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CASE NOTES

STATUS OF COMMUNITY PROPERTY
IN THE REVOCABLE INTER VIVOS TRUST:
KATZ V. UNITED STATES (S.D. CAL. 1966)

In recent years, the revocable inter vivos trust has become a popular device in estate planning because of the advantages which it offers over disposition by other devices such as wills, gifts, and irrevocable trust. Characteristically, the revocable trust operates as a will substitute, effecting no noticeable change in the rights of the parties at the time of execution, remaining ambulatory until the death of the settlor, and then operating to dispose of the corpus in accordance with his wishes. In the typical family trust situation, the spouses have the benefit of the trust property during their lifetime, the survivor having a life interest, and the children being entitled to distribution of the trust assets after the death of both spouses. The revocability feature allows the spouses to recover the property, free of the trust, at their discretion. In spite of its similarity to disposition by will, the revocable inter vivos trust is not considered to be a testamentary disposition within the Statute of Wills. Rather, it is considered as passing a present interest, the enjoyment of which is postponed until the settlor’s death. It is, however, includable in the decedent’s gross estate for estate tax purposes.

In the recent case of Katz v. United States, the husband and wife, apparently intending to use the revocable trust device as a will

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1 The advantages often cited are: control, economy, privacy, continuity, stability, and choice of law. See 1 LASSER TAX INST., ESTATE TAX TECHNIQUES 1247 (1966), Casner, Estate Planning—Avoidance of Probate, 60 COLUM. L. REV. 108 (1960).
2 President of Bowdoin College v. Merritt, 75 Fed. 480 (9th Cir. 1896), appeal dismissed, 167 U.S. 745 (1897); Nichols v. Emery, 109 Cal. 323, 41 Pac. 1089 (1895); Hill v. Conover, 191 Cal. App. 2d 171, 12 Cal. Rptr. 522 (1961); RESTATEMENT (SECOND), TRUSTS § 57 (1959) provides: “Where an interest in the trust property is created in a beneficiary other than the settlor, the disposition is not testamentary and invalid for failure to comply with the Statute of Wills merely because the settlor reserves a beneficial life interest or because he reserves in addition a power to revoke the trust in whole or in part, and a power to modify the trust, and a power to control the trustee as to the administration of the trust.”
3 Nichols v. Emery, 109 Cal. 323, 41 Pac. 1089 (1895); Hill v. Conover, 191 Cal. App. 2d 171, 12 Cal. Rptr. 522 (1961). The rule that a trust is presently effective even though revocable is embraced in California Civil Code section 2280 which provides that all voluntary trusts are revocable unless expressly declared otherwise in the trust instrument.
4 INT. REV. CODE OF 1954, §§ 2036, 2038.
substitute, inadvertently succeeded in transmuting their community property into the separate property of the husband. The ultimate purpose of the Katz trust was to pass ownership of the trust property to their children. The husband, however, was accorded the sole right to revoke, terminate, or amend the trust. The wife was entitled to receive income if she survived the husband. Relevant portions of the trust read as follows:

Section 4: During the lifetime and competency of the Trustor, the Trustee shall have no rights, duties, or powers with respect to any property held under this trust, it being understood that the trustor retains all such rights, and shall collect, receive, and disperse, without accounting to the trustee or any other person, all income of every nature and description from the real and personal property held hereunder. The trustee shall not exercise any of the powers set forth in Sections 1, 2 and 3 hereof without first obtaining the written consent of the trustor, during his lifetime, and after his death without first obtaining the written consent of all of the adult beneficiaries who are then entitled to receive the income hereunder.

Section 13: The right is reserved unto the trustor to revoke, terminate or amend this trust, in whole or in part, at any time or from time to time, by written request therefor addressed and delivered to the trustee, provided, however, that no such amendment shall affect the duties, liabilities or compensation of the trustee, without its written consent.

Approval of Wife: I, Sadie Katz, wife of the trustor, do hereby fully approve the foregoing declaration of trust No. PP-13003.6

Upon the husband's death, the Commissioner of Internal Revenue imposed an estate tax upon the entire corpus. Plaintiff-wife claimed a community property exclusion contending that the transfer of the property into trust was not inconsistent with its status as community property and did not deprive her of her statutory rights. On cross motions for summary judgment, the court held for the defendant; the transfer of the property into trust terminated the wife's interests and made it the separate property of the husband.

