The Impact of Estate and Gift Taxes Upon the Disposition of Community Property

*Walter L. Nossaman**

THE marital deduction is roughly the counterpart of the surviving spouse's interest under community property laws, the principal differences being that the former is voluntary and is new, while the latter is created by law and in its origins is of a respectable antiquity.

The conclusions stated in this paper are predicated upon the assumptions implicit in the 1948 legislation, namely, that the interests of spouses in community property are substantially equal[1] and that there is a difference between California community property acquired prior to July 29, 1927, and that acquired thereafter in that the wife has only an "expectancy" in the former, whereas in the latter she owns an undivided half interest.[2]

GIFTS OF COMMUNITY PROPERTY INTER VIVOS

Prior to January 1, 1943, gifts of community property—with the exception, always to be understood, of community property in which the wife had only an "expectancy"—were deemed to have been made by both spouses.[3] The state law permitting,[4] it follows that community property might be partitioned between spouses without incurring

* Member of the Los Angeles Bar; author of TRUST ADMINISTRATION AND TAXATION (Albany, 1945).

[1] See Senate Finance Committee Report, 1948–1 CUM. BULL. 344-346, 353. The rationale of the following cases is implicitly adopted: Lang v. Commissioner, 304 U.S. 264 (1938) (estate tax); United States v. Malcolm, 282 U. S. 792 (1931) (income tax); Poe v. Seaborn, 282 U.S. 101 (1930) (income tax); Overton v. Sampson, 138 F. 2d 417 (9th Cir. 1943) (estate tax); Commissioner v. Cadwallader, 127 F. 2d 547 (9th Cir. 1942) (estate tax); United States v. Goodyear, 99 F. 2d 523 (9th Cir. 1938) (estate tax); Sanchez v. Bowers, 70 F. 2d 715 (2d Cir. 1934) (estate tax); Estate of Paul M. Vandenhoeck, 4 T.C. 125 (1944) (estate tax); Estate of Jose Simon, 40 B.T.A. 651 (1939) (acq.; estate tax); Alice A. Bigelow, Executrix, 39 B.T.A. 635 (1939) (acq.; estate tax).

[2] Senate Finance Committee Report, 1948–1 CUM. BULL. 345; United States v. Robbins, 269 U.S. 315 (1926) (wife's interest a mere expectancy); United States v. Malcolm, *supra* note 1 (post-1927 community earnings).

Query: Does the wife have more than an "expectancy" in Nevada and New Mexico, where she has no testamentary power if her husband survives? Hernandez v. Becker, 54 F. 2d 542 (10th Cir. 1931) (New Mexico). In Idaho and Louisiana the wife's testamentary power is limited in that case. See generally, DE FUNIAK, PRINCIPLES OF COMMUNITY PROPERTY §198 (1943).

[3] Joe J. Perkins, 1 T.C. 982 (1943) (Texas; gift of insurance policy purchased with community funds), app. dism. 5th Cir.

[4] On partition of community property see Note, 171 A.L.R. 1336. The right to partition, formerly not existing in Texas, is conferred by a 1948 constitutional amendment, ART. XVI, §15, adopted November 2, 1948.

a gift tax, the reshuffling of interests occurring through this means being deemed made for adequate and full consideration.[5] Two recent decisions, not yet final, hold this rule applicable even under the 1942 statute which treated gifts of community property as being made by the husband alone.[6]

The effect of the Revenue Act of 1948 is to restore pre-1943 rules as to gifts of community property.[7] Except as to pre-July 29, 1927, community property, no marital deduction is allowed.[8] Property becoming separate through the conversion of community into separate property during 1942 or after April 2, 1948, is regarded as continuing in the community status for this purpose.[9] The regulations extend this rule to the "rentals" from converted property.[10]

The spouses being regarded as substantial owners of their respective community interests, it follows that each has the $30,000 specific exemption allowed by Section 1004(a) of the Internal Revenue Code, and the $3,000 annual exclusion allowed in the case of gifts of present interests by Section 1003(b)(3). In addition to the privilege of tax-free partition referred to above, either spouse, state law permitting, can give to the other the donor's interest in community property, paying a tax only on the value of the half interest transferred.

Although it is generally the rule that any saving of death taxes through inter vivos transfers must be inadvertent (*i.e.*, made not with a purpose to reduce death taxes)[11] it is a fact that such savings do

---

[5] See Rickenberg v. Commissioner, 177 F. 2d 114 (9th Cir. 1949), an estate tax case holding a December 1942 partition of California community property in contemplation of the husband's death not subject to estate tax as to post-July 29, 1927 community. Reg. 105, §81.15, under which such a partition was regarded as a transfer by the husband, disapproved.

