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Lifetime Transfers and Estate Planning

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THE FIRST prerequisite to intelligent counseling in estate planning matters is to be fully informed of the nature and extent of the estate with which you are dealing. There are certain basic items of information which should always be ascertained. The value of the estate is, of course, the most important thing to know. However, the percentage of liquid assets and the types of property which compose the estate are also vital. The astute counselor will also determine whether the client holds any interests in partnerships or closely held corporations. Ownership of realty in foreign jurisdictions should be listed as well as the possibility of future inheritance by the client or members of his family. In this regard, it is most important to discover any powers of appointment held by the client or which he may receive. If the client holds a power, the attorney must be careful to distinguish any general power granted prior to October 1, 1942. Rights under pension plans or profit sharing trusts should also be considered. If there is any insurance on the life of the client, ownership of the policy and the named beneficiary must be determined. Always, of course, the division of the estate between separate and community property must be ascertained. The attorney should also find out the details of the make-up of the family: marital status, separate property of a spouse, age and sex of any children, their business experience and managerial ability, and their tendency toward extravagance or frugality. In cases where there are daughters, the client may wish to protect his property from the husbands’ mistakes through the use of trusts for their benefit.

Both federal and state tax rates are progressive. Therefore, any reduction, either in the amount which passes in the estate or in the number of estates through which property passes, will progressively reduce the amount of tax which must be paid. Thus, techniques of estate planning are almost always designed to reduce the volume of property which will be taxed in the estate. If this objective cannot be achieved, then the goal is usually to eliminate “middle-men,” by

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1 This is essential because the will may have to comply with the laws of the state where the realty is located as distinguished from the law of the state of the testator’s domicile. 3 Page, Wills § 28.7 (1961). In addition, real property situated outside of the United States is not includible in the gross estate for purposes of the federal estate tax. Int. Rev. Code of 1954, § 2031(a).

2 A general power granted prior to October 1, 1942, is not taxable unless exercised. Int. Rev. Code of 1954, § 2041(a)(1).

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passing property through trusts, life estates and powers of appointment to an eventual rather than immediate heir, while retaining the enjoyment, but not the unlimited control, of the property for the immediate beneficiary. If the number of times that property is taxed in someone's estate is thus reduced, the tax saving is fully as great as a reduction in the amount of the original estate.

The standard technique used to reduce the amount of the estate is the inter vivos gift. The Internal Revenue Code allows an annual exclusion from the gift tax of $3,000 per donee if the gift is either a present interest or a trust for the benefit of a minor under Section 2503(c). In addition to the annual exclusion, a lifetime exemption of $30,000 is allowed; thus, an individual may give $3,000 yearly to each beneficiary plus an additional $30,000 before any gift tax is payable. In this simple manner, therefore, liability for a considerable amount of estate tax may be avoided. The only limitation on the use of this technique is the possibility of the death of the donor within three years from the date of the gift in which case it is presumed that the transfer was in contemplation of death. Unless the taxpayer proves that the transfer was not in contemplation of death, the property subject to the transfer, valued at the decedent's death, will be included in the gross estate for tax purposes. Subject to this pitfall, the use of inter vivos gifts in estate planning may be of considerable benefit. It should be remembered that a gift of separate property to a spouse qualifies for a marital deduction of one-half of the value of the gift. If the gift is to a third party, it will be attributed one-half to each spouse if the spouse consents to the gift. In this manner, the gift tax may be reduced even further. Even if the tax must be paid on a gift, however, it is preferable to the estate tax, since the gift tax rate is approximately three-fourths of the estate tax rate. For example, if a taxpayer reduces his $100,000

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4 The § 2503(c) trust will qualify for the annual gift exclusion if (1) the property and income may be used for the minor's benefit, (2) unexpended property and income will become the outright property of the minor at age 21, and (3) if the minor dies during minority, the trust property and income will pass to his estate or his appointee under his will. The trust instrument, however, may provide for a gift to another in the event that the power is not exercised. Treas. Reg. § 21.2503-4(b)(3) (1958). For a good discussion of the use of present interests in trusts see Caplin, Trusts for Minors, N.Y.U. 14th Inst. on Fed. Tax 361, 374-89 (1956).
estate to $95,000 by giving $5,000 in addition to his annual exclusion and lifetime exemption, the tax on the gift will be only $112.50; however, if the same $5,000 remains in the estate, the tax will be $1,400.

