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H. Brice Graves

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SOME DIFFERENCES BETWEEN FEDERAL AND VIRGINIA TAXATION IN THE ESTATE AND GIFT TAX FIELDS

Estate and Inheritance Taxes

H. Brice Graves*

A number of differences between the Federal estate tax and the Virginia inheritance tax necessarily arise because of the different incidence of the two taxes. The estate tax is a tax on the privilege of the decedent to transfer his estate at his death. It is a tax on the right to *transmit* property. As the Supreme Court of the United States has said: The estate tax "is an excise imposed upon the transfer or a shifting in relationships to property at death."[1] Thus the measure or basis of the tax is the entire net estate after a single exemption of $60,000 applicable in all cases.[2]

The Virginia inheritance tax, on the other hand, is a tax on the right to *receive* property. It is imposed on the beneficiary rather than upon the estate of the decedent. This is made plain by the statute[3] which levies the tax "upon the shares of the respective beneficiaries." In a recent case the Supreme Court of Appeals has explained the nature of the Virginia inheritance tax as follows: "The tax imposed is a succession tax, laid upon the right to succeed to the property or to an interest therein as distinguished from an estate tax laid on the right to transmit property."[4] Thus the measure of the tax is the value of the property received by each beneficiary, and therefore there is a separate exemption for each beneficiary varying in amount depending upon the closeness of the relationship between the beneficiary and the decedent.[5]

* Based on a paper presented at the Second Annual Tidewater Tax Conference, Norfolk, Virginia, January 19, 1957, by H. Brice Graves, Hunton, Williams, Gay, Moore and Powell, Richmond, Virginia.

[1] United States Trust Company v. Helvering, 307 U.S. 57, 60 (1939).

[2] Section 2052, Internal Revenue Code of 1954. Future statutory references to the Federal law will be to the Internal Revenue Code of 1954 unless otherwise specified.

[3] Va. Code, §58-152 (1950). Future statutory references to the law of Virginia will be to the 1950 Code unless otherwise specified.

[4] Commonwealth v. Morris, 196 Va. 868, 871 86 S.E.2d. 135, 136 (1955).

[5] Section 58-153.

Both the estate and the inheritance taxes are graduated; the former on the basis of the total net estate, the latter on the amount received by the particular beneficiary. It has been said that the principal disadvantage of inheritance taxes in general, and the observation is equally applicable to the Virginia tax, is the practical administrative difficulty of dealing with contingent future interests where the persons who will take and the amounts they will receive may remain uncertain for many years after the decedent's death.[6] This problem is dealt with specifically by statute in Virginia.[7] The general rule of the statute is that the tax is payable immediately on temporary interests at the actuarial value as of the date of death. The tax on remainder interests is deferred until the time when the beneficiary becomes entitled to possess the property, and the measure of the tax is the full fair market value at that time.

An important practical solution to the problem also is contained in the statute which grants authority to the Department of Taxation to effect such settlement at the date of death of the decedent as the Department shall deem to be in the best interest of the Commonwealth. Application of that statutory grant of authority to the Department of Taxation eliminates many administrative problems and is helpful to the beneficiary in that he may fix the amount of the liability immediately. It has the disadvantage in some cases that the beneficiary would have to pay the tax before he receives the inheritance. As a practical matter, except in rare and unusual cases, the remainder beneficiary has an option of paying the tax as of the date of death based on the actuarial value of the property at that time or of waiting until the remainder falls in and paying the tax based on the full fair market value of the property when it comes into possession. In the usual case the Department of Taxation favors an immediate settlement of the tax liability as of the date of death of the decedent, and if the beneficiary does not request such a settlement, the Department will suggest, but cannot require, it.

The differences in application of the estate tax and the inheritance tax mentioned to this point result from the essential difference in the nature of the two taxes. Other differences, some

[6] 1 Paul, *Federal Estate and Gift Taxation,* 20 (Little Brown & Company, Boston, 1942).

[7] Section 58-173.

of considerable importance, may be noted, and these do not result from that reason in all cases.

