August 2013

Dear Federal Estate and Gift Tax Student:

This file contains an excerpt of the new Ninth Edition of Federal Estate and Gift Taxation: Including the Generation-Skipping Transfer Tax, by Stephens, Maxfield, Lind, and Calfee, which has been assigned as the textbook for your Fall 2013 tax class. It also includes an excerpt of the Study Problems that relate to this new Ninth Edition, which appears in this file before the main volume excerpt.

We had hoped that the printed versions of these course materials would be available at the very start of your Fall 2013 semester. However, production issues, though not affecting the excerpted content, required that we delay printing and shipping.

These excerpts are provided for the sole purpose of allowing you and your professor to begin coverage of this area while we complete production of the printed versions of the student edition of this treatise (your textbook) and its study problems. The printed versions of the treatise and study problems should be available for purchase in your college or university bookstore in early September 2013. These excerpts are intended to serve temporarily as course materials until these printed versions are available for your purchase, after which you should cease use of this file and delete it.

Sincerely,

Bruce Furst

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PROBLEM 1

[SML&C refers to the abridged edition of Federal Estate and Gift Taxation (9th ed.). Appendix begins on page 105 of the Study Problems.]

Assignment

Code: In the final analysis, estate planning must include a consideration of all taxes, state and federal, since the surprise exaction of a tax may upset expectations that are otherwise reasonable. Here, however, consideration is limited to the federal transfer taxes, the estate tax, the gift tax, and the generation-skipping transfer tax. This assignment explores the basic computational relationship of those three taxes. The Code sections principally to be examined are:

§§ 2001(a)–2001(c); 2010(a), 2010(c); 2501(a)(1); 2502(a); 2505(a); 2601; 2602; 2611(a); 2622; 2641.

SML&C: Preface; ¶¶ 2.01[1]–2.01[2]. Skim ¶ 1.01–1.05.

Appendix: Applicable Credit Amount Table

Questions

(1) \( T \), who never married nor made any prior inter vivos gifts, made taxable gifts of $6 million in 2013. \( T \) dies in the current year, leaving a taxable estate of $5 million.

In 2002, \( G \) created a trust, the income to be paid to \( G \)'s child \( T \) (our same good old \( T \)) for life, remainder to \( T \)'s child \( R \). (Don’t worry about \( G \) who is not a part of the problem.) At \( T \)'s death in the current year, the remainder interest of the trust corpus, valued at $4 million, was paid over to \( R \).

(a) Using the proper rate computation provided by Section 2502 and considering the Section 2505 applicable credit amount, disregarding inflation adjustments to the applicable
exclusion amount, what is T’s gift tax liability for 2013?

(b) Determine the estate tax payable on T’s death in the current year, using the Section 2001 computation and the Section 2010 applicable credit amount disregarding inflation adjustments to the applicable exclusion amount.

(c) Consider the Section 2001(b) statutory method for computation of estate tax liability: Are the “taxable gifts” being taxed twice? What is being taxed? How?

(d) Proper computations in both questions (1)(a) and (1)(b), above, make use of the applicable credit amount. Is the credit allowed twice?

(e) Using an inclusion ratio equal to one and a taxable amount equal to the value of the remainder interest, what is the amount of tax imposed on the taxable termination generation-skipping transfer that occurs upon T’s death?
PROBLEM 2

[SML&C refers to the abridged edition of Federal Estate and Gift Taxation (9th ed.). Appendix begins on page 105 of the Study Problems.]

Assignment

Code: §§ 2031(a); 2033; 2034. Skim §§ 691(a); 1014(a), 1014(c); 7520.


SML&C: ¶¶ 4.01; 4.02[1]–4.02[2][a]; 4.05 (omit ¶ 4.05[8]); 4.06.

Appendix: Table S.


Questions

(1) D transferred property to T, as trustee, in trust, the income to be paid to X for X’s life, remainder to Y if living at X’s death or, if not, remainder to Z or Z’s estate.