While a gift may be made of a complete present interest, it is often preferable to donate in trust form. In this case, however, the donor must be careful to “cut all the strings,” for otherwise the trust property will be included in the taxable estate of the donor. Thus, the whole motivating purpose of estate tax avoidance may be thwarted if the trust is revocable, life benefits are retained, the transfer takes effect at death, or the trust is subject to the exercise by the deceased of a power to “alter, amend, revoke, or terminate.”

This last provision may have unanticipated application when the donor is also the trustee and is a pitfall to be avoided. Particular care must be exercised in this area, for the powers which a settlor-trustee may possess under Section 674 of the Code and yet escape taxation upon the income from the trust are still sufficient to cause the trust to be included in the donor’s estate for tax purposes. Administrative powers in the donor-trustee which are too broad may result in the inclusion of the trust in his estate. Therefore, if the

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10 Int. Rev. Code of 1954, § 2036. This category includes: trusts for the support of the taxpayer’s wife, Commissioner v. Dwight Estate, 205 F.2d 298 (2d Cir. 1953); trusts for the support of the taxpayer’s minor children, Robert Manning McKean, 25 T.C. 697 (1956); funded insurance trusts if the insurance is on the life of the settlor, Int. Rev. Code of 1954, § 677(a)-1(d), 1.677(b)-1(d) (1953); see Blumenthal v. Commissioner, 296 U.S. 512 (1935). If, however, the trust creates a new obligation for which the settlor is not liable, the rule is not applicable. Rev. Rul. 54-516, 1954-2 Cum. Bull. 54; cf. Edwards v. Greenwald, 217 F.2d 632 (5th Cir. 1954); Haye’s Estate v. Commissioner, 181 F.2d 169 (5th Cir. 1950).


A donor who keeps so strong a hold over the actual and immediate enjoyment of what he puts beyond his own power to retake has not divested himself of that degree of control which . . . [the Code] requires in order to avoid the tax.

If the trust embodies provisions which would render it taxable if the donor were the trustee, the trust will also be included in the donor’s gross estate if there is an independent trustee who may be removed by and replaced with the donor. Van Beuren v. McLoughlin, 262 F.2d 311 (1st Cir. 1958).

14 Cf. Commissioner v. McCormick, 43 F.2d 277, 280 (7th Cir. 1930). Although the settlor in this case was not the trustee, the court held that the provisions of the trust caused the trust to be taxable as a “transfer intended to take effect in possession or enjoyment after death.” A provision of the trust instrument upon which the court placed great reliance was “it being the intention that no change shall be made by said Trustee
donor is also to be the trustee, he must retain no discretionary powers other than strictly administrative powers and, of course, no express rights of reversion.\textsuperscript{6}

Thus, the basic principles of estate planning through the use of lifetime transfers may be repeated. The first is to distribute the tax load among as many different taxpayers as possible. The second is to prevent the vesting of fee simple title for as many generations as is possible within the Rule Against Perpetuities\textsuperscript{7} and thereby cause the property to be included in the estates of the least possible number of people.

I. USE OF INTER VIVOS TRUSTS

A. Revocable Trusts

A revocable trust created to protect the settlor's property may contain a provision for its continuance after death. Although this device achieves no tax advantage, it does relieve the settlor of the burden of management of the property during his lifetime. Moreover, if the trust continues after death, it will be a better safeguard against successful contest than a will would provide.

If, however, the donor wishes to avoid taxation on the income of the trust, he may provide for the accumulation of the income for the benefit of someone other than himself by creating a trust under Section 673(a) of the Code. If the trust is to last for at least ten years with only a reversion of corpus to the grantor, the trustee and not the grantor will be taxed on the income, unless it is used to support dependents.\textsuperscript{8} A good example of a situation in which this

\textsuperscript{6} However, the statutory right to inherit the estate because of the failure of the beneficiaries to survive the donor is not a taxable reversionary right. Treas. Reg. § 20.2037-1(c)(2) (1958).

\textsuperscript{7} While the Rule is that the estate must vest within a period measured by lives in being plus twenty-one years plus a reasonable gestation period where appropriate, the draftsman is not limited to the lives of the beneficiaries but may use a reasonable number of other people as the measuring lives. E.g., a will provides that "the trusts are to terminate no later than twenty-one years after the death of the last survivor of my descendants living at the time of my death" and that the trust property is then to go "to the beneficiaries then receiving income hereunder in the proportions in which they are then entitled to receive or have the benefit of such income." In this manner, the draftsman can provide for future generations yet not run afoul of the Rule even if the last descendant dies too soon.

