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ECONOMIC PHASES OF THE INHERITANCE TAX LAW*

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Inheritance or succession taxes have been the subject of vast litigation, and their avoidance the occasion of considerable subterfuge during the past few years; before discussing them, therefore, it would perhaps be well to define and describe estate taxes.

An inheritance tax, properly considered, is not a tax upon any specific property. It is an obligation placed upon an individual by the state, in return for the privilege of acquiring property. Usually the proportion of the tax increases with the value of the estate, and also in scale with the degree of relationship of the decedent to the beneficiary. As the right to bequeath and the privilege of benefit have been created by the state, and are subject to its control, there can be no doubt of the right of the state to regulate inheritance insofar as the gradation of taxation is concerned.

Every student is familiar with the development of the feudal system in England after the Battle of Hastings. The lands formerly held by the Saxons were distributed among the soldiers and the friends of William the Conqueror. Instead of being held allodially, that is to say, free of supervision, as the Saxons had them, the lands were subject to the will of the King in whom title and disposition vested. The feudal system gave rise to many kinds of estates and interests in lands differing widely in all respects save that of kingly jurisdiction. In these various holdings, called tenures (from tenir, to hold) there were certain privileges maintained for the lord paramount, and among these privileges were the reliefs. A relief was the payment of a stipulated sum to the lord by one taking possession of an estate upon the death of a former owner. These payments were in the nature of a tribute to the lord and were paid in recognition of his indulgence and were not taxes upon the lands. Thus they were founded upon the same theory as our

*The writer has drawn largely from Henry Black's discussion in The Encyclopedia of Law, and from Andrew Mellon's late work, Taxation, the People's Business. The purpose of the writer in presenting these facts is not to criticize destructively, but rather to explain the nature of the theory and the practical application of succession taxation.

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own inheritance tax and constitute the first real succession tax in the history of jurisprudence.¹

Because the tax is placed upon no specific real or personal property within a given jurisdiction, it is generally held that the power of the legislature to levy a percentage of the value of a given estate is not restricted by any constitutional provision governing regular taxation. For the same reason the exemptions that usually attach to securities outside the pale of the taxing authority of a state, are vitiated. Thus, even though an estate be composed of United States securities not ordinarily taxed by the state, still inheritance tax must be paid upon the complete value of such estate. The levy, though proportionate to the value of the inheritance, is imposed upon the privilege running to an individual by the indulgence of the state. Properly speaking, therefore, the old term succession tax is more applicable than inheritance tax.

Practically all suits arising out of the tax upon the right of succession attack the constitutionality of the tax law. At present there are two separate and distinct taxes: namely, the federal and the state. The maximum federal is twenty-five per cent and the maximum state tax varies from two and one half per cent in Rhode Island to forty per cent in Wisconsin. The right of the federal government to impose a tax is based upon no specific constitutional power, but is levied, as Andrew Mellon explains, more in the nature of an excise tax. Thus we see, under the powers of the Constitution running to Congress, we may enact such laws. So far as the states are concerned, the constitutionality of estate taxes has been sustained in principle and detail. In order to justify the imposition of an inheritance tax, it is sufficient only if the constitution does not prohibit it. It is not necessary that there be any specific authorization therefor.

Insofar as succession taxes are not levied in rem, provisions in state constitutions providing restrictions on taxation of property are not always applicable. Restrictions to the effect that taxing laws must distinctly state the tax percentage, the subject taxable and the object to which the money derived is to be applied are somewhat common, but do not affect the validity of a law imposing a tithe upon the privilege of legal benefit. To illustrate the extent to which our courts have upheld the theory of the tax upon governmental indulgence, the Supreme Court of Massachusetts has held that because the constitution of Massachusetts had authorized the imposition of excise taxes upon commodities, the succession tax was valid. This decision established that the priv-

ilege of transmitting and inheriting property effective at the death of the former owner thereof is a commodity.²

Thus we revert to the fundamental principle of constitutional law that Congress may act only insofar as empowered by the constitution (excise taxes are so included) and that the states may enact any laws which do not violate, restrict or transcend their own or the Federal constitutions.