(a) If T died, survived by X, would the value of the property be included in T’s gross estate?

(b) Will the value of the property be included in X’s gross estate upon X’s death? Is any wealth transfer tax possibly applicable upon X’s death?
(c) Will a part of the value of the property be included in Y’s gross estate if Y dies survived by X?

(d) Will a part of the value of the property be included in Z’s gross estate if Z dies survived by X but not by Y? In the current year, what amount, if any, would be included in Z’s gross estate if the trust corpus is worth $100,000, X is 60 years old, the Section 7520(a)(2) interest rate is 4 percent, and Z’s estate uses a date-of-death valuation? See Table S in the Appendix to the Study Problems.

(e) Will a part of the value of the property be included in Z’s gross estate if Z dies survived by X and Y?

(f) Will a part of the value of the property be included in Z’s gross estate under the circumstances of question (1)(d), above, if the trust was an inter vivos trust created by D, subject to D’s power of revocation, and Z was also survived by D?

(g) If D had made the transfer in question (1)(a), above, but had provided for a reversion to D or D’s estate (rather than a remainder to Z or Z’s estate) if Y was not living at X’s death, will anything be included in D’s estate if D predeceases X and Y?

(2) Consider the extent to which state law may affect federal tax liability.

(a) D died owning a residence that is protected from the claims of creditors by the state’s homestead law. Is the residence includable under Section 2033?

(b) Under state community property law, D’s spouse is the owner of one half of their community property during their lives and at the death of D. Is spouse’s interest in such property a part of D’s gross estate? Note, however, IRC § 1014(b)(6).

(c) Under the law of a state that uses common law property concepts, D’s spouse became entitled at D’s death to one third of D’s realty and one third of D’s personality outright. Are these interests a part of D’s gross estate?

(d) D and D’s spouse own property as equal tenants in common, which, under state law, involves no right of survivorship. Is any part of D’s interest included in D’s gross estate under
(2) If D dies survived by D’s spouse?

(e) What is the result in question (2)(d), above, under Section 2033, if D and D’s spouse own the property as joint tenants or as tenants by the entirety and, under a decision by the state supreme court, the tenants enjoy rights of survivorship? What is the result if state courts disagree as to whether there is a right of survivorship and the state supreme court has not yet resolved the issue?

(3) D’s employer owed D $15,000 in salary that had not been paid at time of death.

(a) Is D’s right to that amount includable in D’s gross estate?

(b) For the estate’s or beneficiary’s income tax purposes, what difference may it make whether D was an accrual or a cash-method taxpayer? See IRC § 691, especially IRC § 691(c).

(c) What if the $15,000 is a benefit that D’s employer agreed to pay to D or D’s estate only if D continued to work for the employer until D’s retirement or death, and D works until the day D dies?

(d) If the $15,000 is a benefit that D’s employer is not required by contract to pay, but that the employer decides to pay all employees at the end of the year, and if D dies during the year and the amount is paid to D’s estate, is the benefit included in D’s gross estate under Section 2033?

(e) Are Social Security benefits paid to D’s family at D’s death includable in D’s gross estate under Section 2033?

(4) D dies owning a real estate business.

(a) What is included in D’s gross estate under Section 2033 if the business is unincorporated?

(b) What is included if the business is incorporated?

(c) What if D owns a one-fourth interest in the business, which is a partnership?

(5) At D’s death, which of the following are included in D’s gross estate under Section 2033?
(a) A life insurance policy owned by D on B’s life. B survives D.
(b) B’s survivorship rights in a joint and survivorship annuity policy for D and B’s lives purchased by D.
(c) An installment sales obligation from the sale of property that D sold a few years ago.
PROBLEM 3

[SML&C refers to the abridged edition of Federal Estate and Gift Taxation (9th ed.).]

Assignment


Regulations: § 20.2043-1(a).

SML&C: ¶¶ 4.07 (omit ¶¶ 4.07[2][b][ii], 4.07[2][d], 4.07[4]); 4.15[2].