\textsuperscript{8} Int. Rev. Code of 1954, § 677(b), provides:

Income of a trust shall be considered taxable to the grantor . . . merely because such income . . . may be applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed . . . .

Not to be overlooked is Treas. Reg. § 1.662(a)(4) (1956) which, while not supported by any specific provision of the Code, provides that income from a trust, regardless of who created it, will be taxable to the individual whose obligations it discharges. Thus,
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Technique should be applied is the parent in a high income tax bracket with income from both investments and large earnings. Facing the prospect that the earnings will be largely non-existent in his old age and that he will be compelled to live primarily on the income from his investments, the father may create a trust to accumulate income from the investments for the benefit of his four year old child. The investment income will be taxed at a much lower rate in the trust than it would have been if included in the father’s tax return. The income will not be included in the father’s return if the income is accumulated until the child is seventeen, for example, and then placed to his credit in a bank account in order that he may draw on it to finance his college education. In this manner, the income will not be used to discharge the obligation of the father within the meaning of Section 677(b), and the investments will return to the father when the trust terminates to provide support in his retirement. It must be realized, however, that the grantor will be taxed on gains in the corpus of the trust during the trust period, and if the father dies during the term of the trust, the value of the corpus will be included in his estate for tax purposes.

If the donor is faced with the problem of supporting a relative such as an aged parent, brother or sister, income tax relief may be obtained through the use of a trust to pay its income to the beneficiary with a reversion of the corpus upon the death of the income beneficiary. In this manner, the income beneficiary and not the donor will be taxed on the trust income, although the donor will be taxed on the gains in the corpus. Moreover, since the corpus will revert to the donor upon the death of the income beneficiary, the corpus will be included in the donor’s taxable estate. For the donor who wishes to divert income to a charitable organization, a trust with a reversion in the grantor may be set up. Income from the trust will be exempt from taxation if the income is irrevocably committed to the charitable organization for a period of at least two years.

B. Irrevocable Trusts

If a donor wishes to avoid estate taxes as well as income taxes by the income from a trust created by a grandfather to support his grandchildren will be taxable to the son-parent to whatever extent it satisfies the son’s obligation to support his children.

Treas. Reg. § 1.673(a)-1(a) (1956); see Treas. Reg. § 1.677(a)-1(g) (Example 2) (1956).

Int. Rev. Code of 1954, § 673(c); see Treas. Reg. § 1.673(a)-1(b) (1956).

Treas. Reg. § 1.673(a)-1(a) (1956).

the use of an inter vivos trust, he must, as noted above, reserve neither an interest in the trust nor any discretionary power over distributions of corpus or income, if he is serving as the trustee. Therefore, if the donor wishes the trustee to exercise discretion in distributions of corpus and income, an independent trustee must be appointed.29 Neither can the donor be a trustee of a trust formed under Section 2503 (c) of the Code if the estate tax is to be avoided. Because of the nature of the powers granted to the custodian by the Texas Uniform Gifts to Minors Act,25 the donor must not be the custodian of a gift under that Act if inclusion in the estate is to be prevented.26

Trusts of the kind described in the preceding paragraph may be granted for the life of the beneficiary or for a limited period only, e.g., until the beneficiary reaches the age of thirty-five. However, it is usually preferable to have a succession of beneficiaries, e.g., income and corpus benefits for the son and after his death for his children. In this manner, inclusion of the trust in the son's estate may be avoided, provided that the son's right to invade the corpus is measured by an ascertainable standard "relating to the health, education, support, or maintenance. . . ."27 On the other hand, if the donor anticipates an accumulation of income and also plans to have several beneficiaries, it will be better to create a separate trust for each beneficiary, as this will provide a separate taxpayer for each accumulation and result in a corresponding income tax saving.28 The use of the inter vivos trust is limited, however, by the probability that it will be taxed as a corporation rather than as a trust if it must operate a business.29

The general rule of taxation of trust income is that the trustee

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23 While the fact that a trustee is related or subordinate is immaterial for estate tax purposes, it is decisive for income tax purposes; hence the definitions in § 672 of the Code must be considered in connection with the trusts to which § 674 is applicable. Thus, a son, other relatives, or employees mentioned in § 672 (c) (2) would be unacceptable as trustees.

