Federal Estate and Gift Taxation of Community Property

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The subject of my address, "Federal Estate and Gift Taxation of Community Property," encompasses three rapidly expanding fields: community property, life insurance and, needless to say, federal taxation. You in Arizona do not have to be reminded that each year finds a higher percentage of Americans living here and in the other community property states. Let's start with Louisiana to the east; go to Texas, New Mexico, Arizona, California; skip Oregon (Oregon had a community property system for a very brief period, abandoning it when, as in a number of other states, it was no longer felt to be advantageous taxwise); go on to Washington; and then down to Idaho and Nevada. The whole southwestern part of the United States is experiencing a mass movement of population in its direction. I think that your Governor, in his noon address, was unduly conservative in his projected population figures. In a recent magazine article some population estimates for 1970 were a 57% increase for California, 65% for Florida, and 79%, the highest percentage of all, for Arizona. By a rough calculation I conclude that you will have a population of two million by 1970.

The figures on the growth of life insurance in recent years are equally impressive. As of a year ago, it was estimated that there were over one hundred million life insurance policy holders, a quarter of a billion policies, and over 500 billion dollars in insurance protection. That amounts to an average of almost $10,000 per family throughout the country. The figure of 500 billion dollars is well over the national debt, and well over our gross national product each year. Should Congress want to pay off the national debt, all it would have to do is levy a 100% tax on the face value of all life insurance policies, and the debt would be paid off. The recent growth in life insurance is impressive when compared with figures before the war. For example, ten billion dollars of life insurance was sold in 1940 and sixty-five billion was sold last year. It is obvious that when we combine these two areas of growth, the rapidly increasing population of the community property states

* See Contributors' Section, p. 284, for biographical data.

and the growth of life insurance, we discover that community property life insurance has become a highly significant type of property in this country.

We are all familiar with the growth of the third component of today's talk, federal taxation, so I will not dwell on that. Suffice it to say that when federal tax problems are superimposed on community property life insurance, the amalgamation is truly big business and, moreover, complicated business.

Before one can answer the many tax questions that arise with reference to community property, and especially community property life insurance, one must understand the nature of the particular property involved. This requires a reference to the laws of whichever community property state is involved. There are eight such states, and their laws do vary to some extent. The United States Supreme Court has made it clear that state property concepts are by and large controlling even when we are dealing with federal tax questions. This was not true in the period from 1942 to 1948 when Congress tried to ignore community property law, but we have now gone back to the earlier rule.

There is one point that I want to make clear at this time, and that is that I am no authority on Arizona community property law. I have made an effort to study Arizona statutes and decisions, but if I err in my reading of your laws, I hope you will correct me. There have been several instances where I have been unable to find answers in your decisions and statutes, so I have looked into the decisions of neighboring states, particularly those of Texas and California. We seem to be a bit more litigious, although I suppose the more likely answer is that Arizona attorneys are more competent and more careful, and consequently their work breeds fewer lawsuits.

My talk is to be divided roughly between (1) problems arising when the husband is the first to die, which, as you may know, is the more likely situation, and (2) problems that suggest themselves when the wife dies first. In both cases I will assume that the husband was the acquiring spouse, since in all likelihood the community property came from his earnings. My remarks are for the most part going to be addressed to the wife's half of this community property, whether the husband predeceases her or whether she dies first, in contrast to Mr. Bowe's discussion this morning when he was dealing with the residuary trust that the husband might set up consisting of his half of the community property.

Prior Death of the Husband

The first situation, then, is when the husband dies before the wife. Let us examine the property law, without getting involved in tax problems just yet, and inquire how much protection is afforded

the wife when the husband predeceases her. I might interject a few remarks at this point with reference to separate property in Arizona and in California where I think we have been derelict in the protection of wives. Individuals who come to us from non-community property jurisdictions may bring with them substantial amounts of property acquired over a period of a life time, and whether it is property that stemmed from the husband's earnings or whether it was inherited, Arizona gives no protection to the widow with respect to the property owned by the husband at his death.

This is not entirely true in California. We have a statute which originally provided that when property was brought into the state from a non-community property jurisdiction it would become community property if it would have been community property had the spouses been living in California when it was acquired—in other words, if it stemmed from earnings. However, this was declared unconstitutional by the California Supreme Court, which reasoned that you couldn't take the husband's property and convert it into half the husband's and half the wife's; the statute was later changed, in large part by interpretation, to a statute of succession. The California Law Revision Commission revised this statute rather substantially two years ago to provide that when the husband's property, stemming from earnings, is brought into the state, it is not community property, but if the husband dies first, at least one-half of it will go to the wife; he does not have a power of testamentary disposition over more than half. Where the wife dies first, she now has no power of testamentary disposition over any part of her husband's property; it is still separate property. I think that there is a fair probability that before this change was made, the law which gave the wife a power of testamentary disposition over such property might have surprised her husband who thought the property was all his. There is a good chance that this might have been declared unconstitutional, but under our new law the wife has no power of testamentary disposition over this type of property. However, she is protected if the husband dies first.

As to other types of property that the husband might have, for example, property acquired by inheritance, the wife will have no protection. If he inherited the property before coming to California, she gave up all rights in that property by way of dower and statutory substitutes when she left the separate property state. Consequently, if the wife wants to get protection in that kind of property in our state, and I assume in Arizona as well, she had better divorce the husband rather than wait until he dies, because she can get substantial alimony rights that may well be a charge against his separate property. It seems to me that with the increasing number of individuals coming

to our community property states where the wife does not have any protection in a great deal of the property, something might well be done about that in the future. The non-community property states by and large do not distinguish between inherited and earned property owned by the husband during his lifetime. Especially in the case of real estate, the wife would have her dower rights in either case.

