Rev. 762, 764 (1926). But see Kirkwood, *The Ownership of Community Property in California*, 7 So. Calif. L. Rev. 1, 4-6 (1933).

into the federal law of estate and gift tax, as well as the income tax. These revenue measures were constructed entirely upon a common law system of ownership, and no consideration was given to the community property system.<sup>25</sup>

## II. THE FEDERAL INCOME, ESTATE, AND GIFT TAX TREATMENT OF COMMUNITY PROPERTY

Having had the benefit of the foregoing general, but nevertheless necessary, background and nature of the community property system, let us take a further general look at the treatment accorded community property under the federal income, estate, and gift tax structure.

### A. *The Federal Income Tax Treatment of Community Property.*

#### 1. *Income Problems.*

In community property jurisdiction, consistent with the concepts of property ownership set forth above, one-half of the income which belongs to the marital community is taxable to each spouse, whether such income is derived from the personal services of one of them, or from the community property. Accordingly, each spouse may report his or her share of the community income on his or her separate return.<sup>26</sup>

The principal problem, therefore, is to determine what is community and what is separate property. Although, as noted above, certain general principles are applicable to community property in all eight states, the results in specific cases may differ sub-

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<sup>25</sup> Cf. Bruton, *The Taxation of Family Income*, 41 Yale L. J. 1172 (1932). This statement certainly seems indisputable so far as the original enactment of the estate tax is concerned. The statement seems to be equally correct with respect to later acts, which failed to circumvent difficulties posed by the community property system and judicial interpretation. Congress' failure to act hardly indicates that it reenacted the estate tax with community property complications in mind. Cf. *Helvering v. Hallock*, 309 U. S. 106, 120 (1940), *rehearing pursuant to Supreme Court mandate*, 111 F. 2d 143 (6th Cir. 1940).

<sup>26</sup> *Poe v. Seaborn*, 282 U. S. 101; *Goodell v. Koch*, 282 U. S. 118; *Hopkins v. Bacon*, 282 U. S. 122; *Bender v. Pfaff*, 282 U. S. 127; all decided in 1930.

stantially. Since property rights under local law are the determinative factor, the result in one jurisdiction should be transposed cautiously to a problem in another. Let us turn now to a general resumé of some of the principal, recurring problems in the income tax field.

The burden of proving the community ownership of property normally rests upon the taxpayer.<sup>27</sup> Where, however, separate and community properties are commingled, a presumption under local law that the entire property belongs to the community is sufficient to overcome the contrary determination of the Commissioner of the Bureau of Internal Revenue.<sup>28</sup>

The taxability of income generally depends upon the ownership of that income at the time it is realized. However, where compensation is earned prior to domicile in a community property state, the earning spouse is separately taxable therefor although the compensation was not definitely ascertained or paid until after such domicile was acquired.<sup>29</sup>

Where a taxpayer domiciled in a community state changes his status by marriage during a taxable year of a partnership, he may not treat his entire distributive income from the partnership for that year as community income. Moreover, apportionment on a time basis is not permitted where the actual earnings before and after marriage can be ascertained.<sup>30</sup>

The law of the situs of the property determines whether

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<sup>27</sup> See *Johnson v. Com'r*, 105 F. 2d 454 (8th Cir. 1939), *cert. denied*, 308 U. S. 625 (1940).

<sup>28</sup> *McFadden v. Com'r*, 148 F. 2d 570 (5th Cir. 1945); *cf. dictum in W. D. Johnson*, 1 T. C. 1041 (1943), *app. dism.*, 139 F. 2d 491 (8th Cir. 1943). See also *Com'r v. Fleming*, 155 F. 2d 204 (5th Cir. 1946); *Emma Frye Estate*, 44 B.T.A. 835 (1941).

<sup>29</sup> *Wrightsmen v. Com'r*, 111 F. 2d 227 (5th Cir. 1940); *Howard Veit*, 8 T. C. 809 (1947). For a general discussion of problems resulting from change of domicile from common law to community property jurisdictions, see *Ray and Hammonds, Change of Domicile*, 1947 Taxes 891.

<sup>30</sup> *Kemp S. Dargan*, 6 CCH T. C. MEM. DEC. 1078 (1947). *Cf. § 51, INT. REV. CODE*, providing that husband and wife married on December 31 may split their income for the entire year by filing a joint return.



income from real property is community income.<sup>31</sup> Thus, even where the property was acquired by one spouse as compensation for personal services, income from property situated in a community state is divided between a husband and wife domiciled in a non-community state.<sup>32</sup> The same rule was applied in a case where, apparently, the income from property situated in a community state was divided only because of an agreement to that effect between the husband and wife.<sup>33</sup>

The ownership of income from property is generally dependent upon whether the property is owned separately or by the community, whether governed by the law of the situs or by the law of the domicile. Where the property is separately owned by one spouse (as in the case of a non-community state, or acquired by gift, devise or descent), the general rule is that the income from such property is separate income.<sup>34</sup>

An allocation is required if income is attributable partly to separate property and partly to personal services. Thus it was held, in the case of a sole proprietorship business owned by the husband, for which business he rendered personal service, that income from capital equaled 7 per cent of capital, and that the balance of the income belonged to the community.<sup>35</sup>

In cases where one spouse is a member of a partnership, a more complex formula has been applied. The portions of total income attributable to capital and to personal services are determined by allocating such income in the ratio which a fair return on capital bears to a reasonable compensation for services.<sup>36</sup>

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<sup>31</sup> *Com'r v. Skaggs*, 122 F. 2d 721 (5th Cir. 1941), *cert. denied*, 315 U. S. 811 (1942).

<sup>32</sup> *Hammonds v. Com'r*, 106 F. 2d 420 (10th Cir. 1939); *cf. Noble v. Com'r*, 138 F. 2d 444 (10th Cir. 1943).

<sup>33</sup> *Black v. Com'r*, 114 F. 2d 355 (9th Cir. 1940).

<sup>34</sup> See *Shea v. Com'r*, 81 F. 2d 937 (9th Cir. 1936); *Otto S. Grunbaum*, 44 B.T.A. 810 (1941); *W. L. Honnold*, 36 B.T.A. 1190 (1937).

<sup>35</sup> *Lawrence Oliver*, 4 T. C. 684 (1945); see *Ashley Manning*, 8 T. C. 537 (1947).

<sup>36</sup> *Clara B. Parker*, 31 B.T.A. 644 (1934); *J. Z. Todd*, 3 T. C. 643 (1944), *remanded*, 153 F. 2d 553 (9th Cir. 1945), *on remand*, 7 T. C. 399 (1946), *aff'd*, 165 F. 2d 781 (9th Cir. 1948); see I. T. 3890, 1948-1 CUM. BULL. 52.