Questions

(1) Two years ago, Decedent gave Child $750,000 in cash. Decedent dies in the current year.

(a) What is included in Decedent’s gross estate?

(b) What is the result in question (1)(a), above, if Decedent gave Child a life insurance policy on Decedent’s life worth $100,000, with a face value of $750,000, instead of cash?

(c) What is the result in question (1)(b), above, if, after the gift, Child made annual premium payments totaling $30,000? Assume that Decedent’s total pre-gift premium payments were $120,000.

(d) What is the result in question (1)(b), above, if, during the time between the gift and Decedent’s death, the insurance policy paid dividends to Child totaling $10,000?

(e) What amount is included in Decedent’s gross estate if, between the gift and Decedent’s death, Child cashes in the policy and receives $120,000?

(f) What amount is included in Decedent’s gross estate if Child paid Decedent $100,000 for the policy when the policy was worth $100,000?
FEDERAL ESTATE & GIFT TAXATION: STUDY PROBLEMS

(g) What amount is included in Decedent’s gross estate if Child paid Decedent $50,000 for the policy when the policy was worth $100,000?

(2) In year one, Deathly III made a $300,000 gift of cash to Child, and, in year two, Deathly paid a $120,000 gift tax on the transfer.

(a) Upon Deathly’s death later in year two, what is included in Deathly’s gross estate under Section 2035?

(b) If Deathly had held on and lived for four years after the gift, what would be included in Deathly’s gross estate under Section 2035?

(c) If Deathly had not made the gift (and, consequently, had not paid the $120,000 gift tax), what would be included in Deathly’s gross estate?
PROBLEM 4

[SML&C refers to the abridged edition of Federal Estate and Gift Taxation (9th ed.).]

Assignment

Code: §§ 2035(a); 2036; 2043(a).

Regulations: § 20.2036-1.


SML&C: ¶ 4.08 (omit ¶¶ 4.08[6], 4.08[7][c], 4.08[9]).

Suggested references:


Estate of Maxwell v. Comm’r, 3 F3d 591 (2d Cir. 1993), 93-2 USTC ¶ 60,145, 72 AFTR2d 6733.


United States v. Allen, 293 F2d 916 (10th Cir. 1961), 61-2 USTC ¶ 12,032, 8 AFTR2d 6055, cert. denied, 368 US 944 (1962).


Questions

(1) \( D \) transfers securities to a trust, retaining some right to the trust income for some period described in the subparts of this question. What does Section 2036 require to be included in \( D \)’s gross estate in the following alternative circumstances?

(a) One half of the income is to be paid to \( D \) for \( D \)’s life, remainder to Child \( C \) or \( C \)’s estate.

(b) All the income is to be paid to \( D \) annually, generally for \( D \)’s life, but \( D \) is entitled to no trust income earned in the three-month period preceding \( D \)’s death. The remainder and undistributed income is to be paid to Child \( C \) or \( C \)’s estate at \( D \)’s death.

(c) All the income is to be paid to \( D \) for ten years, when the trust is to terminate and the corpus is to be distributed to Child \( C \) or \( C \)’s estate. \( D \) dies after nine years have elapsed.

(2) Several years ago, \( D \) created a trust under which the income was to be paid to \( D \)’s sibling, \( S \), for \( S \)’s life, then to \( D \) for \( D \)’s life. Upon the death of the survivor of \( D \) and \( S \), the corpus was to be distributed to \( R \) or \( R \)’s estate. At \( D \)’s death more than three years later, \( D \) was survived by \( S \) and \( R \). The corpus of the trust was then worth $300,000, with \( S \)’s and \( R \)’s interests worth $100,000 and $200,000, respectively. What amount should be included in \( D \)’s gross estate?