Let's get back to the question of community property when the husband dies first. All of the community property states preclude the husband from making a testamentary gift of more than one-half to someone other than the wife. This is just elementary law, and it makes no difference whether it is personal or real property. It is interesting to observe that today, by and large, personal property is far more significant than real property in the average estate, and very frequently this personal property takes the form of life insurance. I would like to emphasize that this fact of the husband's inability to make a testamentary disposition of more than one-half is very significant in what I will have to say in the remainder of this discussion. This limitation not merely applies to outright gifts to third persons, but it also precludes the husband from leaving the wife's half to her in trust; that is, a life estate to her and remainder to the children. He cannot give away that remainder interest in his wife's property by testamentary disposition without her consent. Yet this is precisely the result that many husbands desire, and if there is any central focus in the present discussion, it is this particular device of leaving a life estate to the wife and remainder interest to the children. This was the type of thing that Mr. Bowe spoke about this morning with reference to the husband's half, which is a device the husband can use for *his* half, of course, and then at the death of the wife you avoid the tax on his half of the property. But as to *her* half he cannot dispose of it by his testamentary disposition—the wife can say, "I will not accept that; I will take the property outright."

Why do husbands so frequently desire to make that type of disposition? This preference goes back to a much earlier time than the period when the federal estate tax was adopted. Husbands are perfectly willing to leave their wife the entire income from all the community property plus various powers of invasion, but are frequently reluctant to have any of the property go outright. The reasons for this I suppose are obvious: the fear that the wife's lack of business experience, or presumed lack of such experience, will result in mismanagement and loss of property; the fear that she will be importuned by relatives and others if she has unfettered control over the property; and no doubt the concern of some that a second husband may come

along and take over the property the first husband spent a life time acquiring. Whether there are, in addition, tax advantages, is something I will discuss shortly.

Lifetime Dispositions

Let us now suppose that the husband, instead of waiting until death to leave the property in the probate estate, makes a lifetime disposition of the community property. What are the wife's rights? How much protection does she really have? As to real property, she has good protection in both community property and non-community property states. She has to join in the deed. But as to personal property, and the average estate today consists primarily of this type of property, there is much greater variation. Let us consider on the one hand Texas, Louisiana, and Arizona. Your statute provides that the husband can by an inter vivos disposition dispose of the community personal property; he is the manager of the community property. There is no question but that he is the manager with reference to any business transactions; but even beyond that, he can give the property away just so it is not, according to the language of the Arizona Supreme Court, "in fraud of the wife."

Just how much protection does Arizona law give the wife? If the husband gives everything away, I suppose you can make out a pretty good case of fraud. But suppose he stops short of that and gives substantial amounts away. There are a number of dispositions that closely approach a testamentary disposition. The husband, for example, makes an out-and-out gift to a third person the day before he dies. This is a lifetime disposition; presumably it is not governed by the strict half-and-half rule of testamentary disposition. Suppose he sets up an inter vivos revocable trust, or buys life insurance and retains the right to change beneficiaries. In any of these cases he may be giving a life estate to the wife. He may give her a life estate in the insurance proceeds by setting it up in trust, or by one of the installment options; in the inter vivos revocable trust he may reserve a life estate in the wife. In any event he is doing something that he could not do by a testamentary disposition short of getting his wife's consent.

Then will these lifetime transfers in Arizona be set aside because they are in fraud of the wife? There are a few guideposts. The Arizona court has said that you should look to the amount that he gives away compared with the amount that is left to her, as a rough measure of whether the gifts are in fraud of the wife. You are to ask: Was this a reasonable disposition? I am puzzled, however, as to how to apply this test in the case of insurance. Do we in that case look to the amount of insurance premiums, which may be $20,000, and compare it with the property that is left, which may be $20,000;

or do we look to the proceeds which may be $200,000, and compare that with the property left, $20,000, in a case where the husband is making the insurance payable to a third person? I don't know what the answer to this would be in Arizona. The cases do indicate that if the insurance that he takes out is payable entirely to his own estate, that will be in fraud of the wife; but where it is payable to a third person, the results are rather inconclusive.

In Arizona it seems clear that the husband may, by means of an inter vivos revocable trust or by means of life insurance, even though he retains all the powers of ownership prior to death, set up a life estate for the wife, remainder to the children. It would be difficult, if not impossible, to show that this was in fraud of the wife, since he has taken care of her by means of the life estate. It is not like an outright gift to a third person of all community property. I question, however, whether the courts have reached the right conclusion when they treat insurance and revocable inter vivos trusts as lifetime dispositions, where the husband's only limitation is that he cannot defraud the wife, rather than as testamentary dispositions, where the limitation is a flat power to dispose of only one-half. Again bear in mind that this problem looms larger and larger where insurance is a major asset, as it is in most estates today.

Let me compare the situation in California. There the wife really gets greater protection during her lifetime than she does at death. By California statute any gift of community personal property by the husband without the wife's written consent is completely voidable, 100%, at the wife's election, but not the husband's, unless it is a business transaction; the husband is still the manager of the community so far as a business transaction is concerned.[1] However, the California courts have said that if the wife does not elect to call back the gift, does not elect to void it before the husband's death, then she can claim only half the property. In other words the courts treat it somewhat as an advance testamentary disposition inasmuch as the husband could dispose of half at death.

Wife's Interest In Insurance Proceeds

Very significantly, and quite appropriately in line with the above statute, California has held for some years that in the case of life insurance where the husband names some third person as beneficiary, the wife can claim half the proceeds. That comes as a great shock to many husbands who had not been aware of this right of the wife in California. It comes as an even greater shock to many life insurance salesmen and life insurance companies when they discover that the

[1] See Thurman, *Federal Estate and Gift Taxation of Community Property Life Insurance*, 9 STAN. L. REV. 239, 246-49 (1957).

husband, who presumably is paying for an insurance policy, does not have complete control over the policy where it is a community policy and the premiums are being paid from community property. He does not have complete control, and at his death, no matter who the beneficiary is, the wife is co-owner, not merely of the premiums which were paid, but also of the proceeds. So in California we have a consistent scheme. Whether by way of testamentary gift, by way of insurance, or by way of inter vivos revocable trust, the wife can always claim her one-half and the husband can in no case compel her to take a life estate, with remainder to the children, in her one-half of the community property.