The value of corporate stock originally owned by the husband was held partly allocable to the community, such part being the portion of the stock's present value attributable to the husband's services to the corporation for which he had not otherwise been adequately compensated.<sup>37</sup>

Where oil lease income would ordinarily be the husband's separate income by reason of his separate ownership, part of the income may nevertheless be allocated to the community by reason of his personal services.<sup>38</sup> Income in excess of fair rental value derived from farming on the husband's separate property has similarly been held community income.<sup>39</sup>

In Texas the general rule applies to "increase" of the property not attributable to the time and efforts of the spouse during marriage. Gain on the sale of separately owned real estate is thus normally separate income.<sup>40</sup> Similarly, as to the sale of separately owned securities.<sup>41</sup> Oil royalties and bonuses are regarded as a removal and disposition of the contents of the soil; such income derived from separate property is therefore separate income.<sup>42</sup> This rule applies even where such income is derived through a trust or partnership.<sup>43</sup> It applies also to distributable income consisting of gain on trust corpus, if that corpus is classifiable as separate property.<sup>44</sup>

On the other hand, rents, crops, increase in cattle, and other

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<sup>37</sup> Guy C. Earl, 4 T. C. 768 (1945); G. A. Axelson, 1942 CCH B.T.A. MEM. DEC. No. 12,500-B, P-H 1942 B.T.A. & T. C. MEM. DEC. ¶ 42,216.

<sup>38</sup> Trapp v. U. S., 177 F. 2d 1 (10th Cir. 1949), *cert. denied*, 339 U. S. 913 (1950) (Tex.).

<sup>39</sup> C. Clifford Minnick, 14 T. C. 8 (1950) (Wash.); *followed*, G.C.M. 26535, 1950-2 CUM. BULL. 31.

<sup>40</sup> McFaddin v. Com'r, 148 F. 2d 570 (5th Cir. 1945).

<sup>41</sup> O'Connor v. Com'r, 110 F. 2d 652 (5th Cir. 1940).

<sup>42</sup> Com'r v. Wilson, 76 F. 2d 766 (5th Cir. 1935).

<sup>43</sup> Welder v. Com'r, 148 F. 2d 583 (5th Cir. 1945); Crabb v. Com'r, 136 F. 2d 501 (5th Cir. 1943); Com'r v. Wilson, *supra* note 42.

<sup>44</sup> McFadden v. Com'r, cited *supra* note 40.

ordinary income derived from separate property are community income.<sup>45</sup> Income of a spendthrift trust actually distributed to a Texas beneficiary is community income, in the absence of a clearly expressed intent by the grantor to make it separate income.<sup>46</sup>

In Louisiana, "fruits" of separate property belong to the community. This includes "civil fruits" such as interest, dividends, and rents. It does not, however, include all "profits." Therefore, oil royalties and bonuses received by a lessor upon the lease of his separate property are separate income.<sup>47</sup> Trust income belongs to the community where one spouse is the trustee as well as the beneficiary.<sup>48</sup>

In Louisiana, the fruits of the wife's paraphernal property belong to the community if the property is managed by the husband.<sup>49</sup> Under a 1944 legislative amendment, the income from even the wife's separately managed property is community income unless she records an instrument preserving her separate rights.<sup>50</sup> As in the case of the husband's separate property, however, this rule apparently does not apply to other "profits."<sup>51</sup> Even in the case of fruits, however, the parties may by antenuptial contract provide that management shall not affect the separate status of income.<sup>52</sup>

Where the husband and wife agree that their respective incomes shall be owned separately, and where the state law (as in Arizona,

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<sup>45</sup> *Com'r v. Skaggs*, cited *supra* note 31; *Com'r v. Wilson*, cited *supra* note 42.

<sup>46</sup> *Com'r v. Porter*, 148 F. 2d 566 (5th Cir. 1945); *Ernest Hinds Estate*, 11 T. C. 314 (1948), *aff'd on other grounds*, 180 F. 2d 930 (5th Cir. 1950).

<sup>47</sup> *U. S. v. Harang*, 165 F. 2d 106 (5th Cir. 1947); *Com'r v. Gray*, 159 F. 2d 834 (5th Cir. 1947), *rev'g* 5 T. C. 290 (1945).

<sup>48</sup> *U. S. v. Burglass*, 172 F. 2d 960 (5th Cir. 1949).

<sup>49</sup> *Melanie D. Marks*, 8 T. C. 1255 (1947); *Helen E. Hyman*, 46 B.T.A. 992 (1942), *aff'd*, 135 F. 2d 49 (5th Cir. 1943); G.C.M. 23798, 1943 CUM. BULL. 1049.

<sup>50</sup> *U. S. v. Burglass*, cited *supra* note 48.

<sup>51</sup> See *Com'r v. Gray*, cited *supra* note 47; *Hebert v. U. S.*, 68 F. Supp. 230 (E. D. La. 1946), *rev'd per stipulation*, 38 AM. FED. TAX. REP. 1568 (5th Cir. 1947).

<sup>52</sup> *Clay v. U. S.*, 161 F. 2d 607 (5th Cir. 1947), *aff'g* 66 F. Supp. 99 (E. D. La. 1946).

California, Texas and Washington) recognizes the validity of such an agreement, the entire income earned by one spouse, as well as the income from his separately owned property, is taxable to him.<sup>53</sup> Conversely, separately owned property may be converted into community property where the state law recognizes the rights created by such an agreement.<sup>54</sup>

If income has been earned as community property, one-half of such income is taxable to each spouse on a cash basis when it is received, even though the parties have agreed in the interim that all income is to be separate property.<sup>55</sup> If the parties substitute an assignment of part of the husband's income for the wife's community right, the entire income is taxable to the husband.<sup>56</sup> It has been held, however, under California law that a partnership agreement entered into by the husband and wife with others does not transmute community property into separate property.<sup>57</sup>

An agreement converting existing community property to the separate ownership of one spouse is recognized under Texas law. Future income from such property is, therefore, governed by the Texas rules applicable to income from separate property. On the other hand, an agreement which purports to vest future income in one spouse (except as such vesting may be accomplished by the transfer of existing property) is invalid; such income therefore continues to be divided between the spouses.<sup>58</sup> Where the wife's share of community property is placed in trust

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<sup>53</sup> *Van Every v. Com'r*, 108 F. 2d 650 (9th Cir. 1940), *cert. denied*, 309 U. S. 689 (1940); *Woodall v. Com'r*, 105 F. 2d 474 (9th Cir. 1939), *cert. denied*, 309 U. S. 655 (1940). *Helvering v. Hickman*, 70 F. 2d 985 (9th Cir. 1934).