[6] INT. REV. CODE § 1000(d). Essick v. United States (S.D. Cal. 1948) (appealed); Edward M. Mills, 12 T.C. 468 (1949) (appealed). The Treasury persists in its former attitude. Reg. 108, §86.2(c).

[7] See Senate Finance Committee Report, 1948–1 CUM. BULL. 351, 353.

[8] INT. REV. CODE §1004(a)(3)(F); Reg. 108, §86.16c.

[9] INT. REV. CODE § 1004(a)(3)(F)(iii); Reg. 108, §86.16c(b)(2). Property converted between 1943 and 1948 retains its acquired separate property status, because upon conversion in these years a gift tax was payable, according to the Treasury's view. But see cases cited notes 5 and 6, *supra*.

[10] Reg. 108, §86.16c(b)(3).

[11] Vanderlip v. Commissioner, 155 F. 2d 152 (2d Cir. 1946) (gift of insurance policies motivated solely by desire to avoid estate taxes); Farmers' Loan & Trust Co. v. Bowers, 98 F. 2d 794 (2d Cir. 1938), *cert. denied*, 306 U.S. 648 (1939).

Cf. Allen v. Trust Co. of Georgia, 326 U.S. 630 (1946); Denniston v. Commissioner, 106 F. 2d 925 (3d Cir. 1939).

sometimes accrue where the donor's innocence of tax saving motives is made sufficiently to appear. Mr. Looker has explored the tax as well as the practical aspects of this problem, which is substantially the same whether the subject matter is community or separate property.

The principal effects of the 1948 legislation as far as inter vivos transactions between spouses are concerned seem to be:

1. To nullify any previously existing inducement to partition community property. It can be partitioned with equal effectiveness at death.

2. To minimize—in many cases to remove—any tax advantages that might follow from the inter vivos transfer of one spouse's community interest to the other, particularly when it is remembered that in certain brackets it costs more to dispose of property by gift than to transmit it at death.[12] A further consideration applicable to bequests and devises to a spouse applies also to inter vivos gifts. The property transferred being subject to tax to the donor or testator and again taxable in the estate of the donee or devisee, the tax advantages of the new legislation are nullified to the extent that this double tax is voluntarily, and not unavoidably, incurred.

COMMUNITY PROPERTY PASSING AT DEATH[13]

Once the problem of what is community property for the purposes of the Act has been solved,[14] suppose the spouse disposes only of his or her own share of the community property, requiring no election of the other spouse. This presents no particular problem. Considering only taxes, that share should not be given outright to the surviving spouse or made subject to a taxable power of appointment,

[12] A man with a $200,000 community estate, desiring to leave his community half to his wife, would gain nothing by giving it to her inter vivos at a tax expense of $8,595 ($14,895 or more if the husband has exhausted his $30,000 exemption), when he could leave it to her by revocable inter vivos trust at an expense of $4,800. (If the transfer were by will or intestacy, there would be probate expense in addition to the figure given.) If the community estate were $120,000, he would incur no tax at all on a gift to her by will, which compares favorably with the $2,580 tax ($8,614 or more if the husband's specific exemption has been exhausted) incurred on an inter vivos transfer of $60,000.

[13] The value of the community proper is "subtracted" from the value of the gross estate in order to ascertain the adjusted gross estate. INT. REV. CODE §812(e)(2)(B).

[14] The tests are the same as for gift tax purposes. See Notes 1, 2, 8 and 9, *supra*, and corresponding text. Here as in the case of the gift tax, community property in which the wife has a mere "expectancy" is considered separate (§812(e)(2)(B); Reg. 105, §81.47d(b)); Senate Committee Report, 1948-1 CUM. BULL. 346. Community property partitioned or converted into separate in 1942 or after April 2, 1948, is considered as continuing in community status (§812(e)(2)(C); Reg. 105, §81.47d(b)), together with the "rentals" therefrom.

thereby incurring another tax in respect of the same property in the same generation.

Suppose (the state law permitting) the husband purports to dispose of the entire community estate, by giving his wife a life estate and remainders to the children, thereby putting his wife to an election either to claim her share of the community property or to let it pass by the will.[15] The spouse's election to take under her husband's will should not result in bringing her community half into the husband's taxable estate, since as to her community half there is no "transfer" by him.[16] Whether it will result in subjecting her to a present gift tax, and her estate to estate tax upon the theory of a transfer with income retained, has not been determined.[17]

If for practical or other reasons it is considered desirable to permit the husband, if he dies first, to dispose of the entire community estate, minimum tax risks would be incurred, and any question as to a gift on the part of the wife avoided, by putting her share of the community property in a trust which she can revoke, or over which she has absolute power of appointment to herself or her estate. The

---

[15] Cases on Election:

Arizona: La Tourette v. La Tourette, 15 Ariz. 200, 137 Pac. 426 (1914) (held, no election).