The value of the estate for Federal estate tax purposes is the value at the date of death of the decedent.[8] To relieve an estate of hardship in a period of declining property values, however, the estate is given the option of valuing the property as of the date one year after the death of the decedent.[9] The Virginia rule is that value shall be determined as of the date of death of the decedent in all cases except that of remainder interests previously mentioned.[10] In recent years property values in general have been rising and therefore, as a practical matter, most estate valuation has been determined as of the date of death for estate as well as for inheritance tax purposes. But in those cases in which the estate has elected the alternative valuation date, the tax basis of the property would be different, and usually lower, for purposes of Federal income taxation from the basis for purposes of Virginia income taxation.[11]

In 1948, because of pressure exerted by the community property states primarily in the income tax field, Federal income, estate and gift tax provisions were added by statute to give the citizens of all states essentially the same tax advantages as those enjoyed by citizens of community property states. In the estate tax field the provision in question is the so-called marital deduction[12] which grants a deduction in computing the net taxable estate for the value of all property passing from the decedent to his surviving spouse, with certain technical exceptions, up to a maximum amount of one-half the adjusted gross estate. The marital deduction, of course, can apply only if the decedent leaves a surviving spouse.

The marital deduction undoubtedly is the most important deduction in the present Federal estate tax law insofar as the tax saving feature is concerned. The Treasury will catch up partially in the end when the surviving spouse dies, but even so the deduction allows estates to be split between husband and wife for tax purposes, and lower rates therefore apply.

[8] Section 2031(a).
[9] Section 2032(a).
[10] Section 58-155.
[11] Compare §1014(a) with §58-85.
[12] Section 2056.

Virginia does not have a similar provision. The Federal provision, however, has been the subject of considerable legislative consideration in connection with the Virginia apportionment statute.[13] That statute, orginally enacted in 1946, provided that the Federal estate tax, and the Virginia inheritance tax if based on the Federal tax, in the absence of a contrary provision in the will, shall be prorated among the persons interested in the estate in proportion to the value of property received by each, and that each beneficiary shall have the benefit of any exemptions, deductions and exclusions allowed to him or with respect to the property passing to him. This meant that no part of thé estate tax would be apportioned to a surviving spouse with respect to property received that qualified for the Federal marital deduction. The statute was amended in 1952 to provide that "a surviving spouse shall not have the benefit of the marital deduction allowable in determining the net estate under the estate tax law of the United States."[14] In 1954[15] the 1952 amendment was deleted, so that now we are back to the original provision that gives the surviving spouse the benefit of the Federal marital deduction for apportionment purposes.

The proceeds of life insurance are not subject to the Virginia inheritance tax unless payable to the estate of the insured. This is a rule founded in history, beginning at a time when the inheritance tax applied only to the estate subject to probate. By administrative interpretation the exemption of insurance proceeds payable to named beneficiaries other than the estate of the decedent was continued after the 1918 amendment[16] subjected to the tax property "which shall pass by . . . grant . . . made or intended to take effect in possession or enjoyment after the death of the grantor. . . ." It seems improbable, after such a long period of uniform administrative interpretation, that the Department of Taxation could change this rule now in the absence of legislative action.[17]

The Federal rule, as recently amended,[18] is that insurance

[13] Section 64-151.

[14] Acts of Assembly, 1952, Chapter 294.

[15] Acts of Assembly, 1954, Chapter 664.

[16] Acts of Assembly, 1918, p. 416.

[17] See Commonwealth v. Appalachian Electric Power Company, 193 Va. 37, 45, 68 S.E. 2d 122, 125 (1951).

[18] Section 2042.

proceeds are included as a part of the gross estate if payable to the estate or if the insured retained at his death any of the incidents of ownership in the policies. Thus, the present Federal law treats insurance policies like any other property, but the Treasury, we understand, is making a strong effort to have Congress re-enact the former payment of premium test.

The last difference in the estate tax and the inheritance tax that will be mentioned here, and one that is the subject of current litigation in Virginia, has to do with the taxation of the value of property subject to a power of appointment. In this discussion we will speak of the person who created the power as the donor of the power, the person who has the power as the donee of the power, and the beneficiary to whom the property is appointed as the appointee.