<sup>54</sup> *J. Harold Dollar Estate*, 41 B.T.A. 869 (1940) (Calif.); *E. C. Olson*, 10 T. C. 458 (1948) (Wash.).

<sup>55</sup> *Johnson v. U. S.*, 135 F. 2d 125 (9th Cir. 1943).

<sup>56</sup> *Van Every v. Com'r*, cited *supra* note 53; *F. Eldred Boland*, 41 B.T.A. 930 (1940), *aff'd*, 118 F. 2d 622 (9th Cir. 1941); *cf.* *C. A. Hawkins*, 6 CCH T.C. MEM. DEC. 1087 (1947).

<sup>57</sup> *George W. Van Vorst*, 7 T. C. 826 (1946); *G. C. M. 25642*, 1948-1 CUM. BULL. 57.

<sup>58</sup> *Mellie E. Stewart*, 35 B.T.A. 406 (1937), *aff'd*, 95 F. 2d 821 (5th Cir. 1938); *G.C.M. 20960*, 1939-2 CUM. BULL. 175.

pursuant to a separation agreement, the income is not that of an "alimony trust" taxable to the husband.<sup>59</sup>

If the husband and wife should agree upon an unequal division of community property, gain may be realized by the spouse who derives the advantage.<sup>60</sup> Presumably, however, the corresponding loss to the other spouse would not qualify as a loss "incurred in a transaction entered into for profit." Where one spouse "purchases" the other's community interest for less than value, his basis upon a subsequent sale is the purchase price, not the cost to the community.<sup>61</sup> Conversely, the husband may increase the basis of his property by the amount paid out of his separate funds in a divorce settlement to obtain a release of the wife's community interest in the property.<sup>62</sup>

If there has been a termination of the community status by divorce, a subsequent decree vacating the divorce decree does not reconvert the husband's separately owned interim income into community income.<sup>63</sup> Where, however, an interlocutory decree of divorce does not terminate the community, one-half of the community income is still taxable to each spouse.<sup>64</sup>

## 2. Deduction Problems.

Deductions connected with community property are generally divided between husband and wife.<sup>65</sup> This is true even with respect to separately owned property which produces community income.<sup>66</sup> Where, however, one spouse is separately liable for taxes, interest and attorneys' fees incurred in connection with separately owned

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<sup>59</sup> Howard S. Dudley, 39 B.T.A. 1170 (1939); Ernestine Mitchell, 38 B.T.A. 1336 (1938).

<sup>60</sup> Johnson v. U. S., 135 F. 2d 125 (9th Cir. 1943).

<sup>61</sup> C. C. Rouse, 6 T. C. 908 (1946), *aff'd*, 159 F. 2d 706 (5th Cir. 1947).

<sup>62</sup> Long v. Com'r, 173 F. 2d 471 (5th Cir. 1949), *cert. denied*, 333 U. S. 818 (1949).

<sup>63</sup> James E. West, 44 B.T.A. 1159 (1941), *aff'd*, 131 F. 2d 46 (9th Cir. 1942).

<sup>64</sup> Ethel B. Dunn, 3 T. C. 319 (1944).

<sup>65</sup> Alice G. K. Kleberg, 43 B.T.A. 277 (1940).

<sup>66</sup> Stewart v. Com'r, 95 F. 2d 821 (5th Cir. 1938); Catherine F. Wagoner, 7 CCH T. C. MEM. DEC. 130, P-H 1948 B.T.A. & T. C. MEM. DEC. ¶ 48,029.

property, he or she is entitled to the entire deduction where there is an offsetting community income from that property during the taxable year.<sup>67</sup>

The entire deduction for expenses paid out of his separate funds may be taken by one spouse, even if they benefit the other spouse. This rule is applicable to medical expenses. Where, however, the payment is from commingled funds, it is presumed that the expenses are those of the community, and the deduction must be divided. Charitable contributions, on the other hand, are deductible by the payor in the absence of a consent by the other spouse to the contribution.<sup>68</sup> Alimony paid to the husband's former wife has been held to be collectible out of community funds and therefore divisible as a deduction.<sup>69</sup>

The loss from a claim arising against the husband while domiciled in a non-community state is deductible only by the husband, although the loss was not "incurred" until after he acquired a domicile in a community state.<sup>70</sup> Although a husband is allowed to deduct the cost of litigating his right to report income on a community basis, his wife may not deduct her share of the expense where the income in the prior year was that of husband and a former wife.<sup>71</sup>

Under California law the husband is equally and primarily liable for state income tax due on the wife's return. Where he paid the entire tax, he was held entitled to the entire deduction.<sup>72</sup>

### 3. *Special Income Tax Problems Involved in the Administration of Estates in Community Property States.*

As has been previously noted, during the marital status income

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<sup>67</sup> Irma J. Hunt, 47 B.T.A. 829 (1942).

<sup>68</sup> Ernest W. Clemens, 8 T. C. 121 (1947), *app. dism.* (5th Cir. 1949).

<sup>69</sup> Robert A. Sharon, 10 T. C. 1177 (1948), *remanded per stipulation*, 1949 P-H FED. TAX. SERV. ¶ 71,128 (5th Cir. 1949); see *Godchaux v. U. S.*, 102 F. Supp. 266 (E. D. La. 1952).

<sup>70</sup> Lottie Zukor, 43 B.T.A. 825 (1941).

<sup>71</sup> Herbert Marshall, 5 T. C. 1032 (1945).

<sup>72</sup> Al Jolson, 3 T. C. 1184 (1944).

derived from community property is community income, taxable one-half to each spouse, and the deductions from such income are community deductions, equally divisible. When, however, one of the parties to the marriage dies, and the estate of the deceased spouse is in process of administration, it is then important to know the particular rules applying to the taxation of the income derived from their erstwhile community property. The problem then is as to the income tax treatment of income earned or produced from that community property after the death of one of the spouses and during the period of administration of that spouse's estate.<sup>73</sup>

Some of the income tax problems presented for consideration during this period of administration are: how and to whom the income from the community property of the deceased spouse is to be taxed; determination of the basis of that property for the purpose of gain or loss, depreciation and depletion; and the proper handling of administration and like expenses.<sup>74</sup>

#### *Treatment of Income During the Period of Administration.*

The pertinent statutory provision with regard to the income tax treatment of the community property of one of the deceased parties to the community partnership is Section 161 of the Internal Revenue Code. It reads as follows:

“(a) *Application of tax.* The taxes imposed by this chapter upon

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<sup>73</sup> Excluded from present consideration is the treatment of community income earned or accrued prior to the death of one of the spouses (see *Com'r v. King*, 69 F. 2d 639 (5th Cir. 1934), and see also INT. REV. CODE § 126), and where either there has been no administration or such has been concluded, attention here being confined only to the relationship between the property of the surviving spouse and that of the deceased spouse during the period of administration.