Many states have rules of uniformity or of equality in regard to taxation. For instance, in Wisconsin Sections 31 and 32 of Article 4, provide that any such laws passed “shall be uniform in their operation throughout the state.” The Supreme Court of Wisconsin in *State ex rel. Sanderson v. Mann,*³ held that a law imposing a certain tax upon all estates in Milwaukee County above $3,000 to be paid to the county treasurer, was invalid as controverting the above mentioned sections. This case has been widely quoted in regard to succession taxes, but the learned Mr. Justice Cassody who wrote the opinion, himself an authority in matters pertaining to probate, distinctly stated that a law taxing all estates was not a succession tax. The law was termed unconstitutional for many reasons, but particularly because it lacked uniformity of operation in that it applied only to Milwaukee County and insofar as it was a double imposition upon the estate itself regardless of its solvency.

As regards the question of uniformity of tax where large estates are taxed more than small estates or where degrees of kinship regulate, it is generally conceded that so long as the same general gradation of tax is adhered to, no constitutional guaranty is infringed. Furthermore, the distinctions above mentioned are natural and logical, and, strictly speaking, there is no inequality between members of the same class.⁴

An inheritance tax law should be construed strictly against the government and in favor of the tax payer and a doubt as to the taxation of a certain fund should be resolved in favor of the citizen.⁵ Nevertheless, as Chief Justice Marshall says in his famous tax decision, “When the law is not prohibited, and is really calculated to effect any of the objects instructed to the government, to undertake here to inquire into the degree of its necessity would be to pass the line which circumscribes the judicial department, and to tread on legislative ground.”

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³ 76 Wis. 469, 45 N.W. 526.
⁴ *Beals v. State,* 139 Wis. 561, 121 N.W. 351; see also 37 Cyc. 1556.
Consequently, when possible, unconstitutional portions of a divisible enactment of the legislature are usually stricken by our state courts, and the body of the law, if in harmony with the intent of the legislature, is enforced. Many suits have arisen out of attempted taxation of property undistributed at the time of the enactment of the law and where the owner died prior to the enactment of said law. The regular rules regarding retroactive laws are followed in such cases.

In a few states the succession taxes have been amended repeatedly. This confusion always encourages tax litigation. Many cases were brought in New York which alleged that each succeeding statute abrogated the former. The rule here is that a general revision and complete new order of taxation repeals and abrogates former legislation whether so stated or not. But if a later statute may be read into the existing law, and is not necessarily inconsistent therewith, there is no repeal.

From the above it may readily be seen that it is not necessary that property subject to an inheritance tax be the same as that assessable for purposes of general taxation. It must, however, ordinarily be subject to the jurisdiction of the state and it must have belonged to the decedent in actuality at the time of his death. Bonds and certificates of stock, however, are subject to a slightly different rule.

Generally, shares of stock in a company are subject to tax at the domicile of the corporation regardless of where the certificates be kept; this rule holds true even if the decedent owner of the shares be a nonresident. Bonds, however, are not taxable at domicile of the corporation if they are at the domicile of a nonresident owner. If, however, the nonresident owner has bonds actually inside the jurisdiction of the state where the corporation is domiciled then the bonds are taxable.

So far we have been concerned with the law which has upheld the theory that succession taxes were duties levied upon the privilege granted by statute. Now we come to the inconsistent and from the rich man’s viewpoint, the pernicious application of these laws.

It is generally held that even though the succession tax runs against a person’s privilege, still it is attachable by some strange figment of juristic manipulation to the property inheritable. Thus where a man dies in one state and owns land in a second state, and the heirs are in the first state, no inheritance tax can be imposed at the home of the devisee. Land is taxable only where it lies. Of course, one state cannot control the privilege of inheritance of something physically under the jurisdiction of another state, but on the other hand there can be
no abridgment of the rights of citizens as between states. When a tax lies against a privilege rather than actuality, the rule *mobilia sequuntur personam* should apply as easily as in personality.