The Texas rule, and presumably the rule in Arizona, puts a premium upon the husband's taking some kind of action during his lifetime if he wants to reduce somewhat the claim of the wife as to her half of the community. I might point out that a third type of community property treatment, that found in Washington, goes even farther than in California. There the wife can claim 100% of the proceeds of a community property life insurance policy after the death of the husband. That seems a bit anomalous. Although your court has said from time to time that Arizona law is somewhat like that of Washington, it clearly is not in this respect.

Community Property v. Separate Property

So much by way of the property background. We turn next to the tax consequences of these rules that I have briefly summarized. Still assuming the prior death of the husband, the first question must be: Are we dealing with separate property, or are we dealing with community property? A leading case in this area is *Greenwood v. Commissioner*,[2] which went up to the Ninth Circuit from Arizona. Here the sole question was whether the husband had transmuted his separate property, earned in another jurisdiction—New York, I believe—into community property. If not, it was all to be included in his gross estate; if it had been transmuted, only half would be included. This estate consisted mainly of securities and cash which the husband had inherited, the couple later moving to Arizona. He leased a joint deposit box and set up a joint bank account, but the securities were in his own name. The husband managed everything, buying and selling without consulting his wife beforehand. From time to time the couple would refer to this property as half the husband's and half the wife's. They even made the remark, "Well, we have a lot of community property," probably with about as much understanding as many individuals have when they use the term "community property."

[2] 134 F.2d 915 (9th Cir. 1943).

The Ninth Circuit agreed that the law of Arizona would govern. If the property was community property under Arizona law, then only one-half would be taxed. The taxpayer argued that you can transmute personal property informally in Arizona, and the court agreed, citing the case of *Rundle v. Winters*,[3] an Arizona case where the Arizona Supreme Court said that whether personal property is community property depends on the intent of the parties. You don't necessarily have to have formalities in the transfer. However, the federal court said that the personal property must be *treated* as community property by the parties—mere intent is not enough—and we have very few Arizona decisions telling us just exactly what that means. Washington cases have said that an oral agreement is not enough. In California it is sufficient if the property is treated as community property, but California is unbelievably liberal—far too liberal, in my opinion—so far as any practicable workable rule is concerned. For instance, every morning over the breakfast table you can convert your property from community to separate, or vice versa. You can also convert real property, that is, ignore completely the statute of frauds. Whether it is community or separate property apparently depends upon what its status was on the day of the husband's death.

The court, in *Greenwood v. Commissioner*, held for the Commissioner, pointing out that the box rental agreement seemed to indicate that the property was separate. The court did not think that the signature card for the joint bank account, and such statements as "It is half yours," necessarily indicated that the property was community property. The taxpayer had made the argument that it is doubtful whether you can have joint tenancy in personal property in Arizona. The federal court disagreed and said that under the Arizona cases you can have joint tenancy in personal property. So the conclusion was that this was separate property and therefore all includible in the husband's estate.

It thus becomes very important to decide in the first place whether we are dealing with separate property or with community property. I am not going into the various presumptions in this field since most of you are well familiar with them. But if we find that we are dealing with Arizona community property, then it is quite clear that only half will be taxed in the husband's estate when he dies. You don't have any complications, such as a distinction between property that was acquired before July 29, 1927, and property that was acquired after that date. We in California do, and in our state it is only the post-1927 community property that is taxed as community property.

[3] 38 Ariz. 239, 289 Pac. 929 (1931).

With respect to separate property it is frequently advisable to have a husband and wife enter into a formal written agreement whereby they transmute it into community property, especially if it is low basis, high value separate property. There are many instances in which it is desirable to do that. There may be a gift tax involved, although it is frequently done informally with no thought given to the gift tax consequences, which may not come up for many years, if ever.

Shares of corporation stock are an illustration of property which the husband and wife may find highly desirable to transmute into community property by formal written agreement. It is impossible to buy shares of stock in General Electric or any other concern that I know of and have them registered in this manner: "Mary Doe and John Doe, as tenants in community property." A transfer agent of a corporation will look askance at any such suggestion, so you have to register them in the names of individuals or, as most brokers do, in joint tenancy with right of survivorship. To the broker, that is the answer to everything and he gives little thought to the tax consequences. It is especially important in a community property state to make sure that the community property owned by the spouses is not converted to separate property via the joint tenancy, right of survivorship, route. I have suggested that it is a good idea in many cases to take separate property, admittedly separate, and convert it to community; but it is even more important to make sure that property that is already community—earnings of the husband and wife—is not converted into separate property by putting it into joint tenancy with right of survivorship. California again has a rather liberal rule which will allow the parties to come forward later and say that they did not understand that this was to be joint tenancy and that they still considered the property as community. This is the famous *Tomaier* doctrine from *Tomaier v. Tomaier.*[4] As you might imagine, the internal revenue agents aren't too happy with a rule of that kind, and they will fight it out in the courts if you come forward with an alleged oral understanding that the parties intended the property to remain community. I think, therefore, that it is highly desirable to have the written agreement.

Let me now point to the disadvantages in commuting community property to separate property, primarily joint tenancy. In the first place, you know that the surviving wife has the burden of proof as to her contribution, and even though it was half from the husband and half from the wife because it was community property, she may not be able to prove that, and therefore the law reads that it shall all be included in the husband's gross estate.

[4] 23 Cal. App. 2d 754, 146 P.2d 905 (1944).

Disadvantage number two is that estate planning is made much more difficult. The wife now takes the property outright, inasmuch as she takes it as a survivor. This property will bypass any will, there being nothing for the will to "bite on," and there is no widow's election possibility, a point I want to discuss shortly. Also, there may well be a greater tax at the wife's death because there will be more in her estate. Any incidental probate savings at the husband's death (this is frequently the objective of individuals who want property put in joint tenancy) may be far outweighed by these disadvantages.