<sup>74</sup> See also Brookes, *The Tax Consequences of Widows' Elections in Community Property States*, 1951 MAJOR TAX PROBLEMS (Proceedings of the Tax Institute, Univ. of So. Calif. School of Law) 83.

individuals shall apply to the income of estates or of any kind of property held in trust, including—

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(3) Income received by estates of deceased persons during the period of administration or settlement of the estate. . . .

The question which arises under this Section with regard to community property is the meaning of the phrase, "estates of deceased persons." If this phrase is synonymous with the phrase "gross estate," as used in the federal estate tax provision, it is clear, under the provisions of the Revenue Act of 1948, that the taxable estate for income tax purposes during the period of administration would include only the decedent's separate property, plus his share of the community property.<sup>75</sup> Stated differently, the taxable estate of the deceased spouse for income tax purposes would include only property owned by him under the local laws of the several community property states. For simplicity, inclusion only of such property within the taxable estate is referred to as that falling under the "ownership of property" rule. Corollary thereto, it would readily appear that income received by the surviving spouse from his or her share of the community property would not be taxable to the "estate" of the decedent spouse for income tax purposes.

Unfortunately, however, due to the nature of the community property system, particularly in relation to the administrative handling of community property estates, the solution has not been so simple. Under the community system as developed above,<sup>76</sup> the survivor's share of the community is administered together with the deceased's share in the community.

The question therefore arises as to whether "estates of deceased persons," as used in Section 161(a)(3) of the Internal Revenue Code, is intended to include therein for income tax purposes not

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<sup>75</sup> See below at p. 148.

<sup>76</sup> See also Huie, *The Powers and Liabilities of a Qualified Community Survivor*, 15 Dallas Bar Speaks 275 (1952).



only the property owned by the decedent, but, to the extent the property of the surviving spouse is subjected to administration along therewith, also the survivor's share therein "during the period of administration or settlement of the estate." Again, for purposes of simplicity, this interpretation of the possible statutory scope is referred to as the "administration of property rule." Corollary to this interpretation of the statute is the resulting exclusion from taxation to the surviving spouse of any part of the income from the community property in administration, as such. Instead, the survivor would be considered taxable only on amounts in fact "distributed currently" to him<sup>77</sup> or amounts "properly paid or credited" to him or her.<sup>78</sup>

The statutory provision in question has in fact received the benefit of both of the interpretations just discussed from the Treasury and the courts. At the outset, the Tax Court<sup>79</sup> and the Bureau<sup>80</sup> followed the "ownership of property" rule and held that the estate of the decedent and the surviving spouse were each taxable on one-half of the income derived from the community property. The Court of Appeals for the Fifth Circuit then upset this result in a Texas case where the husband died first, leaving independent executors to administer his estate.<sup>81</sup> The court's holding, in effect, required the taxation of the entire income during administration to the estate of the deceased husband, the wife being taxed only on amounts actually distributed to her.<sup>82</sup> This last holding was followed by the Commissioner and the Tax Court<sup>83</sup> until both were reversed by circuit court decisions.<sup>84</sup> As

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<sup>77</sup> INT. REV. CODE § 162(b).

<sup>78</sup> INT. REV. CODE § 162(c).

<sup>79</sup> J. R. Brewer, Administrator, 17 B.T.A. 704 (1929) (Tex.).

<sup>80</sup> Estate of Bartlett, 21 B.T.A. 751 (1930) (Calif.), *acquiesced in*, X-2 CUM. BULL. 5.

<sup>81</sup> Barbour v. Commissioner, 89 F. 2d 474 (1937).

<sup>82</sup> See Clara Wilson, 2 CCH T. C. MEM. DEC. 946 (1943).

<sup>83</sup> Stella Wheelor Bishop, 4 T. C. 588 (1945) (Calif.); Estate of Hunt Henderson, 2 CCH T. C. MEM. DEC. 1092 (1943).

<sup>84</sup> Henderson's Estate v. Commissioner, 155 F. 2d 310 (5th Cir. 1946); Bishop v. Commissioner, 152 F. 2d 389 (9th Cir. 1945).

a result, it now appears settled that the "ownership of property rule" rather than the "administration" rule is to prevail and that the decedent's estate and the surviving spouse will be taxed accordingly on community income during the period of administration.<sup>85</sup>

### *Basis Problems Arising During the Period of Administration*

The problem of the basis of community property for determining gain or loss, or depreciation, or depletion during the period of administration is closely related to that of the treatment of the income from such property just discussed. Again the basic question is the determination of what part of the community property is subject to application of the federal taxing statute, which in the case of basis is governed by Section 113(a)(5) of the Internal Revenue Code.

Section 113(a)(5) provides in pertinent part:

If the property was acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, the basis shall be the fair market value of such property at the time of such acquisition.

Here, in contrast with Section 161(a)(3) above, the use of the qualifying phrase "by the decedent's estate *from the decedent*" (italics supplied) has made it fairly clear that the property subject to basis adjustment is only that of the decedent himself and not also that of the surviving spouse. And, until the Revenue Act of 1948, the Commissioner uniformly held, with the exception of California property,<sup>86</sup> that Section 113(a)(5) applied only to the decedent's half of the community property and not the survivor's half, the latter's basis being cost. Section 366(a) of the Revenue Act of 1948, however, amended Section 113(a)(5) of the Internal Revenue Code to provide that the basis of the

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<sup>85</sup> G.C.M. 25008, 1946-2 CUM. BULL. 49; *Blackburn's Estate v. Com'r*, 180 F. 2d 952 (5th Cir. 1950).

<sup>86</sup> See G.C.M. 24292, 1944 CUM. BULL. 162.

one-half share in the community of the surviving spouse should be its fair market value at the applicable valuation date, if there was included in the determination of the value of the decedent's gross estate at least one-half of the whole of the community property. Currently, therefore, the basis of the entire community property of both spouses is fair market value at the applicable valuation date.<sup>87</sup>

### *Deduction Problems Arising During the Period of Administration*

Section 162 of the Internal Revenue Code provides in pertinent part:

The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual. . . .