(3) Grantor created a trust naming a bank as trustee. The trust income was to be expended equally for Grantor’s two children toward their support during their minority, which under state law was age 21. As each child came of age, that child became entitled to receive the child’s share of the trust income directly. Upon the death of each child, that child’s share of the trust corpus was to be distributed equally among the child’s children. The trust instrument contained suitable provisions for distribution of income and corpus in the case of premature death of a child or the child’s death without children. Grantor died when one of the children was age 15 and the other 22. To what extent, if any, does Section 2036 apply to the transfer?
(4) Consider the Section 2036 consequences to Homeowner, H, who, in the alternative, does the following:

(a) H transfers H’s residence to Child C for no consideration, and H continues to live in the residence until H’s death.
(b) H transfers the residence to C for no consideration, and H leases the property from C at its fair market value.
(c) H sells the residence to C for cash in an amount equal to its fair market value, and H continues to live in the residence until H’s death.
(d) H sells the residence to C for an interest-only note with a face value equal to the fair market value of the residence. Shortly after the sale, H executes a will that provides for forgiveness of the entire mortgage debt upon H’s death. H also forgives $14,000 of the principal obligation on an annual basis. H continues to live in the residence until H’s death pursuant to a lease entered into with C that provides for the rental of the residence at its fair rental value. At the time of the transfer the fair rental value and the interest obligation on the debt are close in amount.
(e) Same as question (4)(d), above, except that the note provides for payments that are part interest and part principal.

(5) Grantor transfers $1 million to a trust that provides income to Grantor for life, with a remainder to Grantor’s Child. On creation of the trust, the remainder interest is worth $300,000. Child transfers $300,000 of Child’s own funds to Grantor to purchase the remainder. At Grantor’s death, the corpus is worth $2 million. What amount is included in Grantor’s gross estate?

(6) Grantor creates a trust with income to X or X’s estate for Grantor’s life, and a remainder to Y or Y’s estate. Grantor predeceases X and Y (and Z, where Z appears in the subparts below). How, if at all, does Section 2036 apply in the following situations?

(a) Grantor, as trustee, retains a power to invade corpus for Z.
(b) Grantor, as trustee, retains a power to accumulate income and add it to corpus.
(c) Grantor, as trustee, retains a power to invade the corpus of the trust for X.
(d) Grantor names unrelated friend $E$ trustee, and $E$ holds a power to give income to $Z$.

(e) The facts are the same as in question (6)(d), above, but Grantor also retains a power to remove $E$ as trustee at any time and name Grantor trustee, holding all powers that $E$ held.

(f) The facts are the same as in question (6)(d), above, but Grantor names a corporate trustee and retains the right to remove the trustee without cause and to appoint another corporate trustee.

(g) Grantor names Grantor trustee and provides that the trustee is required to give $Z$ as much income as is needed each year for $Z$’s support and maintenance, with any excess income to go to $X$.

(h) Grantor names unrelated friend $E$ trustee and provides that the trustee is required to give Grantor as much income as is needed each year for Grantor’s support and maintenance, with any excess income to go to $X$.

(7) Decedent and Spouse each own 10 percent of the voting power of Corporation $A$. Decedent transfers $100,000 to a trust with income to $X$ for $X$’s life, and a remainder to $Y$ or $Y$’s estate. Decedent is trustee with normal fiduciary powers, including the right to vote stock. Assuming that both spouses each retain their 10 percent ownership, to what extent is Section 2036(a)(1) applicable in the following situations, when Decedent dies survived by Spouse and $X$:

(a) Decedent, as trustee, purchases $100,000 of $A$’s voting common stock (5 percent of the voting stock) from an unrelated third party.

(b) Same as question (7)(a), above, except that Decedent and Spouse each own 7.5 percent of $A$’s voting power.

(c) Same as question (7)(a), above, except the stock is nonvoting stock.

(d) Decedent, as trustee, invests the $100,000, one half in voting stock of $A$ (2.5 percent of the total voting stock) and one half in nonvoting stock, again purchased from an unrelated third party.
PROBLEM 4

(8) Schemer is a person not to be outdone by Congress and the Code. Aware of Section 2036, Schemer agrees with Sibling that Schemer will transfer $100,000 in trust, with income to Sibling for Sibling’s life, and a remainder to Sibling’s children or their estates, if Sibling transfers $100,000 to a trust with income to Schemer for life, and a remainder to Schemer’s children or their estates.