California: Estate of Whitney, 171 Cal. 750, 154 Pac. 855 (1916); Flanagan v. Capital National Bank, 213 Cal. 664, 3 P. 2d 307 (1931); Security-First National Bank v. Stack, 32 Cal. App. 2d 586, 90 P. 2d 337 (1939).

Texas: Baldwin v. Baldwin, 134 Tex. 428, 135 S.W. 2d 92 (1940); Pope v. Pope, 175 S.W. 2d 289 (Tex. Civ. App., 1943) (held, no election).

Washington: Andrews v. Kelleher, 124 Wash. 517, 214 Pac. 1056 (1923); Herrick v. Miller, 69 Wash. 456, 125 Pac. 974 (1912) (held, no election).

Election by wife (tax cases). Cases under former (pre-1942) federal law involving election by wife to take under her husband's will: Pacific National Bank of Seattle, Executor, 40 B.T.A. 128 (1939) (acq.); Coffman-Dobson Bank & Trust Co., 20 B.T.A. 890 (1930); G.C.M. 7773, IX-2 CUM. BULL. 426 (1930) (Texas decedent).

See generally on election, DE FUNIAK, *op. cit. supra* note 2, §217; Note, 171 A.L.R. 664.

[16] See Reg. 105, §81.47a(f), which refers somewhat obscurely to election in favor of or against community property right.

[17] See Scofield v. Bethea, 170 F. 2d 934 (5th Cir. 1948) (case of joint will). Reg. 108, §86.2(a)(9), deals with a cognate gift tax problem involving life insurance purchased with community funds. Benefits to be received by the wife from the husband's the yielding of her rights. *Cf.* Giannini v. Commissioner, 2 T.C. 1160, *aff'd.* 148 F. 2d 285 (9th Cir. 1945)), *cert. denied,* 326 U.S. 730; Robinette v. Helvering, 318 U.S. 184 (1943); Reg. 108, §86.8. See Surrey, *Federal Taxation of the Family—The Revenue Act of 1948,* 61 HARV. L. REV. 1097 at note 189 (1948).

latter would seem to resolve the principal uncertainties that arise under the 1948 Act and the regulations interpreting it.

EFFECT OF CALIFORNIA PROBATE CODE SECTION 201.5

A special problem exists in California, arising out of Probate Code Section 201.5. For purposes of succession and testamentary disposition, this statute purports to give community status to personal property acquired in non-community jurisdictions under such circumstances that it would have been community if acquired here. Although the validity of this 1935 statute has been assumed,[18] the constitutional questions suggested by *Estate of Thornton*[19] have been dealt with only inconclusively.[20] Nowhere has the drastic effect of a statute purporting to take away from a husband half his personal property at his wife's death and give it to her legatees been adequately dealt with.

Since the death of the husband is a taxable event as to all such property, it seems desirable that he make complete disposition of it. It is sufficient that his will evidence such an intent. An express intent to put the wife to an election is not necessary.[21] " . . . By making use of a trust conforming with marital deduction requirements, or by permitting the wife to take her 'community' half outright, a division of the estate into two taxable entities can be achieved."

Suppose the wife dies first. Probate Code Section 201.5 purports to say she can dispose of one-half of her husband's *personal* estate.[22] Assuming the validity of the statute, it affords an opportunity at the death of the wife for division of the husband's personal estate into two equal parts. The wife's "community" share may be given to the children, or placed in trust for the husband for life, with remainders over. In the ordinary case, it will be inadvisable to take the marital deduction as it results in bringing that part of the property back into the husband's estate to be taxed again at his death. If the husband is given a power of appointment over the trust, consideration should be given to the kind which is exempt under Section 811(f) of the Internal Revenue Code.

---

18 *In re* Miller, 31 Cal. 2d 191, 187 P. 2d 722 (1947); Estate of Schnell, 67 Cal. App. 2d 268, 154 P. 2d 437 (1944).

19 1 Cal. 2d 1, 33 P. 2d 1 (1934).

20 Estate of Way, 157 P. 2d 46 (1945) (Cal. App.) petition for hearing in Supreme Court granted and dismissed.

21 Estate of Cowell, 164 Cal. 636, 642, 130 Pac. 209 (1913); Estate of Vogt, 154 Cal. 508, 98 Pac. 265 (1908); Estate of Moore, 62 Cal. App. 265, 216 Pac. 981 (1923).