In the third place if the wife does succeed in proving that this was community property originally, even though it is now joint tenancy, and that each therefore contributed half, so that only half will be includible in the husband's gross estate, there will be no "stepped up" income tax basis as to the one-half that is not included. The treatment is different from that accorded community property, and this becomes a major consideration today with inflated property the general rule in most estates. If you leave it as community property, only one-half will be included in the gross estate for estate tax purposes, but both halves will get a "stepped up" basis as of the date of death, or other applicable valuation date, for income tax purposes. On the other hand, if you have changed to joint tenancy, one-half will be includible in the gross estate if the wife proves that she contributed half, but only that half will get the "stepped up" basis for income tax purposes.

Estate Tax Upon the Death of the Husband

Now let us assume that you have succeeded in proving that the property in the estate is community property—there is no longer any problem of its being separate or community. Only one-half will be taxable in the husband's estate. It makes no difference under federal law whether he left it in the form of life insurance, a revocable trust, outright to the wife, or in trust to her. Under most state inheritance tax laws the relationship of the beneficiary makes a difference. As you know, that is not true with reference to the federal estate tax, with one exception, and that is in the case of a testamentary gift to a charity. There, of course, it does make a difference. Also, in non-community property states, in the case of the marital deduction, you do look to the identity of the donee. But for the most part, we don't care to whom it is left. It is included in the gross estate and is taxed accordingly. If it is community property, it is only half-taxed.

Compare the situation in non-community property states. Reference was made this morning to the problems of obtaining the marital deduction. That will depend upon leaving one-half, at least, in a particular fashion. You may not leave all of your property, life estate

to the wife, remainder to the children, and obtain the marital deduction. unless you put in a taxable power of appointment. The general rule is that you must leave the property in such fashion that it will be taxable in the wife's estate.

Now must this result follow in a community property state? I think that at first blush the conclusion is yes. But let us examine that. Suppose that the entire property is left outright to the wife and there is no attempt to have her put it in trust or anything of that nature. She takes her half outright, and there is no insurance and no trust. She may do this in all community property states when the disposition is testamentary—and we shall assume that—and when there is no question of insurance or lifetime gift. If her half isn't spent by the time she dies, it is going to be taxed at her later death. Of course, whatever she does with her half has no bearing on the tax on the husband's half at his death; his half is taxable at that time. This, then, is the situation when the husband leaves all the community property to his wife, both his half and hers. There is a tax on one-half of the community when the husband dies and a later tax on the entire value of the community, whatever is left, when the wife dies.

But let us suppose that the husband does not leave a simple will leaving everything to the wife, or leaving her at least her half of the community. Instead, he attempts this kind of a disposition: "All of our community property, my half and my wife's half, is to go to my wife in trust for life, remainder to our children." Bear in mind that even with this type of provision the property is still taxed only one-half to the husband when he dies. This was decided a number of years ago when the Commissioner of Internal Revenue claimed unsuccessfully that where the husband attempted to dispose of all the community, it should all be taxed in his estate. The Commissioner has since acquiesced in that decision which made one-half only, taxable in the husband's estate. Also, we don't have to leave it to the wife in such a fashion as to have it taxable at her death in order to get a marital deduction. We don't have to worry about that when we are dealing with community property.

Estate Tax at Later Death of Wife

Superficially then, it seems that we have escaped the tax at the death of the wife; half of the property was taxed when the husband died, and the wife has only a life estate with some limited powers of invasion which can be quite broad and yet not be taxable. Actually, however, what is the situation? The husband has given his half of the community property to the wife and the children. There will be

no tax when she dies. The tax was paid on his half at his death and he is only giving her a life estate in his one-half of the community; but as to the wife's half, the wife has really given one-half to herself and the children by acquiescing in what the husband has set up. Instead of claiming it outright, she has really made a present gift of a remainder interest in her half of the community property, and the cases are very clear now that a gift tax is payable. May I emphasize that we are talking about ordinary community property now, and not about insurance or any other complications. When the husband dies with a provision of this kind, that is, a life estate in the wife in all the community property, and the wife goes along with this provision in her husband's will and elects to leave it in trust, she is in effect making the gift of her half just as clearly as if she put that property in trust directly. She has made an inter vivos gift of the remainder interest to the children, the value of which will depend on her age.

Furthermore, her entire interest put in trust in this fashion will be included in her gross estate at her death, under Internal Revenue Code, § 2036. This is a reserved life estate situation where the entire value of the property, not merely the remainder interest or her life estate, will be included in her gross estate for estate tax purposes, with some credit for the gift tax which was paid on the remainder interest. Thus there is apparently no community property advantage in such a situation. It would seem that the end result is the same as in the case of the marital deduction trust which must be taxable at the wife's death. I am sure that is what Congress was thinking about —half of the tax when the husband dies, the other half when the wife dies.

Widow's Election

But, and this is the big point in a community property jurisdiction today, suppose the husband adds in his will the very familiar clause to the effect that all of the community property, his half and his wife's half, is to go into a testamentary trust, life estate to the wife, remainder to the children, but if the wife elects to take her half outright instead of leaving it in trust, then she is not to get a dime out of his half of the community property. He doesn't state it quite that crudely, but that is the effect. She is cut off from any interest in the husband's half of the community property if she doesn't elect to go along with the trust he has set up, even though it takes in her half of the community as well as his. Why did he do this? Again there are the old reasons—it is a little added pressure on her to get her to elect to put her half in trust and keep only a

life estate so that other third persons, possibly later husbands, won't get their hands on it. Again there is frequently the feeling that the wife is much better off with her half in trust—and I am sure she is, in many cases—than to have this property outright. In addition, today it seems that there are new tax reasons for doing this, both with respect to the gift tax and the estate tax.