The "estate" referred to above in Section 162 is the same "estate" as referred to in Section 161(a), discussed above, which imposes the tax on estate income. Accordingly, it is clear that deductions of the estate are to offset income of the estate. Therefore, if the entire income from the community property is considered taxable to the estate, the latter is entitled to offset that income in determining its net income by deducting all deductions chargeable against that community property. If, on the other hand, only the income from the decedent's half of the community property is taxable to the estate, as discussed above, then it has the benefit of only one-half of the community deductions in offsetting that income.<sup>88</sup>

Except for administration expenses and losses incurred during the settlement of estates of the kind covered in Section 23(e) of

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<sup>87</sup> The community property rules of Nevada and New Mexico may preclude this result in certain circumstances in the case of the wife's prior death. 2 NEV. COMP. L. 1929 (1931-1941 Supp.) § 3395.01; N. M. STAT. 1941 ANN. § 38-104. Similarly with regard to certain California property acquired by the community prior to April 16, 1923. Sen. Rep. No. 1013, 80th Cong., 2d Sess. (1948), 1948 CUM. BULL. 285, 351.

<sup>88</sup> Estate of James F. Waters, 3 T. C. 407 (1944) (Calif.), *acquiesced in*, 1944 CUM. BULL. 29.

of the Internal Revenue Code, casualty losses, there is no relation between income deductions of the estate, just discussed, and deductions of the estate for determining the taxable estate for estate tax purposes under Section 812(b) of the Code, a separate problem. These two items, however, may only be deducted in either the estate tax return or the income tax return of the estate, but not the returns of both.

The extent to which administration expenses and uninsured casualty losses are deductible varies in the individual community property states. Thus, in some of the states only one-half of the executors' commissions and attorneys' fees are deductible in the estate tax return, whereas they are deductible in full in the income tax return of the estate. Accordingly, special consideration must be given to which return these particular items will be deducted on.

#### *B. The Federal Estate and Gift Taxation of Community Property.*

The estate and gift tax treatment of community property under federal law has had a complex history culminating in the Revenue Act of 1948.<sup>89</sup> The primary purpose of the estate and gift tax provisions of that Act were, briefly, to equalize the tax burdens as between residents of the community and non-community property jurisdictions.

Initially, the basic difficulty arose from the fact that in a community property state, as previously noted, the entire community property of a married couple is considered to be owned one-half by each spouse, whereas in the non-community property states most of the property is generally in the name of one spouse, the husband.

Prior to 1942, the federal tax structure took into account this

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<sup>89</sup> For a discussion of some of the pertinent inheritance tax problems, as distinguished from federal estate tax problems, arising in a particular community property jurisdiction, and on which the scope of this work does not permit any detailed consideration, see Triplett, *Selected Inheritance Tax Problems in California*, 1950 MAJOR TAX PROBLEMS (Proceedings of the Tax Institute, Univ. of So. Calif. School of Law) 573.

division of ownership in community property and on the death of one of the spouses subjected to estate tax only that spouse's one-half of the community property. In the case of a gift of community property, only one-half was taxed to each spouse. In the non-community property states, when the husband died, most, if not all, of the family holdings were subjected to estate tax. Gifts were generally made by the husband from his own property, and therefore were all taxed to him.

In 1942, however, Congress sought to remove the presumed tax advantages of the residents of the community property states by providing that on the death of the spouse first to die all of the community property should be subject to estate tax, except to the extent that it could be shown that the community property was derived from the separate property of, or from personal services actually rendered by, the surviving spouse.<sup>90</sup> It was also provided that in any event there would be included in the taxable estate the one-half of the community property over which the deceased spouse had the power of testamentary disposition. The proceeds of life insurance on the decedent's life, where the premiums had been paid out of community property, were to be included in the taxable estate of the decedent. With respect to the gift tax, all gifts of community property were to be taxed to the husband, except to the extent that it could be shown the property was derived from the separate property of, or from personal services rendered by, the surviving spouse.

It soon became evident to the citizens of the community property states that the 1942 statutory changes, while eliminating the prior advantages of the residents of community property states, had now resulted in new and distinct disadvantages to them fully as great in magnitude as their former advantages. Among these disadvantages were the following:

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<sup>90</sup> For a general discussion of the background of the 1942 Revenue Act, see Ray, *Proposed Changes in Federal Taxation of Community Property: Income Tax*, 30 Calif. L. Rev. 397, 527 (1942).

(1) In many cases the 1942 provisions resulted in double taxation.

(2) They also imposed a virtually impossible burden of tracing the community property derived from the separate property or earnings of the surviving spouse.

(3) Where the surviving spouse later sold property of the community which had increased in value, the Treasury Department held<sup>91</sup> that as to Texas community property the basis of the surviving spouse's half, as distinguished from that derived from the decedent spouse, was one-half of the original cost basis of the property to the community, rather than one-half of the value at the date of the decedent's death.

(4) It was not at all clear from the statute that if, after the death of one spouse, the surviving spouse died within five years, Section 812(c) of the Code, relieving from estate tax property previously taxed within the last five years, would apply. Although the Treasury took the position that the provision did apply,<sup>92</sup> there was nothing to prevent it from changing its opinion.

(5) Congress had not seen fit to decide how the estate tax burden should be borne as between the decedent's portion of the community property and that of the survivor; and the Supreme Court, in upholding the constitutionality of the 1942 estate tax provisions,<sup>93</sup> skirted that as a problem for the states. In states such as Texas, where there was no rule for this situation, it was necessary to adopt statutory provisions for apportioning the burden of the estate tax between the decedent's and the survivor's portions of the community property. The rule adopted in Texas imposed the burden on the decedent's estate to the extent of all the tax, except for one-half of what the tax would have been had the com-

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<sup>91</sup> I. T. 3808, 1946-2 CUM. BULL. 58.

<sup>92</sup> U. S. Treas. Reg. 105, § 81.41.

<sup>93</sup> *Fernandez v. Weiner*, 326 U. S. 340 (1945); *U. S. v. Rompel*, 326 U. S. 367 (1945).

munity property been the only property of the spouses subject to tax.

(6) One more difficulty lay in the fact that Congress, in providing that community property should be taxed as the property of the spouse first to die, had failed, in both the statute and the committee reports, to provide any rule in case of simultaneous death of both spouses.