TAXING THE ENTIRE CORPUS

The court concluded, as a matter of law, that the entire trust property was validly and properly taxable under sections 2036 and 2038 of the Internal Revenue Code of 1954. Section 2036 provides that the decedent’s gross estate includes the value of any property transferred by the decedent, without consideration, into a trust wherein he has retained for life, the possession, enjoyment or right

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6 Above trust provisions courtesy of Donald M. Fenmore, Assistant United States Attorney, Central District, California.
to income from the property or a power to designate who should have the possession, enjoyment or income. Section 2038 provides that the decedent’s gross estate includes the value of any property transferred by the decedent, without consideration, into a trust which, at the time of his death, was subject to a power to alter, amend, revoke or terminate exercisable by the decedent alone or in conjunction with another. It is significant that, under the language of either section, the interest taxed is that which the decedent has transferred and not the entire interest which he and another may have transferred jointly.\(^8\) Thus, in the present case, the conclusion that the entire corpus was taxable under sections 2036 and 2038 was necessarily based on a finding that the husband was the sole transferor and not a joint transferor together with his wife.

Under what principle then, did the husband become the sole transferor? There is language in California Civil Code section 172 and in the cases cited in *Katz* which, taken alone, might be used to support an argument that the husband is the transferor of the property even though it is still owned by the community at the time of transfer.\(^8\) Thus, section 172 provides:

> The husband has the management and control of the community personal property with like absolute power of disposition \ldots as he has of his separate estate; provided, however, that he cannot \ldots dispose of the same without a valuable consideration \ldots without the written consent of the wife.

Although this section refers to the husband’s power of disposition and characterizes the wife’s role as one of giving consent, it is no where contended that such language makes the husband the sole transferor within the meaning of sections 2036 and 2038 of the Internal Revenue Code.\(^9\) Likewise, in *Kirkwood v. Bank of*

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\(^7\) There have been cases where the decedent was deemed a transferor even though he had no interest in the property at the time of transfer into trust. This exception seems to be taken only where the decedent has provided the consideration for the creation of a trust in his favor from the property of another. An example of this is the creation of “cross trusts” where two settlors set up trusts in favor of each other. Where the court finds that the trusts were set up in consideration for each other, each settlor is considered to be the transferor of the property in the trust benefiting him. Cole’s Estate v. Comm’r, 140 F.2d 636 (8th Cir. 1944); Lehman v. Comm’r, 109 F.2d 99 (2d Cir. 1940). Compare Newberry’s Estate v. Comm’r, 201 F.2d 874 (3d Cir. 1953).

\(^8\) This argument was not presented in the principal case but is developed here because it has tended to cloud the issue in similar cases in the past. See United States v. Goodyear, 99 F.2d 523 (9th Cir. 1938), distinguishing “management and control” from “possession and enjoyment.”

America\textsuperscript{10} which was cited in the principal case and in \textit{Strong v. Strong}\textsuperscript{11} and \textit{Riley v. Gordon}\textsuperscript{12} which were relied on by the Kirkwood court, there is language designating the husband as the transferor with the wife's consent. These cases may be distinguished from the principal case however, on the grounds that each of them involved a transfer of pre-1927 community property which, by definition, was vested solely in the husband.\textsuperscript{13} It follows that the same language could not be applied to transfers of post-1927 community property such as occurred in the principal case.

The decision in the principal case that the husband was the transferor was not based on the husband's powers over community property, but rather on the interests which he acquired by virtue of the execution of the trust agreement. Certainly, it is well settled that a husband and wife may agree that their community property should be transmuted into separate property and vice versa.\textsuperscript{14} In principle, moreover, there is no reason why a trust agreement should not be available as a vehicle for effecting the transmutation if the parties so intend. But, even if it is conceded that the effect of the trust agreement in the \textit{Katz} case was to transmute the community property into the separate property of the husband, it does not follow that the trust property should be taxable under sections 2036 and 2038. Since both of these sections contemplate a transfer by the decedent, the fair inference is that all of the property taxed must have been his at the time the trust agreement was executed. But it is clear that, in \textit{Katz}, the property was community property up until the agreement was executed and that only one half of it was vested in the decedent at the time of transfer. To hold that the transfer under those circumstances operated in the same manner as a transfer of the separate property of the husband is to force an unnatural and unnecessary construction on either the trust instrument or the code sections.

