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HIGHLIGHTS OF THE 1954 INTERNAL REVENUE CODE AS IT RELATES TO TRUSTS AND ESTATES

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PART I

Miss Lasseter, who is Assistant Trust Officer of the First National Bank of Atlanta and a member of Atlanta Chapter of ASWA, presented this paper to The Estate Planning Council of Chattanooga at a dinner meeting in Chattanooga, December, 1954. Part II will be published in the June Edition.

Because of the scope and magnitude of the 1954 Revenue Code it would be impossible during the course of one evening to even touch upon all the highlights. Furthermore, no amount of preparation of a paper on this subject at this time could be wholly satisfying because to date there still are no regulations; nor have we even seen a copy of the Federal Form for Fiduciary Returns.

In spite of the sweeping changes which the 1954 Code hath wrought, the changes to a large extent merely give statutory expression to the principles underlying former Regulations and decisions. That will eliminate continuous and unnecessary battling with Revenue Agents on some rather important points everytime they come up in an estate and trust. The end result of others is disappointing to say the least.

As is the case with tax laws, however, changes designed to cure a defect often create two more instead, and some present such complex problems in application and administration that fiduciaries fairly cringe at the mere thought of them.

Nevertheless, the possibilities and, shall I add, *im*possibilities, of the 1954 Code warrant an immediate re-examination of existing wills and estate plans.

PROCEEDS OF LIFE INSURANCE

Perhaps the most widely hailed, and overrated, change in the Internal Revenue Code of 1954 in respect to trusts and estates relates to life insurance. Of course, proceeds of insurance payable to the estate always have, and doubtless always will be, includible in the gross estate for estate tax purposes. Prior to the 1954 Code, proceeds of insurance payable to beneficiaries other than the executor were includible if the decedent retained any of the incidents of ownership. Payment of premiums, either directly or indirectly, was specifically listed as an incident of ownership. That precluded insurance from escaping estate tax except in rare cases. Under the new Code, premium payment has been removed as an incident of ownership. The underlying reason was the belief that life insurance policies should be placed in a position analogous to other property. Consequently, it was necessary to provide in the new Code that proceeds of life insurance be includible in the gross estate if the decedent had a reversionary interest, whether arising by express terms of the policy or other instrument, or by operation of law, if the value of such reversionary interest exceeded 5% of the value of the policy immediately before the death of the decedent, the value to be determined by usual methods involving mortality tables. A possible reversionary interest previously had not been considered to represent an incident of ownership.

At first blush these liberalized provisions regarding proceeds of life insurance appear to be the answer to the life underwriters' most fervent prayer—and supreme success for the lobbyists! Its advantage as an estate tax savings, however, must be weighed against the possible effect, not only upon the insured during his lifetime, but upon his overall estate plan. Estate planners should always bear in mind that however desirable estate tax savings are, they are secondary to arrangements that most nearly will carry out the wishes of the insured in providing for the welfare of his family.

Let us presume that A assigns a $100,000 policy to his wife in such a way that it would

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OUTLOOK FOR 1955

1. By mid-1953 we had this situation:
   a) We had made good most of the accumulated shortages and needs left over from the depression, and World War II.
   b) We had fought and concluded a half-war in Korea.
   c) Consumer credit had risen, by any yardstick, to rather high levels.
   d) Inventories, partly to protect defense orders, were rather high, relative to new orders and to sales.
2. By the present time, we *have reduced* inventories by several billions. Consumer credit first shrank and is expanding moderately. Defense orders and spending have dropped.
3. The slack has partly been taken up by income tax reductions, which have encouraged consumers to maintain their purchases.
4. Until lately, business capital expenditures have also been well maintained.
5. The net effect has been that industrial production has dropped from a 1953 high of 137 (1947-49 average=100) to a figure for the past several months of 124.
6. For 1955 we can expect, as a result of these short and long term influences something like the following pattern:
   a) Defense spending will decline somewhat further.
   b) New plant and equipment spending will drop by about 5% from 1954.
   c) Inventory liquidation, over-all, will be replaced by a slight inventory accumulation.
   d) Productivity per man-hour will rise as usual.
   e) The labor force will be larger.
   f) Industrial production will rise from 124 to about 130.
   g) Unemployment will rise slightly, and there will be much discussion of Government intervention to stimulate the economy.
   h) The Consumer Price-Index (The "Cost-of-Living" index) will remain about where it is.
   i) Unless consumers buy more—as they may well do—there will be renewed talk of personal income tax reductions.

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be excluded from his gross estate. First, during his lifetime he will be denied the advantage of one of the choicest types of collateral for loans that someday might be needed in his business—the cash surrender value of his life insurance policy. Upon his death the proceeds will not be available to his estate for debts, taxes and expenses. That alone would jeopardize his entire estate plan. It has been suggested that to overcome this, there could be a tacit agreement with his wife that she would make the necessary funds available to the executor. If so, however, it could, and most likely would, be claimed that the donee was holding the insurance in trust for benefit of the estate and any part of the proceeds so used would be subjected to estate tax.

Where the proceeds are not includible in the gross estate, they could not form part of the marital deduction. That would pyramid property that would be taxable to his wife's estate upon her death. Thereby, it would merely postpone the estate tax and perhaps put it in an even higher bracket. In addition, it could completely distort the intended division of property between the wife and other beneficiaries.

If the policies were transferred to children who happened to be minors upon the death of the insured, a legal guardian would be required. That is not only costly, but very troublesome. The funds would not be available to meet the estate's cash requirements and the principal would not be available to the children except under Court Order.

Assigning the policies to an irrevocable trust would cure some of the foregoing defects. The insured, however, still wouldn't have use of the cash value of the policies as collateral. Nevertheless, the irrevocable trust seems to be generally accepted as the best bet in freeing insurance proceeds from estate tax. Certainly it has some distinct advantages.