With the adoption of a split-income rule for all states in the Revenue Act of 1948, it soon became evident that the only fair rule would be to repeal the 1942 estate and gift tax provisions. But it was also apparent that if this were done, the situation would result in a restoration of the pre-1942 advantage of community property. The answer to the equalization problem was finally determined by two principal steps: (1) repealing the 1942 estate tax provisions, with respect to community property; and (2) providing, with respect to non-community property, a "marital deduction" which, for estate tax purposes, would put non-community and community property on the same basis. Thus the mountain moved to Mohammed. And judging from the complexity of the "marital deduction" provisions and the length of the Senate Finance Committee's explanation of them, it was truly a mountain that moved.

The restoration of community property to its pre-1942 status, for estate tax purposes, was effected by the repeal<sup>94</sup> of three specific provisions of the estate tax law which had been introduced into the Code in 1942, dealing with community property law. With the repeal of these provisions, the status of the interest of a decedent, for computing the gross estate under Section 811 of the Code, was made determinable under the local state law.

The 1942 provisions repealed by the 1948 Act were: (1) Section 811(e)(2) of the Code, which provided generally that all

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<sup>94</sup> Revenue Act of 1948, § 351.

community property should be included in the estate of the spouse first to die except where it could be traced to the separate property or earnings of the survivor; (2) Section 811(d)(5), which included in the estate of the decedent first to die transfers of community property made in contemplation of death, transfers intended to take effect at or after death and transfers to revocable trusts, or transfers where the decedent retained rights in the property or income therefrom; and (3) Section 811(g)(4), which included in the taxable estate the proceeds of insurance on the decedent's life purchased with community property.

The repeal of these three provisions was, however, made effective beginning only with January 1, 1948, rather than retroactive to the effective date of the 1942 Act. The community property included in the estates of taxpayers dying between the effective date of the 1942 Act, October 21, 1942, and January 1, 1948, must, therefore, still bear the burden of the 1942 estate tax provisions.<sup>95</sup> The new Act further provided<sup>96</sup> that the retroactive application of the repeal of the community property provisions should not increase the estate tax which would have been payable under the old law where the decedent died in 1948, but before enactment of the new Act.

In addition to the repeal of the above provisions of the 1942 Act with respect to community property, Congress adopted a new specific provision,<sup>97</sup> as noted above, amending Section 113(a)(5) of the Code to allow the surviving spouse to use as a basis for the survivor's half of the community property the fair market value of the property at the date of death of the decedent spouse, or at the optional valuation date a year after the date of decedent's death.

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<sup>95</sup> For a good practical discussion of the problems pertaining to community property during this period, see *Transcript of Four Forum Discussions* ("Estates, Wills and Trusts") (Mercantile National Bank, Dallas, Texas, 1946).

<sup>96</sup> § 351.

<sup>97</sup> § 366.



With respect to the gift tax, the 1948 changes in the law were simply made by providing<sup>98</sup> that Section 1000(d) of the Code, added in the 1942 Act to provide for the taxation of gifts of community property to the husband unless they were shown to be derived from the separate property or earnings of the wife, should be applicable only to gifts made after the calendar year 1942, when the 1942 gift tax provisions first became effective, and on or before the effective date of the 1948 Act, April 2, 1948. The gifts taxable during such period are, however, to be included in the net gifts for preceding calendar years in order to determine whether, and at what rate, gifts for the current year are to be taxed. The provisions of Section 1000(d) are not, however, to apply in determining the extent to which transfers of community property are transfers by the decedent under the estate tax.

In the case of the estate tax, the provisions for matching non-community property with community property center about the "marital deduction."<sup>99</sup> This term, contained in a new Subsection 811(e) of the Code, introduces a novel and intricate concept into the federal estate tax structure. What it does, in substance, is to enable one spouse to provide that one-half of his or her property, less certain deductions from the gross estate permitted under Section 812(b) in computing the net estate, shall go to the other spouse free of estate tax.

In computing this one-half of what is called the "adjusted gross estate" that may be given to the other spouse free of estate tax, the deductions from the gross estate to be considered are funeral expenses, administration expenses, claims against the estate, mortgages or other indebtedness against the estate property, and amounts spent for dependents' support during the settlement of the estate. The marital deduction is, furthermore, allowed as a deduction only with respect to property includible in the gross estate; it would not apply, therefore, to foreign real estate or

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<sup>98</sup> § 371.

<sup>99</sup> § 361.

property acquired by the surviving spouse from the decedent by purchase for full and adequate consideration during the decedent's lifetime.

In the case of community property which the decedent and surviving spouse held as such at any time, a special rule applies. The following classes of property are deducted from the gross estate:

- (1) Property held at the decedent's death as community property.
- (2) Property transferred by the decedent during his life, if it was community property at the time of transfer.
- (3) Proceeds of insurance on the decedent's life to the extent the insurance was purchased out of community property.
- (4) Such proportion of the Section 812(b) deductions as the value of the gross estate, less the three items above, bears to the total gross estate.

A special rule on the above special rule provides that where community property was converted into separate property during 1942, or after the date of enactment of the Revenue Act of 1948, the separate property must be included in the first three categories listed above. A further refinement provides that where, in the conversion, the value of the property acquired by the decedent exceeded the value of that acquired by the surviving spouse, the decedent's separate property shall be considered as community for the purpose of the above three categories only with respect to the same portion of such separate property of the decedent as the portion which the value (as of such time) of the surviving spouse is of the value (as of such time) of the separate property so acquired by the decedent.

A whole network of complicated rules is set forth in the Act to preclude the marital deduction where the surviving spouse has

an interest of lesser scope than the surviving spouse generally has in a community property state such as Texas, that is, essentially a fee interest. For example, if the surviving spouse has a life estate or any other form of terminable interest, or if an interest is or may be obtained from the decedent by anyone other than the surviving spouse or the estate of the surviving spouse for less than adequate and full consideration in money or money's worth, no marital deduction is allowed. The ordinary "common disaster" clause, if not more than a six-month period is used, does not, however, result in a denial of the marital deduction.

Further detailed rules are established for dealing with situations involving the following: interests passing to unidentified persons; interests in unidentified assets; valuation of interests, trusts or life insurance where the surviving spouse has a power of appointment; the passing of an interest from the decedent to any person; the effect of disclaimers and of the optional valuation provision and the statutory provisions with respect to previously taxed property; apportionment of tax in cases involving life insurance and powers of appointment; and the gift tax credit.