The construction required seems unnatural because the trust agreement did not purport to operate in two steps, \textit{i.e.} first to transmute the property and then to transfer it into the trust. Nor do sections 2036 and 2038 purport to apply to property transferred into trust for the benefit of the decedent by someone other than the

\textsuperscript{10} 43 Cal. 2d 333, 273 P.2d 532 (1954).
\textsuperscript{11} 22 Cal. 2d 540, 140 P.2d 386 (1943).
\textsuperscript{12} 137 Cal. App. 311, 30 P.2d 617 (1934).
\textsuperscript{13} The limiting language of the \textit{Riley} decision is relevant: "But to whatever the wife's testamentary power may be likened it is plain from the decisions that as to community property acquired previous to 1927 her joinder in a deed thereof is, in legal effect but an expression of her assent to the transfer by the husband." \textit{Id.} at 315, 30 P.2d at 619. (Emphasis added.)
\textsuperscript{14} See, \textit{e.g.}, \textit{Young v. Young}, 126 Cal. App. 306, 14 P.2d 580 (1932) (applying CAL. CIV. CODE §§ 158, 159).
decedent himself, e.g., his wife. Moreover, this construction seems unnecessary in view of the possibility of taxing the entire corpus under section 2041.

Section 2041 includes in the decedent's gross estate, the value of all property over which he had, at his death, a general power of appointment. Under current treasury regulations:

The term "power of appointment" includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of the local property law connotations. Similarly, a power given to a decedent to affect the beneficial enjoyment of trust property or its income by altering, amending, or revoking the trust instrument or terminating the trust is a power of appointment.

Since the decedent in Katz had, at his death, the power to affect the beneficial enjoyment of the trust property or its income by amending or revoking the trust instrument or terminating the trust, it would seem to follow that the entire trust property could be included in his gross estate under section 2041. In the alternative, the portion of the trust transferred from the wife could be taxed under this section while the portion transferred by the husband could be taxed under sections 2036 and 2038.

In any event, it must be remembered that the question before the court was the validity of the tax and not the status of the property. As was stated in Morgan v. Comm'r,

State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed. Our duty is to ascertain the meaning of the words so used to specify the thing taxed. If it is found in a given case that an interest or right created by local law was the object intended to be taxed, the federal law must prevail no matter what name is given to the interest or right by state law.

In short, it seems that, having satisfied itself that a taxable interest had been created under sections 2036 and 2038 or even under section 2041, the court need not have proceeded to find that the husband's interest would constitute separate property in California.

Declaring Corpus Separate Property of Husband

The well settled rule that a husband and wife may agree that their community property should be transmuted into separate

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15 But see note 7 supra.
17 Treas. Reg. § 20.2041-1(b).
18 309 U.S. 78 (1940).
19 Id. at 80, 81.
property has already been noted. In such transactions, the wife is given important safeguards for the protection of her interests.\textsuperscript{20} Civil Code section 158 makes transfers between husband and wife subject to the law of trusts insofar as the husband's duties of full disclosure and fair dealing are concerned.\textsuperscript{21} Where the husband obtains an advantage in an inter-spousal transfer, a presumption of undue influence arises.\textsuperscript{22} Moreover, extrinsic evidence is always admissible to show that property held in one form was actually intended to be held in another.\textsuperscript{26} While the court in the principal case did not expressly refer to section 158, its opinion systematically considers each of the protections afforded the wife under that section and concludes that she was not deceived. For example, the presumption of undue influence was overcome by the court's finding that the trust reflected the true intent of the parties. The husband's duties of full disclosure and fair dealing were satisfied by the court's finding that the wife had the advice of counsel. In addition, the court found that there were no collateral agreements tending to vitiate the trust.