There have been two recent decisions of significance to your jurisdiction. One was *Siegel*,[5] arising in California; the other was *Chase National Bank*,[6] arising in Texas. Both of these cases held that where the husband put all of the community property into a testamentary trust, the gift of a remainder interest to the children that the wife was deemed to have made would not be taxable to the extent that she got something from the husband. What did she get from the husband? She got a life estate in his half of the community property. It is a bargain transaction. The husband says, "I will give you a life estate in my half of the community property if you will give our children a remainder interest in your half. You have in effect a life estate in the entire property now." The husband, of course, is giving a remainder interest to the children in his half and that is taxed at his death. The difference in value between the life estate which the wife gets from the husband's estate and the remainder interest in her half depends upon the age of the wife. The Regulations point out, for example, that if the widow is age 51, the life estate and the remainder interest are approximately equal in value.[7] So if he gives her a life estate in $1,000,000, the value of his half of the community property, it is a transfer to her of $500,000; and if she gives a remainder interest in her $1,000,000 worth $500,000, there is adequate consideration and no gift tax is due. Both the *Siegel* and the *Chase National Bank* cases held that under those circumstances no gift tax was payable.

What is the estate tax situation? In the absence of the type of provision which forces the wife to an election there is an estate tax on the entire interest of the wife—$1,000,000—assuming that is the value when she dies. I see no reason why the consideration argument isn't equally valid so far as the estate tax is concerned. The Internal Revenue Service is now in the process of taking up some of these cases. The argument is being made that there is a distinction between the estate tax and the gift tax, and of course there is, in the matter of valuation. When the wife dies leaving this $1,000,000 estate, that million dollars would be included in her estate; it was

[5] Mildred Irene Siegel, 26 T.C. 743 (1956).
[6] 25 T.C. 617 (1955).
[7] 26 C.F.R. § 20.2031-7 (1959).

a reserved life estate under Internal Revenue Code, § 2036, that she set up during lifetime by acquiescing in the husband's will, and the consideration she received, assuming again a 51-year-old widow, was only $500,000, the value of the life estate in the husband's half. So in her gross estate she will not have $1,000,000, but $500,000. In the case of an older person the remainder interest is going to be greater and the life estate is going to be less. In the case of a younger widow, where the remainder interest is not as valuable, you may get to the point where you have almost as much consideration —it will never be quite as much—as the total value of the wife's half. Of course, you can have cases where the husband in addition says, "I leave you a life estate in my half plus my separate property in return for your acquiescence in this trust," and you may well have enough consideration moving to her to equal the value of her community property half, and there may be no estate tax.

Needless to say, this type of consideration makes the Commissioner very unhappy. And yet, the provisions of the Internal Revenue Code which refer to a gift made in contemplation of death, or to the setting up of a revocable trust, or to a reserved life estate, or to any one of the inter vivos gifts that are taxed in the gross estate, all have the provision "except in case of bona fide sale for an adequate and full consideration in money or money's worth." In all probability Congress was thinking about consideration that would still be in the wife's estate when she died, a substitute for the thing she gave away. Here, however, she received a life estate in the husband's half, which is going to be worth nothing when she dies, and therefore there will be nothing to be taxed. It is that which makes the Commissioner very unhappy. But the Tax Court has said that the life estate is consideration none the less, and the fact that it becomes worthless at the wife's death is immaterial. If a different result is desired, taxwise, it is up to Congress to do something about it. This is a community property advantage that can be made use of in Arizona as well as in California if the property is left by testamentary disposition.

Both the *Siegel* and the *Chase National Bank* cases went up on appeal and were decided in the appellate courts within the past two years. These decisions are of particular interest to us. The *Siegel* case went up to the Ninth Circuit which upheld the Tax Court, finding nothing wrong with that court's reasoning.[8] Although this was not an estate tax decision but a gift tax decision, the court said that clearly the husband put the wife to an election here; she was to get nothing in his half if she did not go along with the trust. If she elects to take her half of the community property and foregoes the interest

[8] Commissioner v. Siegel, 250 F.2d 339 (9th Cir. 1957).

in the husband's half, there is no gift tax for she has her half outright and hasn't given it to anybody; at her death, however, if she still has the property, there will be an estate tax. If she elects to go along with the arrangement, there may be no gift tax, depending upon the age of the widow. The younger the widow, the less valuable the remainder interest in her half, which she is giving up, and the more valuable the life estate in the husband's half, which she is receiving. If she receives more than she gives up, there is no gift tax. So you may have a situation of half a tax at the husband's death, and no tax, or a substantially lower tax, on the remainder interest when the wife dies.

Commissioner v. Chase Manhattan Bank

The case which merits our closest attention, however, is the *Chase Manhattan Bank* case which came down a few months ago in the Fifth Circuit.[9] Although you are not in that circuit, the case involved Texas community property law which in many respects resembles your Arizona community property law. In that case there were three different dispositions of property made by a Mr. Moran, the president of Continental Oil. Chase Manhattan Bank was the trustee and the problem was one of transferee liability.

The number one disposition was the testamentary trust which consisted of something over $1,000,000. Here the Fifth Circuit disagreed with the Tax Court, and concluded that the husband had not in unambiguous terms put the wife to an election, in contrast to the *Siegel* case in California where the husband had done just this. The court pointed out that here the husband spoke in general terms about "leaving all my property in trust" and so on, and did not say specifically "all my community property and all my wife's community property." Nor did he specifically say that the wife could have no interest in his half if she did not go along with the arrangement that he had set up with reference to her half. The court suggested that if the husband had used this specific language, the wife would have been forced to an election according to Texas law (and I believe the same would be true under Arizona law). But since she was not forced to an election, the court held that the wife could take both the interest given her in her husband's half of the community property, and also her half outright. The fact that she did not realize what was going on, and had left all the property with the trustee was said to be immaterial. The court was of the opinion that the trustee was really holding all of her property for her as the outright owner, and not merely as the life tenant. The Tax Court was said to have

[9] Commissioner v. Chase Manhattan Bank, 259 F.2d 231 (5th Cir. 1958).

misread Texas law. The wife was not put to an election, and therefore there was no gift tax. She owned her half outright, and had not given a remainder interest to the children. That part of the will purporting to set up the testamentary trust was completely ineffective. There will, of course, be an estate tax when Mrs. Moran dies, upon her half, assuming that she hasn't spent it before that time.