(a) What is Schemer trying to do, and will the plan succeed?
(b) What is the result to Schemer if Sibling places only $75,000 in the trust that Sibling creates?

(9) T put $100,000 worth of stock in trust with income to X (not a dependent) for ten years, and a remainder to Y or Y’s estate. T retained a power to accumulate dividends and add them to corpus. At T’s death six years later, the stock was worth $150,000 and the trust had accumulated $25,000 of dividend income.

(a) What is included in T’s gross estate under Section 2036?
(b) What is the result in question (9)(a), above, if the remainder had been to X or X’s estate rather than to Y or Y’s estate?

(10) Grantor transfers Grantor’s principal residence to a trust with income to Grantor for life, and a remainder to Child or Child’s estate.

(a) What is included in Grantor’s gross estate when, five years prior to death, Grantor sells the income interest, worth $25,000 (based on Grantor’s life expectancy and the rental value of the property), to Child for $25,000? At all times, the residence that makes up the corpus of the trust is worth $150,000.

(b) What would be included in Grantor’s gross estate if the sale of the income interest in question (10)(a), above (for its then fair market value), was made by Grantor two years prior to Grantor’s death?
PROBLEM 5

[SML&C refers to the abridged edition of Federal Estate and Gift Taxation (9th ed.).]

Assignment

Code: §§ 2035(a); 2037.

Regulations: §§ 20.2037-1(a)–20.2037-1(c); 20.7520-3(b)(3)(ii).

SML&C: ¶¶ 1.02[2][b][iii]; 4.09[1], 4.09[6].


Questions

(1) Grantor creates a trust with income to Spouse for life, remainder to Child if living and, if not, reversion to Grantor or Grantor’s estate.

(a) If Grantor predeceases Spouse and Child, is Section 2037 applicable to the transfer?

(b) Is any part of the value of the trust corpus included in Grantor’s gross estate?

(2) Grantor creates a trust with income to X or X’s estate for Grantor’s life, remainder to Y if Y is then living and, if not, to Z or Z’s estate. If Grantor predeceases X and Y, is anything includable in Grantor’s gross estate?

(3) What interest or interests, if any, are included in Grantor’s gross estate under Section 2037 (assuming the 5 percent test is met) in the following situations:
(a) Grantor creates a trust with income to Spouse, S, for life, reversion to Grantor if living and, if not, to A or A’s estate. Grantor predeceases S and A.

(b) What is the result if Grantor gave the reversion to A and died within two years of the gift?

(c) Grantor creates a trust with income to S for life, remainder to A if living and, if A is not living, reversion to Grantor if Grantor is living; if Grantor is not living, remainder to B or B’s estate. Grantor predeceases S and A.

(d) Same as question (3)(c), above, except that S is also given a general power of appointment over the property.

(e) Grantor, age 50, creates a trust with income to be accumulated for twenty years or until Grantor’s death, whichever is earlier, then principal and accumulated income to Child if living. Grantor dies ten years later, survived by Child. Assume that if Child were not living, principles of local law would effect a reversion to Grantor’s estate.

(f) Same as question (3)(e), above, except that Grantor is age 90 at the time of the transfer.

(g) Grantor creates a trust with income to S for Grantor’s life, with the remainder to X or Y or their estates in any portions Grantor determines; if Grantor fails to allocate the remainder, it is to pass equally to X and Y or their estates. Grantor predeceases all parties without allocating the remainder.

(h) Grantor creates a trust with income to S for S’s life, then income to Grantor for Grantor’s life, and a remainder to Children or their estates.
PROBLEM 6

[SML&C refers to the abridged edition of Federal Estate and Gift Taxation (9th ed.).]

Assignment

Code: §§ 2035(a), 2035(e); 2038.