It has already been suggested that, in principle, there is no reason why a trust agreement should not be available to effect a transmutation if the parties so intend. The \textit{Katz} court apparently felt that, by consenting to the terms of the trust, unequivocally giving the husband the power to deal with the corpus and income without accounting to the trustee or any other person, the wife intended to effect the transmutation. But, it seems just as likely that she did not so intend. There is no evidence that the words "separate property" appeared anywhere in the trust agreement. One intending to effect a transmutation would hardly be expected to leave out the very words that define the interest to be created. Furthermore, it is reported that amendments to the trust were made by the husband and, on each, the wife signed a clause reading "consent of wife to partial amendment."\textsuperscript{24} Such consent would have been unnecessary if the property had already been transmuted into the separate property of the husband. Also, as noted at the outset, the revocable inter vivos trust, when used as an estate planning device, is usually not intended to work an immediate, noticeable change in the rights of the parties. If the \textit{Katz} trust was created with this pattern in mind, the result could hardly have varied more from the intentions of the parties.

It should also be noted that none of the authorities cited by the \textit{Katz} court went so far as to say that the wife's consent to a transfer

\textsuperscript{20} See 1 So. Cal. L. Rev. 388 (1928); 14 Stan. L. Rev. 587 (1962).
\textsuperscript{21} \textit{In re Cover's Estate}, 188 Cal. 133, 204 Pac. 583 (1922).
\textsuperscript{23} Braden v. Braden, 178 Cal. App. 2d 481, 3 Cal. Rptr. 120 (1960).
\textsuperscript{24} 255 F. Supp. at 643.
of community property into a revocable inter vivos trust will transmute the property in the absence of a specific provision to that effect. Two of the cases cited did not involve trust agreements. In the third case, *Kirkwood v. Bank of America*, the husband, as transferor with his wife's consent, transferred pre-1927 community property into a revocable trust reserving the benefits to himself during his lifetime. The wife was to have a life estate with power of appointment over one half the corpus if she survived the husband. In sustaining a state inheritance tax, the court said:

The husband was the transferor with the wife's consent. . . . At the time of the transfer she had the power of restraint . . . but instead of exercising it by withholding her signature . . . she, with the advice of counsel, signed a formal consent to "all the terms and conditions" of the "Trust Agreement." She thereby parted voluntarily with her expectant statutory rights in the community property as they existed before the transfer, and she succeeded to a new and different interest in the property subject to the trust upon giving her consent to the inter vivos disposition breaking up the community status of the property transferred.

Note that the court in *Kirkwood* was able to find a taxable interest without declaring the corpus to be the separate property of the husband. That the court in *Katz* might have used the same approach has already been suggested. In choosing to label that taxable interest the separate property of the decedent, the *Katz* court effected major changes in the rights of the parties. The language of the decision indicates that the trust agreement made the corpus the separate property of the husband not just for estate tax purposes,

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25 In Schindler v. Schindler, 126 Cal. App. 2d 597, 272 P.2d 566 (1954), the husband and wife purchased a home with community funds but took a deed expressly as joint tenants. The issue was whether the wife's written consent to the transaction was vitiated by an unrevealed intention on her part that it remain community property. The court held that the unrevealed intention did not alter the effectiveness of the written consent to the language expressly creating a joint tenancy.

In Metzger v. Vestal, 2 Cal. 2d 517, 42 P.2d 67 (1935), the wife had consented in writing to a transfer of pre-1927 community property to a newly formed family corporation in exchange for shares of stock, most of which were to be issued in the names of the husband and son. A suit was brought nineteen years later, in equity, by the assignees of all of the wife's "right, title and interest" in the corporation. Plaintiffs contended, among other things, that the issuance of stock to the son was in violation of the wife's community property rights in the property transferred to the corporation. The court found that the son had given consideration for the shares and, even if he had not, that the wife's written consent was a release of her rights in that portion of the property.


27 Id. at 339, 273 P.2d at 535.

28 Compare Siberell v. Siberell, 214 Cal. 767, 7 P.2d 1003 (1932), where it was stated that "all property not held as community property must, for want of a better name, be classed as separate property." The issue there was whether the wife had a community interest in the husband's half of real property which they owned as joint tenants.
but for all purposes.\textsuperscript{29} Thus, all of the trust income was the separate property of the husband.\textsuperscript{30} If he had chosen to revoke the trust, he would have taken the trust property free of any restraints which the wife might have exercised under sections 172 and 172a. Had there been a divorce, the court would not have been able to apportion the trust property in its decree.\textsuperscript{31} Such results make it clear that serious questions of draftsmanship have been raised by the \textit{Katz} decision.