In any event, however, where a policy is assigned, gift tax is involved—and it must be remembered that the gift tax is based on the *replacement* value, rather than on the cash surrender value of the policies. If assigned to a discretionary trust, the $3,000 annual exclusion would not apply. Furthermore, if the insured should die within three years after date of assignment, his executor most assuredly would have to combat the "transfer in contemplation of death" contention of revenue agents.

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In addition to the material and labor costs there are also the costs of material handling, plant overhead and administrative overhead. In my opinion, material handling costs should not be buried in plant overhead but should be shown separately as a material handling cost. Too often, material handling is more costly than it should be. The best way to make it efficient and keep it under control is to show the cost separately and relate it to the percentage of material cost.

Estimates or budgets of the total amount of material to be purchased at standard cost during the coming year, the cost of handling such materials at standard, the amount of direct labor expected to be expended during the coming year at standard cost and the various overhead or expense items that must be recovered at standard cost for each direct labor dollar expended, the estimated cost of general and administrative expense that must be recovered for each dollar of factory cost at standard are all taken into consideration and when applied against actual operations reflect the efficiency of operations.

If standards are set on a good firm foundation, they should generally not be changed unless the process changes, and if they are not changed unless the process changes, it is easy to make a comparison of operating results on a year by year basis. If standards are continually changed to reflect price increases in materials, wage rate increases or less pieces produced per hour, etc., even though processes have not changed, then all we succeed in doing is to cover up many inefficiencies that should be brought to light.

If the variance factor climbs, company officials should act, and the higher it climbs, the more quickly they should act. Possibly a review will indicate that different and less costly materials should be used, or if labor rates are rising and production per hour is decreasing, possibly better and more up to date equipment is required to offset such factors. In any case, it is time to act.

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So—look before you leap—into transferring life insurance policies.

Incidentally, quite recently I heard a prominent attorney, whom I consider without a peer in fiduciary matters, say that he had not yet found an instance where he could conscientiously recommend transfer of insurance policies for the express purpose of escaping estate taxes.

Moreover, may I quote from the Estate Planner's Letter of November 18th:

"The Wall Street Journal reports that a strong drive is shaping up to tighten the *life insurance provisions of the 1954 Code* which eliminated the payment of premium test. Reasons why *changes predicted:* (1) Democratic minority on Ways and Means Committee attacked change as 'windfall' for wealthy; (2) Democrats will control tax revision next year; (3) Administration may back modification because provision will cause loss of $25 million in revenue and Treasury is annoyed with life companies for 'selling' provision as only way to escape estate taxes completely; and (4) Administration may propose compromise exempting only cash surrender value."

MARITAL DEDUCTION

The scope of the marital deduction is extended under the 1954 Code in two important respects. Discrimination against a legal life estate coupled with a power of appointment has been eliminated. Heretofore, it was necessary that a power of appointment, to qualify for the marital deduction, be exercisable by will or deed. Now, a legal life estate coupled with a general power stands on a par with the marital deduction trust. Supposedly, this modification should be especially welcomed in agricultural areas where legal life estates with powers of appointment are more frequently employed. Without any detailed analysis, however, I can recall from my own limited experience, several instances in which a denied marital deduction would now be allowable because of this change in respect to marital deductions.

Another inequity removed was the discrimination against fractional interests under a trust. Heretofore, the marital deduction has been denied where the entire net estate was left in trust with the provision that one half of the income be paid to the surviving spouse who was given a general power to appoint one half of the corpus by will or deed. Though under such circumstances the marital deduction would no longer be denied, the single trust idea can be quite costly taxwise—both income taxwise and estate taxwise. The single trust would deny the combined estates the benefits to be obtained through a wasting marital trust.

For example, A, who is survived by a wife and two adult children, leaves a net estate, after taxes, of $400,000 in the conventional manner—one half to a qualifying marital trust and the other one half

to a residue trust, income from both payable to the wife during her lifetime. With a net return of 4%, that would give the wife an annual income of $16,000. She would not be entitled to the lower rates from income splitting for even two years, another new feature of the 1954 Code, since no minors are involved. Her income tax then would be $4,448. Suppose it has been provided that she receive an annuity of $16,000 annually from the marital trust, to be paid from corpus to the extent income was not sufficient, and that income in the residue trust be paid to the children—or, if it were apparent that they would not need it, be accumulated for the benefit of the grandchildren. The wife would be taxed on only the $8,000 income in the marital trust. Her tax would be $1,540, affording her $2,908 more spendable income each year. In addition, her estate would be saved estate tax on corpus distributions made from the marital trust to complete her $16,000 annual annuity. The corpus and accumulated income, if any, of the residue trust would eventually pass to the grandchildren tax free.

If there were any likelihood that the marital trust might be completely exhausted during the lifetime of the wife, it could be provided that encroachments from the residue trust be allowed for her support when funds were not available from other sources, i.e., the marital trust.

If the children did not need income from the residue trust and the father wanted to replace for the ultimate benefit of the children or grandchildren the $200,000 consumed in the wasting marital trust, he could provide that income in the residue trust be used to carry $200,000 of life insurance on the wife's life. The insurance on the wife's life might even be purchased by the husband during his lifetime and placed in a trust into which the residue of his estate would be poured at his death. With proper planning—and luck in his living at least three years thereafter—his estate would be saved considerable estate tax. I am wandering far from my subject, I realize, tempted to some extra comments on the marital deduction which happens to be my pet topic, but, let me suggest that you ponder such arrangements for a bit. You will find the tax savings, both income tax and estate tax, possibilities unlimited!

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