Regulations: §§ 20.2038-1(a), 20.2038-1(b), 20.2038-1(e).

SML&C: ¶¶ 4.07[2][b][ii]; 4.10 (omit ¶ 4.10[10]).

Suggested references: Jennings v. Smith, 161 F2d 74 (2d Cir. 1947), 47-1 USTC ¶ 10,551, 35 AFTR 1203.

Old Colony Trust Co. v. United States, 423 F2d 601 (1st Cir. 1970), 70-1 USTC ¶ 12,667, 25 AFTR2d 1549.


Questions

(1) Grantor creates a trust with income to X or X’s estate for Grantor’s life, and a remainder to Y or Y’s estate. What is the result for Grantor under Section 2038 when Grantor predeceases all other parties in the following situations? This problem is similar to question (6) in Problem 4, relating to Section 2036. Consider the results under Section 2036, as well as Section 2038.

(a) Grantor, as trustee, retains a power to invade corpus for Z.
(b) Grantor, as trustee, retains a power to give the remainder to Z.
(c) Grantor, as trustee, retains a power to invade the corpus of the trust for X.
(d) Grantor provides that the trustee shall have power to give corpus to Z and names friend E trustee.
(e) Grantor creates the trust in question (1)(d), above, but Grantor retains a power to remove $E$ as trustee at any time and name Grantor as trustee.

(f) Grantor creates the trust in question (1)(d), above, but Grantor names a corporate trustee and retains the right to remove the trustee without cause and to appoint another corporate trustee.

(g) Grantor names Grantor trustee, and, as the trustee, Grantor is required to give unrelated $Z$ as much income as is needed each year for $Z$’s support and maintenance, with any excess income to go to $X$. What results if $Z$ is Grantor’s minor child?

(h) Grantor retains a power to order the third-party trustee to return all of the trust corpus to Grantor.

(i) Grantor retains the power in question (1)(h), above, but provides that it shall not become effective until six months after Grantor’s notice that Grantor intends to exercise it.

(j) Grantor names $X$ trustee and retains a power in conjunction with $X$ to direct that all of the trust corpus be returned to Grantor.

(k) Grantor retains a power subject to $X$’s and $Y$’s approval to require the third-party trustee to return the trust corpus to Grantor.

(2) Grantor creates a trust with income to $X$ (not a dependent) for ten years, and a remainder to $X$ or $X$’s estate. Grantor dies after five years, $X$ surviving.

    (a) What inclusion would be required under Sections 2036 and 2038 if Grantor retained a power to accumulate income?

    (b) What inclusion would be required under Sections 2036 and 2038 if Grantor retained a power to invade corpus for $X$?

(3) Settlor transfers some IBM stock to a trust and provides for the payment of income to $A$ for $A$’s life, and a remainder to $B$ or $B$’s estate. Settlor is trustee and, as trustee, holds the power to vote the stock, to sell the stock and reinvest in other stock, even if it is speculative or unproductive of income, and to allocate receipts other than cash dividends either to income or to
PROBLEM 6

principal. What are the estate tax consequences upon the death of Settlor under Sections 2036(a)(2) and 2038?

(4) Grantor makes an inter vivos outright gift of some rental property to Grantor’s Spouse. Spouse dies and devises the rental property to a trust that provides income to whichever of their Children the trustee decides for Children’s lives, and a remainder to Grandchildren. The trustee may also invade the corpus for any of the Children. Spouse names Grantor as trustee of the trust. Grantor predeceases all of the beneficiaries. What are the estate tax consequences to Grantor?

(5) Grantor created a revocable trust several years ago providing for income to Children and a remainder to Grandchildren. Within three years of Grantor’s death, Grantor relinquished the power to revoke the trust.

  (a) Is the corpus of the trust included in Grantor’s gross estate?
  (b) What is the result if, instead, the trust provided income to Grantor for life and a remainder to Children and Grantor relinquished both the income interest and the power to revoke the trust within three years of Grantor’s death?