22 *In re* Miller, 31 Cal. 2d 191, 187 P. 2d 722 (1947).

Aside from the special problems presented by California Probate Code Section 201.5 and considering the effect of the 1948 legislation upon the disposition of community property generally, the following is believed to summarize its more important consequences:

1. The 1948 Act, predicated on the theory of equality of ownership by the spouses, presumably reinstates pre-1942 rulings relative to community property.[23]

2. Double taxation may be avoided by the spouses "by-passing" each other, each making nominal bequests or devises, or none, to the other, and each transmitting the property to its ultimate destination. There is no objection to giving the survivor such benefits, short of a taxable power of appointment or the equivalent of ownership, as may be considered desirable.

3. Required elections should be used sparingly pending further clarification of the law and of the Commissioner's attitude. "Waivers" executed in advance of death, and ripening into contracts at that event,[24] seem particularly undesirable.

4. Bearing in mind that the marital deduction and the community property exclusion are regarded by Congress as means to similar ends, the same general and social considerations apply to both. It seems unnecessary to enlarge upon what Mr. Looker has said regarding these matters.

5. The 1948 amendment to Section 113(a)(5), Internal Revenue Code, giving to the community interest of the surviving spouse the same basis as that which the decedent's spouse's interest takes at death, invites consideration to shifting joint tenancy and tenancy in common holdings to community. Such rearrangements entail no gift tax.

How does the new law operate in actual practice? To what extent do tax considerations suggested by it influence dispositions of property, or affect those which would be made otherwise?

The answers must reflect only the experience, necessarily limited, of one observer. The primary considerations are the size of the estate, and the family situation, but not necessarily in that order. For example, the case comes to mind (Example No. 1) of a couple, child-

[23] See note 1 *supra.*

On federal estate taxation of pre-1927 California community property, see Gump v. Commissioner, 124 F. 2d 540 (9th Cir. 1942), *cert. denied,* 316 U.S. 697; Title Insurance & Trust Co. v. Goodcell, 60 F. 2d 803 (9th Cir. 1932), *cert. denied,* 288 U.S. 613; Talcott v. United States, 23 F. 2d 897 (9th Cir. 1928), *cert. denied,* 277 U.S. 604.

[24] See cases on election cited note 15 *supra.*

less and with no close relatives, who have a $400,000 community estate. Each leaves all property, with insignificant exceptions, to the other. The federal tax penalty of $50,000 ($113,000 as against $63,000) is heavy, but is a matter of indifference, the welfare of the other spouse being the sole concern. Or, take the case (Example No. 2) of a couple, with or without children, having a community estate of $125,000 and no other property. Taxes should play only a minor role here. Usually it will be better for the survivor to take the entire estate, even though it will eventually cost some $10,625 ($10,775 as against $150) more in federal taxes than a "planned" disposition would have cost.

Million dollar estates come to most practitioners with an infrequency which is distressing. Let us therefore go back to example No. 1, bringing one or more children or grandchildren into the picture. Here there will be a powerful urge to save the $50,000 in avoidable taxes incurred under the simple plan first outlined. The normal procedure here is for each spouse to create a trust of his or her interest, giving the life income—and other benefits, if desired, not amounting to the right to consume—to the other, and *no* power of appointment. At the survivor's death, the property goes to, or is held in further trust for, children or other beneficiaries, the hope being that the surviving spouse will make a similar disposition.

The larger the estate, the more fancy the final dispositions can be. For example, powers—limited to spouses and descendants, if desired, and exempt under Section 811(f)—may be conferred. In the ordinary case, tax considerations are less important after the death of the original owners, the economic flow being turned aside into smaller and divergent streams.

Between examples Nos. 1 and 2, and beyond the latter, lies all manner of gradations. Again invoking the result of limited observation, it seems that tax considerations play a part beginning at about the $150,000 level, and assuming increasing importance from there upward.

The ideas suggested above are not new, but the Revenue Act of 1948 has given them renewed impetus through offering again the possibility of effective division of community estates. During the 1942 to 1948 interregnum, there was no point in dividing community property at the husband's death, since it was all taxable in any event. This put a premium on "waivers" by the wife of her community interest. This incentive no longer exists. The tax pattern now conforms to the normal course of succession.[25] The new law, in restoring the integrity of the community property system, has incidentally brought about a result which has social significance irrespective of taxes.

[25] The purist will object to "succession," saying that it suggests inheritance, which this is not. Acknowledging the criticism in advance, I believe the idea is plain.