There is a considerable history leading up to the present estate tax provisions concerning powers of appointment. The rules have changed from time to time in the past, but the present rules will suffice for our purposes. Under Federal law the gross estate of the donor of a power of appointment includes the value of the property over which the donee is given the appointive power.[19] There never has been any problem in that connection. The question is whether the value of the property is subject to estate tax again in the estate of the donee of the power. The answer is in the affirmative if the power is a general power—one exercisable in favor of the donee, his estate, his creditors or the creditors of his estate.[20] In all other cases the power is a special or limited power of appointment and the value of the property subject to a limited power is not included in the gross estate of the donee whether or not the power is exercised.

Virginia does not distinguish between general and limited powers. Section 58-152 levies the inheritance tax upon the shares of the respective beneficiaries "in all property within the jurisdiction of this Commonwealth," and Section 58-157 provides that the provisions of Section 58-152 "shall apply to all estates of deceased persons which shall come into possession of beneficiaries by the exercise or relinquishment of powers" after June 21, 1940.

[19] Of course there might be a related deduction for the value of property qualifying for the marital deduction or for a charitable deduction.

[20] Section 2041(b).

Thus, in Virginia, in order for the appointee or ultimate beneficiary to be subject to inheritance tax based on the value of the appointed property, two conditions must be met. The appointee must come into possession of the property after June 21, 1940, and the property in question must be "within the jurisdiction of this Commonwealth."

Suppose that a New York resident creates a trust, the principal of which is tangible personal property, and the trustee of which is a New York bank. The trust creates a life estate in a resident of Virginia and the life tenant also is given the power to appoint the principal of the trust at his death by will. The power of appointment is exercised when the donee dies domiciled in Virginia and the appointee also is a resident of Virginia. Such a case[21] presently is pending before the Circuit Court of the City of Richmond on the taxpayer's suit for a refund of the inheritance tax assessed by the Department of Taxation.

It would seem that the appointee of the property under the foregoing circumstances is not subject to the Virginia inheritance tax even though both the donee of the power and the appointee were residents of and domiciled in Virginia when the power was exercised. This result seems to be required by the decisions of the Supreme Court of Appeals in Virginia in two recent cases.

In the *Carter* case[22] the Court said that ". . . the thing given by the power of appointment is power, not property, and the appointee takes title from the donor of the power." This eliminates from significance the residence of the donee of the power, for the property passes to the appointee from the donor of the power and the donee acts merely as a catalyst, as it were. This rule of Virginia law, which probably is not required by constitutional limitations in this field and could be changed by statute, makes it necessary to look to the donor of the power, if the property in question is intangible personal property, in determining whether the property is within the jurisdiction of Virginia and therefore is available as a measure of the tax.

This brings us to the *Morris*[23] case in which a New York resident transferred securities to a New York trustee, reserving a life

[21] Davis v. Commonwealth.

[22] Commonwealth v. Carter, 198 Va. 141, 145, 92 S.E. 2d 369, 371 (1956).

[23] Commonwealth v. Morris, 196 Va. 868, 86 S.E. 2d 135 (1955).

estate to himself, giving a subsequent life estate to his wife and the remainder to others. He then removed to Virginia and died. The question was whether the value of the wife's life estate was subject to the inheritance tax. The Court said no:

> It is admitted that none of the trust property was ever physically present in Virginia and that Mr. Morris was not domiciled in Virginia when he executed the irrevocable trust instrument in 1930 . . . . We cannot say, however, that his retention of the life estate gave him such an interest in the trust estate as to cause it to follow him into this Commonwealth when he moved here . . . . The share, i.e., the life estate, of Mrs. Morris therein was not taxable under the provisions of §58-152. [196 Va. at 877].

We conclude from the *Carter* and *Morris* case that if the donor of the power is a nonresident of Virginia and if the property subject to the power is intangible property having a situs outside Virginia, the appointee of the property is not subject to inheritance tax, regardless of his residence or domicile or that of the donee of the power. The inheritance tax depends in large measure on the domicile of the donor of the power. The Federal estate tax, on the other hand, looks to the situation of the donee of the power and the extent of the power of the donee.

Gift Taxes

The Virginia gift tax closely parallels the Virginia inheritance tax. The rates of tax and the classification of beneficiaries are the same[24] except that the gift tax is an annual affair, the same exemptions can be availed of each year, and the tax is not cumulative from year to year.