(6) Having studied Sections 2035–2038, and assuming your Client wants to transfer assets to a trust whose corpus will not be included in Client’s gross estate, what suggestions do you have for Client to avoid Sections 2035–2038 inclusion in Client’s gross estate?
PROBLEM 7

[SML&C refers to the abridged edition of Federal Estate and Gift Taxation (9th ed.).]

Assignment

Code: § 2039. Skim §§ 72(b)(2), 72(b)(3); 2035; 2505.

Regulations: §§ 20.2039-1(a), 20.2039-1(b)(1), 20.2039-1(c).

SML&C: ¶ 4.11 (omit ¶¶ 4.11[2], 4.11[6]).

Suggested references: All v. McCobb, 321 F2d 633 (2d Cir. 1963), 63-2 USTC ¶ 12,173, 12 AFTR2d 6250.

Estate of Bergan v. Comm’r, 1 TC 543 (1943), acq. 1943 CB 2.

Questions

(1) In year 1, D entered into a contract with an insurance company under which D paid the company $750,000 then and there; they agreed that beginning in year 10, the company would pay D $9,000 per month for life and, after D’s death, the company would make like payments to D’s spouse, S, for as long as S should live. However, D died in year 8, survived by S.

(a) Apply Section 2039 to the facts above.

(b) What is the result in question (1)(a), above, if S had paid $250,000 of S’s funds toward the $750,000 cost of the contract?

(c) What is the result in question (1)(a), above, if $375,000 of the cost had been paid by D’s employer?

(d) Would the results in question (1)(a), above, be different if, pursuant to a “qualified” pension plan, D’s employer had purchased the contract for D and S?
(e) What is S’s income tax basis in the right to receive the future payments in question (1)(d), above? If D intended to make charitable donations at death, should D consider leaving other property to S and the pension proceeds to charity?

(2) In year 1, D “sold” D’s ranch to Child C. As full consideration for the transfer, C agreed to pay D $10,000 per month for D’s life, all obligations to cease upon D’s death. For several years, the net income from the ranch had been approximately $10,000 per month. D died in year 5, the current year.

(a) If the value of the ranch equals the value of C’s agreement to pay, of what estate tax significance is this arrangement upon D’s death?

(b) Would the result be different if the agreement called for $10,000 payments each month to D for D’s life and thereafter to D’s spouse for spouse’s life if spouse should survive D? (D’s spouse survives.)

(c) Assuming only payments to D and assuming that the ranch was worth $2 million and the value of C’s agreement to pay was $1 million, what are the estate tax consequences at D’s death? Consider generally whether the gift tax makes the conclusion acceptable.

(d) If, at the time of transfer, the ranch was worth $2 million and the agreement to pay was worth $1 million, and D died in year 2 at a time when the ranch was worth $2.5 million, what are the consequences to D’s estate?

(e) The arrangement in question (2)(a), above, is a “sale,” a transfer for adequate and full consideration, although if D outlives D’s life expectancy, it can be expensive for C. What alternative “sale” estate planning techniques are available to D?

There are also important income tax consequences to private arrangements in the form of property transfers in exchange for annuities. See IRC § 72(b)(2); Rev. Rul. 69-74, 1969-1 CB 43 (consequences to transferor); Rev. Rul. 55-119, 1955-1 CB 352 (consequences to transferee). But see Prop. Reg. §§ 1.72-6(e), 1.1001-1(j).
PROBLEM 8

[SML&C refers to the abridged edition of Federal Estate and Gift Taxation (9th ed.).]

Assignment

Code: §§ 2040; 2056(d)(1)(B).

Regulations: § 20.2040-1.

SML&C: ¶ 4.12 (omit ¶ 4.12[11]).