**AVOIDING THE KATZ RESULTS**

Briefly stated, the principal problem is: what language, if any, in a trust agreement, will prevent the \textit{Katz} results? A threshold question in this regard is whether community property can, under any circumstances, exist within a trust. Since community property is a marital estate, it might be concluded that legal title could not be conveyed to a stranger to the community without destroying the community status. However, the cases indicate the community status can be maintained in the trust situation. For example, in \textit{Bank of America v. Rogan},\textsuperscript{32} the husband and wife joined in a transfer of community property into trust for their own benefit. The trust was revocable by joint action of the trustors only. The court held that they had placed the property in trust as co-owners and that the community status of their interests was not affected. Likewise, in \textit{McCall v. McCall},\textsuperscript{33} where the husband and wife conveyed community real property to a corporate trustee pursuant to a partnership scheme, it was held that their beneficial interest in the property was community property.

Since community property interests can exist within a trust, the problem is to determine what is the proper procedure for preserving those interests when drafting the revocable inter vivos trust. In this regard, the language of \textit{Katz} is instructive. Recall that the plaintiff had contended that the decedent's powers over the trust property could necessarily be exercised only on behalf of and in trust for the community. The court considered the contention ill-

\textsuperscript{29} 255 F. Supp. at 644, "Plaintiff further contends that the power which the trust agreement granted to the decedent over the property could necessarily be exercised only on behalf of and in trust for the community. This contention is likewise not well founded. As previously found, there were no collateral agreements imposing such a limitation on the power vested by the trust agreement in the decedent and there is no such limitation implied in law since the property ceased to be community property when the trust was established."\textsuperscript{30} \textit{Cal. Civ. Code} § 163; \textit{10 Cal. Jur. 2d, Community Property} § 21 (1953).


\textsuperscript{32} 33 F. Supp. 183 (S.D. Cal. 1940).

\textsuperscript{33} 2 Cal. App. 2d 92, 37 P.2d 496 (1934).
founded because there were no collateral agreements imposing such a limitation on the powers granted by the trust instrument. From this language, it appears that, if the provisions of the trust agreement had not given the husband powers inconsistent with his wife's statutory rights or if there had been a collateral agreement qualifying his powers, the result would have been favorable to the plaintiff. Manifestly, any limitation that could be imposed by a collateral agreement could be made a term of the trust agreement itself.

Thus, it appears that the results of the Katz agreement could be avoided by providing that: (1) the property transferred is community property of the husband and wife, (2) the income from the trust is to be community property, (3) the powers of the husband are subject to the same limitations imposed by California community property law on property not held in trust, and (4) that, in the event of revocation or termination, the property freed from the trust shall be the community property of the husband and wife.

**Conclusions**

In Katz, the wife consented to a trust agreement providing that the husband should have rights and powers over the entire corpus which he might exercise without accounting to the trustee or any other person. By virtue of her consent, the wife created in the husband an interest in, or power over, the trust property that was properly taxable under federal estate tax law. However, the use of sections 2036 and 2038 as a basis for the tax appears to do violence to the requirement, found in both sections, that the trust property must have been transferred into the trust by the decedent. It appears that a more rational basis is found in section 2041 which taxes trust property over which the decedent had, at the time of his death, a power to alter, amend, or revoke, without regard to who made the transfer into trust in the first place.

Conceding that a federally taxable interest was created, the court's further determination that the interest would be separate

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34 Supra note 29.

35 Care must be taken to avoid possible gift tax consequences in protecting the wife's interests. For example, the draftsman who provides that the trust shall be revocable only by joint action of the husband and wife, may find that he has jumped from the frying pan into the fire. A completed gift is made when the settlor can revoke only with the consent of someone having a substantial adverse interest. Int. Rev. Code of 1954 § 2511; Treas. Reg. § 25.2511-2. The wife's interest as a beneficiary under the trust would qualify under this rule. Camp v. Comm'r, 195 F.2d 999 (5th Cir. 1952). Note that the provisions suggested above avoid this result by allowing the husband to revoke the trust without the wife's consent within his powers of management and control for the benefit of the community.