These provisions, involving in some cases refined questions of local property law, even to the point of raising a distinction based on whether the particular state law adheres to the rule in *Shelley's Case*, to determine whether the surviving spouse received a fee interest or merely a life estate with remainder to the survivor's heirs, completely ignore Mr. Justice Frankfurter's observation in the *Hallock case*<sup>100</sup> that the "niceties of the art of conveyancing" have no place in the practical law of taxation.

With respect to the gift tax, in order to match donors of property in non-community property states with donors of community property, the 1948 Act provided<sup>101</sup> that where a donor, after the date of enactment of the Act, transfers property to his or her

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<sup>100</sup> *Helvering v. Hallock*, 308 U. S. 106 (1940).

<sup>101</sup> § 372.

spouse by gift, one-half of the value of the property is deductible from the net gifts subject to tax. Under rules similar to those above discussed with respect to the estate tax, the marital deduction is denied with respect to gifts of community property or separate property considered as community property. Detailed rules for the application of the marital deduction with respect to specific types of interests and particular situations, as in the case of the estate tax, are also provided. Gifts made by a husband or wife out of the non-community property may, if both the taxpayers consent and so desire, be considered as made one-half by each.<sup>102</sup>

While the new Act did not forbid the use of the familiar arrangement of a life estate to the spouse with remainder to the children, it does prevent the marital deduction in such case because there has been no estate tax at the death of the life beneficiary. The surviving spouse may, however, be given a commercial annuity or be made the beneficiary of a life insurance policy payable in installments without losing the marital deduction. If a trust with a life estate provision meets the following requirements, the marital deduction is obtained:

1. The surviving spouse must be entitled to all the income from the trust principal, either for life or, if the trust terminates at an earlier date, for the duration of the trust.

2. The trust income must be payable to the surviving spouse annually or more frequently.

3. The surviving spouse must have a power (exercisable alone and in all events) to appoint the entire corpus free of trust to himself or his estate. If the power is exercisable by will only, the trust is not disqualified merely because he also has the power to invade only part of the corpus during his lifetime.

4. If another person is given a power of appointment with regard to any part of the corpus, it must be exercisable only in favor of the surviving spouse.

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<sup>102</sup> § 374.

In the case of life insurance, the marital deduction is similarly obtained if the proceeds are receivable by the surviving spouse in annual or more frequent installments. The installments must commence within one year after the decedent's death, all amounts payable during the life of the surviving spouse must be payable only to such spouse, and the surviving spouse must have the power to appoint all amounts payable after such spouse's death to the estate of such surviving spouse.

In the case of married couples, the net effect of the 1948 provisions is, for all practical purposes, to double all the estate and gift tax exemptions and exclusions. Instead of one estate tax exemption of \$60,000, the couple has two totaling \$120,000, provided, in the case of non-community property, that one-half of the decedent's property is left to the surviving spouse in accordance with the requirements of the marital deduction provisions. Under the gift tax, the effect of the 1948 Act is to give the couple a total of \$60,000 lifetime exemption instead of \$30,000 if, with respect to non-community property, half of the \$60,000 is given by one spouse to the other. In addition, one spouse may in such case also give the other \$6,000 each year without using up any of the lifetime exemption since \$3,000 is tax-free by virtue of the marital deduction and the other \$3,000 falls under the annual exclusion. One spouse may, by using all of the possibilities, give the other \$6,000 per year, plus \$60,000 during the lifetime of the donor, and then \$120,000 more under his will, without being subject to estate or gift tax. Adding the above, over a ten-year period, to their combined gifts to third persons—for example, to two children who would each receive \$60,000 over the same ten-year period—the couple could completely dispose of, without any estate or gift taxes, an estate of \$360,000.

The same possibilities are open to a couple in a community property state such as Texas, where the property of the couple consists in whole or in part of community property. In the case

of community property, the marital deduction does not, of course, apply; but such deduction is not needed since the community property is already owned half by each spouse. As the new law was designed, from the standpoint of the tax cost of dying or gifting, it makes no difference whether the property is community or non-community.

In dollars and cents, the estate tax savings at the time of the husband's death on a \$500,000 community property estate, without making any gifts at all, and assuming five per cent administration costs at the time of death, would be the difference between \$110,000 before the 1948 Act and \$43,000, or approximately \$67,000. Of course, the surviving wife's estate would have to pay an estate tax later at her death on her one-half of the \$500,000; but if that was also \$43,000, there would still be a saving of the difference between \$110,000 and \$86,000, or \$24,000.

A serious question arises with respect to the use of the marital deduction in connection with separate property in a community property state such as Texas, where this income from separate property is considered as community property. Assume that a Texas husband gives his wife a substantial amount of separate property, thereby taking advantage of the provisions of the new Act with respect to gifts of a non-community property by one spouse to another. The income from that property continues to belong half to the husband, since the income is, under Texas law, community property. Has the husband made a transfer which falls under Section 811(c) of the Code, since he "retains the right to income from the property" and to that extent (one-half) the property must be included in his taxable estate at his death? This is only one of the many questions that will arise and must, in the end, be resolved by the courts.<sup>103</sup>

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<sup>103</sup> See Walker, *Community Property and Taxation*, 15 Dallas Bar Speaks 267 (1942).

### III. SOME SPECIAL PROBLEMS FOR THE DRAFTSMAN

The preceding discussion brings us to a consideration of some of the practical problems presented for the draftsman of wills and trusts which dispose of community property.<sup>104</sup>

In the drafting of trusts involving both community and separate property, it will generally appear desirable to use the marital deduction provision with respect to half of the separate property. As to the other half, a trust with life estate to the surviving spouse and remainder to the children will still be worthwhile from the tax-saving standpoint. It would appear desirable to steer away from trusts with powers of appointment, in light of the fact that the Congressional committees have indicated their intention to review the 1942 power-of-appointment provisions with a view toward changing them. Under the marital deduction provisions, a life interest to the surviving spouse, coupled with a taxable power of appointment in such spouse, does not deprive the decedent's estate of the marital deduction. If the power of appointment provisions of the Code should be changed, however, they may again upset trust arrangements containing power-of-appointment provisions.

Another problem arose with respect to life insurance proceeds paid to the decedent spouse's estate where the premiums were paid from community property after the effective date of the 1948 Act. Would the terms of Section 811(g)(1) require the inclusion of the total proceeds in the decedent's taxable estate because they are "receivable by the executor" in their entirety even where the executor is required, as under Texas law, to pay over one-half of the proceeds to the wife as her community property?<sup>105</sup> The Treasury has ruled in such a case that only one-half of the insurance proceeds will be considered "receivable by the executor."

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<sup>104</sup> For a study in estate planning in action for community property, see 1947-1948 TAX LECTURES OF BUSINESS AND ESTATE PLANNING COUNCIL, HOUSTON, TEXAS.