Disposition number two by Mr. Moran was an insurance trust. Judge Wisdom, one of the newer judges on the Fifth Circuit, took about 25 or 30 pages in the Federal Reporter Second to discuss the problems of the insurance trust. There was need for a sound and comprehensive analysis of these problems, and I think Judge Wisdom did a superb job. He tried to disentangle the confused Texas cases which dealt with community property life insurance and concluded that under Texas law, where the husband provides in the insurance policy that all the proceeds are to go into trust, with a life estate to the wife and remainder to the children, the wife cannot claim anything at death. Here again there was no election possibility. The wife could not elect to take half the proceeds outright; she had to leave it in trust, with a life estate to her, remainder to the children. The Tax Court had also reached the same conclusion insofar as Texas community property law was concerned, but then went on to find that the wife had no election at death, and therefore could not be in the position of making a gift of the remainder interest to the children.

The Fifth Circuit, however, said that there was a gift tax payable automatically when the husband died, and the Regulations bear this out with reference to Louisiana and Texas (and the same thing would apply in Arizona). Prior to his death the husband is the agent for the community and, as such, he bought community insurance and paid for it out of community property. It has therefore become community property life insurance. At death, assuming that it was not in fraud of the wife (when he leaves her the life estate it is hard to argue fraud and the cases are pretty clear that there is no fraud), she has to go along with that arrangement; and, as of that time, half of the proceeds—not the premiums, but the much higher-valued proceeds—less the life estate which she has in the property, are automatically deemed to be a gift from the wife. The fact that she can't do anything about it is immaterial; the husband has made the gift for her. It was revocable, so there was no gift during his lifetime; but as soon as he dies it becomes irrevocable. Half the proceeds then go into the husband's estate for estate tax purposes and half the proceeds are a gift from the wife to the extent they have been given away. Here there was a gift to the remaindermen.

This was the holding in the *Chase* case and it is borne out by the Regulations.

When Mrs. Moran dies there will no doubt also be an estate tax on her half of these insurance proceeds. She has, again through her husband, set up a life estate situation for her benefit; and when she dies, there will be a complete estate tax on her half of the insurance proceeds, less any credit for the gift tax that was paid on the remainder interest. There is no possible consideration argument here, for the wife has no choice. That result follows from Texas law. The husband during lifetime can make a gift of life insurance, and the court has refused to treat this any differently from other inter vivos gifts. The fact that he retains the right to change beneficiaries does not make it a testamentary disposition. The court said that this was a lifetime transfer, with the consequences above described. The husband was the agent for the wife as to her one-half. Thus we find that one penalty for the ability of the husband in Texas, and in Arizona, to force the wife to accept a life estate by means of an inter vivos insurance trust is the inability to use the consideration argument available in the case of a testamentary trust.

In California you can employ the consideration argument with respect to all community property, including insurance, because, as you will recall, even in the case of insurance the wife has the absolute right to one-half of the proceeds at her husband's death. The husband can force her to an election and reduce gift and estate taxes by means of the consideration argument. She receives the same protection in all community property, whereas in Texas and Arizona there is a sharp distinction between the inter vivos dispositions, such as insurance and the revocable trust, even though testamentary in nature, and the testamentary disposition. To summarize again, in Arizona the husband has the advantage (he looks on it as an advantage) of forcing the wife by means of an inter vivos disposition to take a life estate in the whole property, remainder to the children, but by so doing he foregoes the possible advantage of being able to avoid gift and estate taxes.

There was a third disposition in the *Chase* case in addition to the testamentary trust and the insurance trust. This was an inter vivos revocable trust created some 20 years previously in New York, but involving community property. The wife claimed that this trust should be treated the same as a testamentary disposition and that she should have the right to elect to take half of it under Texas law. She also claimed that this trust was a nullity—a sham trust. The court of appeals did not agree. It said that this was an inter vivos disposition, that revocable trusts are recognized, and that the

husband's rights in the trust were to be governed by his rights during lifetime, not by his more restricted rights at death. Applying this to Arizona, the husband can, by an inter vivos disposition—either by a revocable or insurance trust—force the wife to take a life estate in all personal property. This is in sharp contrast to his rights in personal property at death, but there is a tax price—there is no consideration argument to avoid or reduce the gift or estate tax. There will be an automatic gift tax at the death of the husband where an insurance or revocable inter vivos trust is involved, and an estate tax at the death of the wife.

Inter Vivos Gifts of Insurance

It will often be desirable in Arizona where the husband has named some third person as life insurance beneficiary or partial beneficiary—such as remainder interest to the children if it is a life insurance trust—for the husband to make that gift complete before his death. The wife, for example, would do well to release her community property interest before the husband dies.

That brings up the *Goodman* case in the Second Circuit[10] where there was a comparable situation. It wasn't community property, but the wife bought and owned life insurance on the husband. The cash surrender value—more accurately, the terminal reserve figure, the replacement value—was about $100,000 the day before the husband died. After he died, the proceeds were $500,000. The beneficiary was a third person, and as of death the gift became complete. This was a gift from the wife, the lifetime owner. She owned the policy, and the husband was merely the insured; his life merely measured the policy. When he died she was deemed automatically to have made a gift of $500,000 to the person who got the proceeds. Had she assigned this policy the day before her husband died, the gift would have been $100,000 and not $500,000 because it would have been measured by the lifetime value of the insurance policy. The same thing can be true in California or Arizona or in any community property state if the wife assigns her interest in the insurance policy to the third person beneficiary, and if the husband does the same thing. There is no problem, so far as the wife's interest is concerned, of a gift in contemplation of death since it is not a gift in contemplation of her death. The gift will be measured by the lifetime value and not the much greater proceeds value. So far as the assignment by the husband of his half is concerned, it may be a gift in contemplation of death, but if he has the incidents of ownership, that half is going to be included in his gross estate anyway.