24 See note 4 supra.


is taxed on income accumulated and the beneficiary is taxed on any income distributed. However, the 1954 Code introduced an exception to this general rule by taxing the beneficiary when accumulations for the past five years were distributed to him except under certain limited circumstances. A further innovation of the 1954 Code was the tier system, which applies to complex trusts which have more than one beneficiary. Beneficiaries to whom income must be distributed under the trust instrument are in the first tier; while beneficiaries to whom distribution of income is discretionary and beneficiaries who are entitled to distributions of corpus only are in the second tier. The first tier beneficiary is taxed on the trust income to whatever extent it is distributed to him and the discretionary distributee is taxed only on whatever income remains to accumulate and is distributed to him.

II. USE OF TESTAMENTARY TRUSTS

Generally speaking, the rules applicable to inter vivos trusts, described in the preceding paragraphs, are also applicable to testamentary trusts. In either case, it is advisable to avoid a situation in which the life beneficiary will be succeeded by a vested remainderman, since the vested remainderman may predecease the life beneficiary. In such a case, the remainderman's interest will be taxed, and, even though the payment of the tax may be postponed, the tax could have been entirely avoided by careful estate planning. Thus, the possible tax will be avoided if, in a trust for the life of the donor's son, the donor will provide that upon the son's death the trust property will pass to the son's "then surviving issue, per stirpes" instead of to the son's "son John" or to the son's "children." In cases in which there are several beneficiaries or several trusts for different beneficiaries, one should always provide for cross remainders in case one of the beneficiaries dies. In many cases, one child, probably a son, will be made the trustee of the trusts created for his benefit as well as for the benefit of the other children. If cross remainders are provided and then one of the children dies without surviving issue, his trust will pass to the trustee's trust and benefit the son-trustee to that extent. Moreover, if the son has discretionary powers over distributions of

31 Int. Rev. Code of 1954, § 665(b). These exceptions should be strongly considered in any situation other than a trust with a relatively small income.
32 Int. Rev. Code of 1954, § 662. Income accumulated and distributed within five years to the second tier beneficiary is taxable to the beneficiary.
income and corpus remaining after mandatory distributions have been made, he will be in an even better position. This reverse power, however, may place him in an unnecessary tax position, unless a standard, such as reasonable support, is provided. In this manner, protection from unnecessary tax consequences can be obtained without too great a sacrifice of flexibility.

III. Use of Powers of Appointment

The son's reverse power, spoken of in the preceding paragraph, illustrates the use of a power of appointment. A general power of appointment is defined by Section 2041(b)(1) of the Code as a power which may be exercised in favor of the decedent, his estate, his creditors or the creditors of his estate. All other powers are special powers, the exercise of which by will is not taxable. Thus, a person may be willed the power to appoint certain property to "such person or persons or institutions in whatever proportions he deems proper," if the provision is made that "he shall not have the power to appoint any property to himself, his estate, his creditors or the creditors of his estate." A power such as this, whether exercised or not, will not cause the property to be included in the donee's estate for tax purposes. If a power, however, includes the right to invade the corpus, it will be taxable unless either measured by an ascertainable standard or limited arbitrarily to $5,000 or five per cent of the value of the trust property each year, whichever amount is greater.

A general power is defined the same whether it was created before or after October 21, 1942; the rules governing their exercise or non-exercise, however, are different. A pre-October 21, 1942, power is a power in a trust created prior to that date, in the will of a decedent dying prior to that date, or in a will executed before that date provided the testator dies before July 1, 1949. Any other power is a post-October 21, 1942, power. The most important difference between the two is that the non-exercise of the former causes the tax not to be levied; whereas, the power in the latter case is taxed whether exercised or not.