<sup>105</sup> U. S. Treas. Reg. 105, § 81.26.

While the changes made in the Revenue Act of 1948 with respect to community property as such are few in number and relatively simple in application (in fact a great relief from the complexities and omissions of the 1942 provisions), he would be a foolhardy soul today who, in drafting a will or trust for a Texas resident, would stop with the new community property provisions alone.

If the testator has, or may have at the time of his death, any separate property, the person charged with drafting his will must consider in detail the effect of the "marital deduction," not only with respect to such separate property but also with respect to the estate as a whole. Failure to do so would make counsel derelict indeed. With respect to the gift tax, the need for detailed consideration is less acute; but whether the prospective settlor of a trust, or the donor in the case of a gift, has, or may later obtain, separate property, consideration should be given to whether the trust transfer or the gift should be made from community property or from separate property. And if it is made from the latter, the further question arises as to the desirability of a prior gift of separate property from one spouse to the other. Such a gift may be desired in order to shift the identity of the donor or settlor or to increase the number of settlors or donors from one to two.

The fact is that in a community property state such as Texas, it is just as necessary to review all wills and all trusts that can be amended as it is in the non-community property states. While the draftsman of wills, trusts and deeds of gift in most non-community property states, unless his client lives near or has interests in a community property state, can generally afford to ignore the provisions of the new 1948 Act with respect to community property, the draftsman in a community property state must master and apply all the estate and gift tax provisions of the new law, as to both community and non-community property. And master them he must, since his clients may die any day, and some



of them, in the case of most counsel, will die before the year is over. Once the client has died, the will cannot, of course, be changed. The draftsman or reviewer of a trust who finds that the instrument is irrevocable will also discover that under the new Act no opportunity for amendment of such a trust is afforded.

A somewhat parallel situation existed when the severe 1942 estate tax provisions with respect to powers of appointment were enacted.<sup>106</sup> Wills could be amended prior to death, but irrevocable trusts could not. Revocable trusts could be amended; but if they were not altered to afford protection to the holder of the power prior to his death, the estate tax attached to the power of appointment. The gift tax on the releases of taxable power<sup>107</sup> has, however, been repeatedly postponed through the annual enactment of legislation granting successive postponements for the release of taxable powers of appointment. It now appears likely that further postponements will be granted until the power-of-appointment provisions of the Code have been considered in their entirety by Congress.

In the case of the 1948 Act, however, it appears clear that counsel responsible for informing testators and settlors of the impact of the new estate and gift tax provisions on their wills, trusts, gifting programs and estate plans in general have not only a heavy but also an immediate, continuing responsibility. In many cases it will prove no satisfactory answer to a widow or heirs, or to a widower, that the only reason why necessary or desirable changes were not made prior to the decedent's death was that the provisions of the 1948 law were complicated and difficult to understand. Counsel are paid to know the law. Knowledge and understanding of the new provisions cannot, moreover, be passed off by the general practitioner as a problem to be left to tax experts. Even if the drafting of the instruments or the consideration of the estate plans in general is delegated to such experts by the

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<sup>106</sup> § 811(f) of the Code.

<sup>107</sup> § 1000(c) of the Code.

general practitioner, the latter has the definite responsibility of protecting his client to the extent, first, of advising him of the necessity of reviewing his will or trusts which the lawyer either drafted or at least knows exist, and, second, of either revising the instruments as necessary or having the job correctly done by an expert to whom that duty is assigned. The responsibility for seeing that the job is done, and as soon as possible, certainly belongs, however, to the general practitioner rather than to the expert.

A client, particularly if a considerable period of time has elapsed since the drafting of the will or trusts in question, may feel at first that his counsel is "making work" for himself; but it certainly is the duty of the counsel to disillusion his client in that respect. Any original resentment by such a client is bound to be dispelled, in most cases, when he finds the extent of the tax saving which is generally involved in a reconsideration of his will or his trusts.

#### IV. SOME PRACTICAL SUGGESTIONS FOR THE HANDLING OF COMMUNITY PROPERTY

To avoid difficulty and litigation in connection with the disposition of community property, it is important that every owner of community property be encouraged, by counsel or otherwise, to adopt a pattern in the handling of such property which will simplify the, at best, difficult problem of identification thereof in relation to separate property.

Some of the practical steps to facilitate this and which will always pay off handsome dividends at some certain date are the following:

A. *Maintenance of Records*: Keep records to show just what is community and what is separate property; the source of property used for new acquisitions; the income from each class of property

and its disposition; and the proportions of each piece of property that are community and separate property.

*B. Keep Separate and Community Property Apart:* Keep separate property physically apart from community property when possible. Use a separate bank account for separate funds; do not put them in a joint account. Separate safe deposit boxes may be useful in maintaining the separate character of securities.

*C. Pay Insurance Premiums from Proper Fund:* If the beneficiary of the insured's life policy is not the other spouse, pay insurance premiums from separate funds.

*D. Execute Formal Agreements:* Execute agreements between spouses with all the formalities prescribed by law (not overlooking statutes other than the community property laws, e.g., statutes on conveyancing and recording.)

*E. Consider Gift Tax Liability:* Remember that gift tax liability may arise from an agreement by spouses fixing their rights in community property.

*F. Watch Credit Extensions:* Is it safe to extend credit to one spouse without imposing liability on the other? For example, can community property standing in the name of one spouse be reached to satisfy a community debt incurred by the other?

*G. Review Estate Plans:* Examine wills, estate plans and insurance holdings in the light of the new law.<sup>108</sup> Consider the impact of federal and state estate taxes.

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<sup>108</sup> The Professional Ethics Committee of the American Bar Association says: "It is our opinion that where the lawyer has no reason to believe that he has been supplanted by another lawyer, it is not only his right, but it might even be his duty to advise his client of any change of fact or law which might defeat the client's testamentary purpose as expressed in his will."

## CONCLUSION

A large awareness of the nature of the community property system and its important relationship to the federal tax structure, income, gift and estate, is essential to the orderly disposition of community property. With such knowledge, an effective disposition can be made of such property in accord with the intent of both parties to the community estate, man and wife. Without it, only confusion and expensive litigation in the probate as well as the tax courts can result.

The complexity of the community property system is summarized in the paradox that "community is a partnership which begins only at its end," that is, upon dissolution of the marriage.

The Revenue Act of 1948 is the source, but not the beginning or the end, of the realistic impact of the federal tax structure on community property.

A hint to the wise is sufficient — or should be!