[10] Goodman v. Commissioner, 156 F.2d 218 (2d Cir. 1946).

Prior Death of the Wife

Now let's turn to the second situation, that is, the case where the wife predeceases the husband and there is community property. Here Congress failed to equalize the tax treatment of community property states and non-community property states. In a non-community property state, assuming that the husband has acquired property amounting to $2,000,000, if the wife dies first, there is no marital deduction. Although there is no tax when the wife dies, there is a full tax when the husband dies, and the benefit of one $60,000 exemption is lost, since there is nothing in the estate of the wife. The community property states, on the other hand, have a built-in marital deduction. When the wife dies, half of the community property is taxed; but she can, by bypassing the husband with her half, either by a gift directly to the children or by a life estate in her half to the husband, avoid a tax on her half when the husband dies. Of course, if she leaves all of her interest to her husband, there will be a tax on half when she dies and a full tax when he dies, but that doesn't have to follow. I think that there is much less danger in Arizona of this one-half plus a full tax because of the Arizona law of intestate succession. If the wife doesn't make a will, her half goes to her descendents and will automatically bypass the husband. That is not true in California where if the wife doesn't make a will, and frequently she doesn't, all the community property goes to the husband.

With reference to the estate tax when the wife dies, the wife does have a power of testamentary disposition in all community property states with the exception of New Mexico. About two years ago I spoke to the Nevada bar, and at that time Nevada and New Mexico did not give the wife a power of testamentary disposition. I pointed out that they were going to get into some tax difficulties; the wife's interest would automatically go to the husband and you couldn't bypass the husband and save taxes. Furthermore the Internal Revenue Service had just decided that, testamentary power or not, they were going to tax half of the community property when the wife died because she had a substantial enough interest in it. So there would be half a tax when the wife died and a full tax when the husband died. I had a letter from the president of the State Bar of Nevada about six months later, saying that Nevada had changed its law, and now the wife is given the power of testamentary disposition. I haven't heard that this has been done in New Mexico, but the wife clearly has that power in Arizona and in all the other community property states. Whether she has it or not, she apparently pays an estate tax on half of the estate when she dies first.

We now come to the intriguing question: Is community property life insurance any different when the wife dies first? The husband has taken out the policy, he is the insured, and the wife's name is not found anywhere in that policy. He can, of course, take out such a policy and can use community funds to pay the premiums. What is the nature of the wife's interest when she dies first? There are two tax cases in the federal district courts in California that are at complete odds on this point. A federal district court decision from Southern California, *California Trust Co. v. Riddell,*[11] held that when the wife dies first, having an interest in community property life insurance on the husband's life, there is to be included in her gross estate her half interest in the lifetime value of that insurance policy. I can't see any escape from that conclusion. It is true of community property generally. Why should it be any different with respect to community property life insurance? And yet the federal district court in Northern California came to the opposite conclusion in *Stewart v. United States.*[12] The court said that the wife doesn't have any interest in this policy since there is nothing she can pass on; she can't give it to her heirs, and her executors can't reach it. This question has not been passed upon by the California courts.

There is a recent Texas case, *Thompson v. Calvert,*[13] holding squarely that the Texas inheritance tax is applicable to the wife's half interest in Texas community property life insurance when she dies first. Bear in mind that the wife's interest in life insurance, certainly after the husband's death, is far less in Texas and far less in Arizona, than it is in California; and yet despite that fact the court squarely recognized that when she dies first, her interest in that community property is just as taxable as her interest in any other community property.

In the *Chase* case the court stressed the wife's rights in a community property life insurance policy, under Texas law, even if she doesn't have substantial rights in the proceeds. Arizona law may well be similar. A rather interesting ruling of the Attorney General of Texas was to this effect: A wife may will half of the community property life insurance to whomsoever she pleases and this will pass, even under a general residuary clause. This is permissible under the community property life insurance law of Texas, and presumably it is true under the Arizona law. The ruling was made in June of 1958 and it seems perfectly logical. And yet attorneys, life insurance companies, and judges still seem to be confused.

[11] 136 F. Supp. 7 (S.D. Cal. 1955).

[12] 158 F. Supp. 25 (N.D. Cal. 1957). Since the date of the speech, this case was reversed in United States v. Stewart, 270 F.2d 894 (9th Cir. 1959).

[13] 301 S.W. 2d 496 (Tex. Civ. App. 1957).

Confusion as to Nature of Wife's Interest

Let us examine just what the reasons are for the confusion in this matter of the nature of community property life insurance and, more specifically, the wife's rights therein. You will find the courts saying, time and time again, that there is no property interest in life insurance. That statement is made in some of the earlier Arizona cases. I think it stems in large part from the cases around the turn of the century when there really was nothing of value in life insurance policies during lifetime. By and large those were term insurance policies—somewhat like fire insurance. Today that is not true in most cases. There can be substantial lifetime values. Where the language of a case deals with term insurance I don't think it is very meaningful.

Secondly, I think there is a failure on the part of many to distinguish between the contractual rights of an insurance company, as set forth in their agreements with the insured as to whom they shall make the proceeds payable, the terms, and so on, on the one hand, and the property rights, the ownership rights, on the other. The companies ignore this distinction in selling community property life insurance, and a confused situation may result.

In the third place, it is argued that the heirs of the wife should not have any greater rights in the community property life insurance policy than the wife herself had. The argument is made that the wife during lifetime cannot cancel the policy and cannot go down to the company and say she wants the cash surrender value or any part of it, for the husband is the manager of the community property. Yet under Texas law, and I think under the law of any community property jurisdiction, the heirs should be entitled to their part of the policy. You can partition a life insurance policy. The practical objections that come to mind are not insurmountable. You can get the company to issue two distinct policies, both of which will still be on the life of the husband. The husband will own one-half of the insurance; and the individual to whom the wife left the policy, if someone other than the husband, will own the other half. It will no longer be community property. Compare a hundred shares of General Motors stock. The wife can't go down and have that split into two 50-share certificates, short of divorce or something of that kind—and yet upon death, if the wife leaves her half to the children, quite clearly the children can have the stock split. I see no reason why community property life insurance is any different.