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37 See note 27 supra.
38 Provisions governing the taxation of powers of appointment are found in Int. Rev. Code of 1954, §§ 2041 (estate tax), 2056(b)(6) (life insurance), 2514 (gift tax). The concept of the power of appointment found in the Code differs considerably from the common-law concept.
41 For an excellent discussion including other less important differences see Johnson, Powers of Appointment, 29 Taxes 965 (1951).
While the use of powers of appointment in Texas has not been widespread, the advantages they offer must not be overlooked. For example, a child may be willed the power to appoint the trust property "to or among such one or more of his issue and in such proportion as he deems fit." By the time the child is middle-aged, he may have a child who is already in a sizeable tax position and to whom a share of the trust property would mean only an increase in tax liability with little corresponding material benefit. In such a situation, the original child could appoint the property to his grandchildren and avoid unnecessary taxation of the affluent child while bestowing the benefit of the property on him in an indirect fashion. In drafting trusts with powers such as these, the taxation of powers of invasion, unless limited, must be remembered in order to avoid unnecessary tax exposure.

IV. Use of the Executor's Powers

The provisions of the Code governing the taxation of complex trusts also apply to the taxation of the income of an estate. These provisions may be used to the testator's advantage by careful estate planning. Under the Code all distributions to beneficiaries are considered to be out of the estate's income with the exception of specific bequests of money or specific devises of property. Thus, all distributions out of the residuary estate during the period of administration are made first out of income. The result is that the executor must be careful each year to make any partial distributions of corpus during the period of administration exactly proportionate to each beneficiary's interest in the residuary. Otherwise, some beneficiaries may be taxed on income which had been considered a corpus distribution. Since income that is retained by the executor is taxed to him while that which is distributed to the beneficiaries is taxed to them, income tax can be saved by planning partial distributions of income during the period of administration. Hence, the will should provide specifically that the executor may in his discretion distribute income to beneficiaries during administration. This is particularly true since the five-year throw back rule does not apply to estates. The use of this device to balance the income distributions will be ineffectual, however, if, in any year after the first year and before the close of administration, corpus distributions are made out

40 See notes 37, 38 and accompanying text supra.
42 Int. Rev. Code of 1954, § 662 (a) (1).
43 Int. Rev. Code of 1954, § 666, applies only to complex trusts. See text accompanying note 30 supra.
of the residuary estate, since in that year all income will be considered distributed before there is any distribution of corpus. If the estate is in such a position that all of the corpus will not be needed for taxes or other obligations, income balancing can be obtained in subsequent years by adopting a short fiscal year for the first year of the estate, e.g., a fiscal year closing two months after the commencement of administration. Distributions of corpus may be made during this two months' period, and, since income for the period will be relatively small, any unbalancing of income distributions will also be relatively small.

Although the method described in the preceding paragraph offers advantages at the present time, it should be carefully noted for its possible future utility, since a movement is now afoot to provide in the next tax bill for the taxation of estates as an entity. Under this plan the estate would not receive an income tax deduction for income distributed during the period of administration. If this proposal is adopted, utilization of a short fiscal year by the estate will be essential, as substantial distributions of corpus from the residuary estate during that period will materially reduce the impact of income taxes on the estate. The careful estate planner, therefore, will provide in his will that the executor may in his discretion distribute both income and corpus to the beneficiaries during the period of administration.

One rule which must not be ignored is to avoid causing an unnecessary increase in the tax burden of others. The most common example of this self-defeating action is a devise by one spouse to the other. For example, in a community estate of $200,000, if neither spouse leaves the other his share of the community, each will have an estate tax of only $4,800. On the other hand, if either spouse leaves the other his share of the community and the surviving spouse lives beyond the estate tax credit period, the survivor's estate will have to pay a tax of $32,700. This needless tax expense can be avoided if a spouse will devise to the other spouse only a life estate or life benefits in the decedent's share of the community with remainders to others. Applying the rules of powers of appointment, the survivor may be given a right to invade the corpus limited by a standard; thus, the survivor can, in effect, enjoy the full benefit

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44 The estate tax credit is described in § 2013 of the Code. Credit for gift taxes on transfers in contemplation of death and, therefore, included in the decedent's estate is covered by Int. Rev. Code of 1974, § 2012. In cases in which a closely held business constitutes 35% of the gross estate or 10% of the taxable estate, the estate tax may be paid in installments. Int. Rev. Code of 1974, § 6166.
45 See notes 37, 38 and accompanying text supra.
of the decedent's share without having it included in his estate for tax purposes. This device, of course, is not limited to a spouse but may be used to good effect in other circumstances, e.g., to the child for life with remainder to his then surviving issue, thereby amply protecting the child but avoiding inclusion of the bequest in the child's estate upon his death. A word of final caution to the will draftsman is always to be certain to specify who must pay the death duties.