Naturally, those with large estates are most concerned with succession taxes. Rich men of late have been given to making life-time gifts of money which they otherwise would have kept until death. The question of the public policy of such conduct need not be discussed here. *Ante mortem* gifts are regarded variously by the several states. Most states have stringent laws as regard *ante mortem* gifts in order to obviate any possibility of a carefully planned evasion of taxation. The method formerly in vogue was to distribute large gifts to one’s family shortly before the death of the owner. The law naturally attaches to all gifts *mortis causa*. Transfers made in good faith and not in contemplation of death and not in flagrant derogation of the spirit of the succession laws are not usually taken into account. Such questions are solely questions of fact; and the age, the physical condition, and so forth, are elements of determination. When a donor retains life interest or an annuity from a gift, the law will usually regard such gift as vesting at death and property taxable.

As an illustration of the method formerly used to evade succession and income taxes, allow me to draw the following example, possible of accomplishment until recent tax reduction and legislation as regards transfers: Suppose a man is worth $500,000, and is receiving an average return of seven per cent and upward from his property, his total net taxable income being $35,000. He is not a millionaire but one of an increasingly large group whose incomes are in excess of $25,000. The surtax rate on $35,000 a year net income does not range above fifteen per cent. The income tax paid on the $35,000 income would be $2,480 normal and $2,150 surtax, a total of $4,630.

He creates a trust of one fifth of his property, $100,000 invested, let us say, in five per cent securities; the annual yield from the trust would be $5,000. Taking out $5,000 from its regular income, his tax on the $30,000 income left becomes $2,080 normal tax and $1,440 surtax, a total of $3,520. The income paid by the trust would be $160 and the trustees fee around $200. This would leave a net annual saving of about $750 which would be enough to pay yearly premiums on approximately $30,000 of additional life insurance at the age of thirty-five. Further, the $100,000 placed in trust yields an annual income of $5,000, subtracting income taxes of $160 and trustees’ fee of $200, and $4,640 is left as net income from the trust which would pay all the life insurance carried plus an additional amount to make $230,000 life insurance. In this manner the $100,000 may easily be turned into a
reserve fund amounting to $330,000 for the protection of the man's family by a saving of taxes with really no additional cost.

In addition, if no trust had been created, the taxes on the $500,000 estate, in the event of death, would be approximately $13,500 federal and about $34,000 state, a total of $47,500. By putting $100,000 during life in trust, the taxes on the remaining $400,000, in the event of death, would be $9,500 estate tax, and $24,000 inheritance, a total of $33,500. Thus, the saving in death taxes would amount to approximately $14,000 and plus a saving of $3,000 administration expenses would effect a total saving to the estate of $17,000.

In other words merely taking the trust device for the purpose of cutting down taxes, not wiping them out, a man under forty with a $35,000 net income, and a maximum surtax of not more than fifteen per cent by setting aside one fifth of his estate in trust has accomplished this much for his heirs:

The estate saves $17,000 in death tax and costs. The $100,000 set aside will grow at once through insurance policies into an estate of $330,000 and in addition enough has been saved in income taxes each year to pay for $30,000 more insurance for the beneficiaries, that is $750 or that amount to do with as wanted.

The figures here given, of course, are merely illustrative. The device admits of many varieties. A man may split his estate up into several separate trusts and avoid practically all surtaxes. The larger the income and higher the surtax the greater the saving.

There are many fascinating possibilities for the individual client. I have merely chosen the saving of the tax for insurance combination to illustrate, and will not run the risk of boring the reader by the development further of the myriad combinations capable of practical application, even now under the improved transfer regulations.

Any estate created by will referable to the death of the decedent is taxable. This rule applies to future estates and interests. A vested estate in remainder created by will is a taxable incident of property, and the fact that the prior estate is free from taxation will not relieve the remainderman. While the provision may seem slightly inconsistent with the theory of the law that succession taxes run to the privilege, still to relieve a future estate of such taxation would resolve itself into a lack of uniformity and would also be contrary to public policy in that it would build up a vast system of vested estates in remainder, and future interests.