The Federal gift tax allows a relatively small annual exclusion of $3,000 per donee.[25] In this respect the tax is analogous to an inheritance tax rather than to an estate tax, but the annual exclusion is necessary as a practical matter to eliminate the inconvenience of reporting numerous small gifts. In addition the taxpayer is granted a $30,000 lifetime exemption which may be claimed by the taxpayer at any time.[26] Gifts in excess of the annual exclusion of husband and wife to $6,000 per donee and the com-

[24] Section 58-219.

[25] Section 2503(b).

[26] Section 2521.

exclusion and the lifetime exemption are cumulative and the rate of tax is graduated upward.[27] The rate of the Federal gift tax therefore depends upon the lifetime gift history of the taxpayer up to any tax year in question.

As in the case of the estate tax, the community property principal has been incorporated in the Federal gift tax field. Thus one-half of a gift from one spouse to another (with certain technical exceptions) qualifies as a marital deduction.[28] In addition, if the spouse of the donor consents to such treatment one-half the amount of gifts made to third persons is considered to have been made by the spouse.[29] This automatically raises the annual Federal gift tax bined lifetime exemption to $60,000. Virginia does not have any similar provisions under its gift tax law.

In the case of future interests, under which the donee does not have a present right to the use or enjoyment of the property, the Virginia gift tax rules follow the inheritance tax rules already mentioned.[30] Future interests in property have given rise to numerous problems in the Federal gift tax field. The statute limits the annual exclusion to present interests.[31] This leads to the incongruous result that a larger annual exclusion might be allowable if the donee is given a life estate in property with remainder to others than if he is given the income for five years after which time he receives the property outright. The 1954 Internal Revenue Code modified the future interest rules in the case of gifts to minors under certain limited circumstances.[32]

Every day people in Virginia are making substantial gifts without realizing it. This results from the widespread practice of purchasing real estate in the joint names of husband and wife as tenants by the entirety. If the husband pays the purchase price of the property he has made a gift to his wife and the value of the gift ordinarily is more than one-half of the payment made during the year. The amount of the gift is determined according to actuarial tables relating to the life expectancies of the joint tenants,

[27] Section 2502.

[28] Section 2523.

[29] Section 2513.

[30] See Section 58-233.

[31] Section 2503(b).

[32] Section 2503(c).

and in a tenancy by the entirety, which is not partitionable without the consent of both spouses, the interest of the wife usually is greater than that of the husband because the wife is younger and women on the average live longer than men.

The Virginia gift tax law does not mention specifically the taxation of property held in a tenancy by the entirety. The Department of Taxation takes the position that §58-218 is broad enough to subject the actuarial value acquired by the donee spouse to the gift tax in that it levies the tax "upon the shares of the respective beneficiaries in all property within the jurisdiction of this Commonwealth, real, personal and mixed, *and any interest therein,* which shall in any one calendar year pass by gift." That position of the Department of Taxation appears to be sound. At least it never has been contested by litigation.

The Federal gift tax law with respect to tenancies by the entirety was modified in 1954 to provide the general rule that, unless the taxpayer elects otherwise, a taxable gift will not result from the creation of the joint tenancy in real property. A gift results only if and when one of the spouses receives outright ownership of the proceeds of disposition of the property in a proportionate amount in excess of his actual investment in the property.[33] This seems to be a very desirable rule because otherwise so many people find themselves liable for a gift tax, plus interest and penalties, that they did not realize they had incurred.

We may note, finally, that the income tax basis of property acquired by gift is different under the two laws. For Federal purposes, the basis of such property is a substituted basis, equal to that in the hands of the donor, if the gift was made after December 31, 1920.[34] In Virginia the basis is the fair market value of the property at the time of the gift.[35]

CONCLUSION

The relative advantages and disadvantages of inheritance taxes, as contrasted with estate taxes, and a related approach in the gift tax field, may be debated at considerable length. In the final

[33] Section 2515.

[34] Section 1015.

[35] Section 58-85.

analysis, policy considerations at the State level will determine the direction that the law will take. In Virginia the policy seems to be firmly established that the inheritance tax approach is more suitable to the local needs. There are, nevertheless, many areas in which the State rules in both the inheritance and the gift tax fields could be made to conform with the Federal rules without doing violence to the fundamental State policy decision.