In the fourth place, there has been a failure on the part of many to distinguish between the rights of a beneficiary and those of

a co-owner. In separate property states the wife can also be an owner or co-owner of a policy, but she is not as likely to be, as in a community property state, where she automatically becomes a co-owner if it is a community property life insurance policy. The wife has these rights of ownership whether she is named as beneficiary or not.

In the fifth place, there is a failure in Texas and Arizona to recognize that insurance is inherently testamentary. Certainly where the husband reserves the power to change beneficiaries the courts should treat the wife's interest—I'm talking now about the case where the husband dies first—the same as they would treat anything left to her under a will. Maybe it will require a statute to bring recognition of this principle, but it seems to me that an attorney could well use this argument before the Arizona courts where the rules in this field are not too well settled. I believe that the same should be true with an inter vivos revocable trust. In other words, even if you continue to allow the husband to give property away without any strings during lifetime so long as he does not defraud the wife, you should not permit him to bypass the limitations on his testamentary power by means of these lifetime transactions that are inherently testamentary in nature.

In the sixth place, it seems to me that some of these decisions fail to recognize that the wife's heirs should have the same rights in a community property life insurance policy when she dies first that she would have in the case of divorce. The Arizona law is clear with respect to the divorce situation. *Blaine v. Blaine*,[14] and other cases, hold that the wife does have an interest in the surrender value of the policy upon divorce, if it is a community policy. I have mentioned the recent ruling of the Attorney General of Texas which concluded that the wife can dispose of her half of the community property life insurance by will and that she can do so by a residuary clause. And yet there is a sharp distinction made in Texas when the husband dies first. His inter vivos power makes it possible to at least limit the wife's interest in the proceeds and he can disinherit the children entirely, leaving a life estate to the wife and the remainder interest to someone else, if effected during his life. This creates the anomalous situation that it may be better for the children if the wife predeceases the husband than if the husband predeceases the wife where the father is of a mind to disinherit the children. Where the wife dies first, the children can get an interest in the policy by becoming

[14] 63 Ariz. 100, 159 P.2d 786 (1945).

tenants in common with the father under the Texas ruling, irrespective of the desires of the father.

Seventh, I think there is a failure on the part of many courts to distinguish between rights in a policy and rights in the proceeds. Insurance does consist originally of rights in a policy—lifetime rights—and later of rights in the proceeds, and I see no reason why the wife's community property interest should be any less protected in one case than in the other.

Eighth, and last among the reasons why there has been confusion in this area is that insurance policies do present complicated problems of valuation. The tax authorities and the courts by and large have tended to limit these values to two; either the cash surrender value (terminal reserve is the more accurate figure), or the face value at death. Obviously there can be many other values and this leads to complications. Take term insurance, for example, owned by an individual who knows he has cancer and has not long to live. That can be a very valuable policy and yet one on which it would be difficult to place a value.

The problem of whether the children get any part of the insurance interest is likely to be more acute in Arizona than in California, because of the fact that all of the wife's interest in community property will go to the children if there is no will. The big question is: Does this include interests in community property life insurance? In California very frequently the wife doesn't leave a will, or if she leaves a will, she leaves everything to the husband. Even if she leaves a will passing all of her interest to the children, she usually doesn't mention the interest in insurance and the attorney never thinks about it. It is questionable whether it was intended to pass by the residuary clause. Thus in California there is very likely to be a tax on half of the lifetime value of the policy when the wife dies and then, because the property all goes to the husband, on the full proceeds at his death. In Arizona, community property should more frequently pass to the children at the wife's death and I can see no reason to conclude that the wife's interest in community property life insurance in Arizona should not be similarly treated.

Conclusion

Life insurance contracts are technical and complex. They are susceptible of great variation. They have proved difficult to equate with other property concepts and from the outset have defied the efforts of Congress to catalogue. Congress has vacillated back and forth on the taxation of life insurance—as have the courts and the

taxing authorities—and no one has come up with a consistent scheme for taxation. This difficulty has been compounded in a number of states by the necessity of accommodating a community property system to a type of contract that was primarily a product of the common law. I believe, however, it is important to recognize that life insurance is merely another form of property, and that it is community property if such funds were used to purchase it. The wife's rights should be protected to the same extent in such property as they are in any other form of property and the tax consequences should follow accordingly.

DISCUSSION

Comment by Joseph T. Melczer, Jr.*

Dean Lyons, Mr. Thurman, ladies and gentlemen. The most appropriate comment that I can make concerning Mr. Thurman's talk is that it was a most thorough and clear presentation of his subject. I would like to ask Mr. Thurman one question concerning the story he related with respect to the exchange of the two twenty-year squaws for the forty-year squaw. Mr. Thurman, would you tell us if the exchange would be treated as a tax-free one?

Mr. Thurman elaborated on the advantages that can be secured in certain instances by use of the widow's election. As he pointed out, this poses certain gift and estate tax problems. He referred to the *Siegel* case which was decided by our Ninth Circuit Court. Judge Yankwich, from the District Court in Southern California, wrote the opinion, sitting with the Ninth Circuit on that particular case.

In the *Siegel* case the taxpayer and decedent were husband and wife, residents of California. Siegel died in California in 1949 leaving an estate consisting entirely of community property. The will provided that the provisions in the will for the taxpayer were in lieu of her community rights, and if she elected to take her community interest, then the provisions for her under the testamentary trust were to be of no force or effect. The taxpayer filed an election to take under the will. The Commissioner contended the taxpayer made a transfer of her remainder interest in one-half of the community property to her son, the remainder-

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