Charitable donations are not exempt from succession taxes solely because they are excused from several other taxations. To avoid the succession tax such donees must show that they are exempt from all
classes and kinds of taxes, either by charter or general law, and that their purpose is in fact charitable, educational or religious.

A testator may provide in his will that a donee shall receive a portion of the estate free of inheritance tax and then the tax will be assessed out of the residue of the estate. This is in spite of the fact that the tax runs against the privilege of inheritance and not the property itself. In many states in fact, the tax becomes a lien upon the lands of the decedent. Yet an inheritance tax is not a debt nor a penalty, and unless a special statute is made, the regular statute of limitations does not lie against it.

Beyond any doubt, inheritance taxes have come to stay. But, reliable authorities concur in that they must be reduced. The federal inheritance tax has outlived its usefulness. Congress made an endeavor to raise the maximum to forty per cent not long ago. The federal income derived from such tax is very small. It forms a very inconsiderable portion of the federal income, and creates a harsh and distinct hardship upon many people. The average income from the same is $110,000,000, only about one dollar and ten cents per person in the country. To use up this income which is properly a state tax, is to force the states to increase other taxes—usually upon the land.

As Andrew Mellon says in his current book on estate taxes, "The character of taxation should not be such as to destroy the very source from which revenue is to flow." Nearly every state has an inheritance tax. The government also has one. A rich man taxable at the maximum of forty per cent in a state and twenty-five per cent in the government is very apt to have some assets properly assessable in one or more other states. Thus, the total tax could easily take two thirds of a large estate, and it is conceivable (though rich men are usually too alert to permit such circumstance to occur) that practically an entire property could be taken. Add to the above circumstance, the fact that many large estates are now in a period of rejuvenation and in ten years they would be worth a larger sum than now. The property would have to be sold for sufficient funds to pay the taxes. Even if there were no possibility of added wealth the mere fact of a forced sale to meet the taxes would tend to beat down the price of an estate five or ten per cent. Few men die with an estate of cash or readily marketable securities. To liquidate the estate necessitates sale at a loss to those who know that the executors must sell.

In England where the custom, if not the law, of primogeniture is still in existence, large estates are taxable but once in a long generation, and they have an opportunity to build up again before the next tax is levied.
In the United States, statistics prove that the average estate is probated oftener than in England. In a generation or two all large fortunes are split up into many inheritances. It is claimed, therefore, that there is no social or economic necessity for breaking up large fortunes in this country.

With such taxation there is another point. Large inheritances place a penalty upon energy and initiative. If, for instance, an estate were taxed forty per cent three times in sixty years, which is not at all improbable, it would die by intussusception. A large portion of our property goes into probate once in a decade. If taxed ten times in one century at the rate of twenty-five per cent each time, the average large estate would dwindle into small stature. In addition, estate taxes go into current federal expenses and so no permanent good can accrue to the tax payer as a result of his sacrifice.

Economically it would be wise to abolish the federal inheritance tax entirely. It places a hardship upon the wealthy and forces them to place money in trust funds where its utility is held in abeyance. Furthermore, it should be held as an emergency measure. Succession taxes were passed and repealed in this country as follows:

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<thead>
<tr>
<th>Passed</th>
<th>Repealed</th>
<th>Period</th>
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<tbody>
<tr>
<td>1797</td>
<td>1802</td>
<td>Revolutionary Period</td>
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<tr>
<td>1862</td>
<td>1870</td>
<td>Civil War Period</td>
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<tr>
<td>1898</td>
<td>1902</td>
<td>Spanish War Period</td>
</tr>
<tr>
<td>1916</td>
<td>....</td>
<td>World War Period</td>
</tr>
</tbody>
</table>

The money derived from this tax now defrays a small part of our current national expense. Other nations use money thus derived for the improvement of national buildings. We are deriving no permanent good from the federal inheritance tax; it is repugnant to America’s spirit which tolerates it merely as a war measure; it is based upon no direct constitutional provision, but is merely an excise tax; economists are all agreed that succession taxes are properly state taxes. Should we then at this time allow Congress to increase the maximum percentage of this tax as was urged recently, or should we advocate its repeal?