Suggested references:

- Gallenstein v. United States, 975 F2d 286 (6th Cir. 1992), 92-2 USTC ¶ 60,114, 70 AFTR2d 5683.
- Tuck v. United States, 282 F2d 405 (9th Cir. 1960), 60-2 USTC ¶ 11,968, 6 AFTR2d 6150.
- United States v. Heasty, 370 F2d 525 (10th Cir. 1966), 67-1 USTC ¶ 12,442, 19 AFTR2d 1767.

Questions

(1) Consider the estate taxation of property owned by the decedent and another.

(a) How does the Code deal with community property?

(b) How does the Code deal with a tenancy in common?

(c) How does the Code deal with a joint tenancy with right of survivorship?

(d) How does the Code deal with a tenancy by the entirety?

(e) Are there good policy reasons (and what are the reasons) for according different estate tax treatment to property owned by the decedent and another in various forms of joint ownership?

(f) How does the Code deal with the estate taxation of property
held in a revocable trust funded by the decedent? Are the consequences comparable to ownership with a right of survivorship?

(2) Child contributed $5,000 of Child’s funds to a joint savings account between Parent and Child. Upon Parent’s death several years later, $20,000 was in the account. The origin of $15,000 of the $20,000 is obscure, but there had been no withdrawals. How does the savings account affect Parent’s gross estate when Parent predeceases Child? See Estate of Drazen v. Comm’r, 48 TC 1 (1967).

(3) A parcel of joint tenancy real property owned by Parent and Child was worth $25,000 at its acquisition in 1995 and $50,000 at decedent’s death. What is the result under Section 2040 in the following situations?

(a) Parent paid the full $25,000 purchase price; Parent predeceases Child.
(b) Parent paid the full $25,000 purchase price; Child predeceases Parent.
(c) Parent and Child each contributed $12,500 of the purchase price; Parent predeceases Child.
(d) Parent contributed $15,000 of the purchase price and Child contributed $10,000; Parent predeceases Child.
(e) Grandparent devised the property to Parent and Child as joint tenants; Parent predeceases Child.
(f) What would the results be in questions (3)(a), (3)(b), and (3)(d), above, if the joint tenants were spouses, not Parent and Child?

(4) Discuss the estate tax consequences of the following transactions in joint tenancy property under Section 2040:

(a) Parent transfers stock outright to Child, who subsequently transfers the same stock, which has not appreciated, to Parent and Child as joint tenants. At the time of Child’s transfer, the stock is worth $5,000. Parent predeceases Child when the stock is worth $10,000.
(b) Same as question (4)(a), above, except that in the current year, Child predeceases Parent within three years of Child’s
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Parent transfers stock outright to Child. Child subsequently uses ordinary cash dividends paid on the stock to pay the entire purchase price for the stock in a joint tenancy between Parent and Child. Parent predeceases Child when the jointly owned stock is worth $10,000.

Parent transfers stock worth $5,000 outright to Child. When the stock has appreciated in value to $10,000, Child sells it and uses the proceeds to purchase other stock worth $10,000 in joint tenancy between Parent and Child. Parent predeceases Child when the jointly owned stock is worth $20,000.

Same as question (4)(d), above, except that rather than selling the original stock, Child transfers it when it is worth $10,000 to a joint tenancy between Parent and Child.

Parent purchased a piece of commercial property for $40,000 to which Parent and Child took title as joint tenants. Several years later, when the property had appreciated in value to $50,000, Parent and Child made a $25,000 improvement to the property (increasing its value to $75,000), with Child providing $15,000 and Parent providing $10,000 of the cost of the improvement. Parent predeceased Child several years later when the property was worth $125,000. What is included in Parent’s gross estate under Section 2040?

Grandparent purchased some land in the current year for $20,000 and contributed it to a joint tenancy with Child. Five years later, Grandparent became terminally ill and several weeks before Grandparent’s death, Grandparent and Child severed the joint tenancy property, then worth $50,000, and converted it to a tenancy-in-common.

What is the result for Grandparent’s gross estate when Grandparent dies with Child surviving?

What is the result for Child’s gross estate when Child dies with Grandparent surviving and the property worth $50,000?

What are the results in questions (6)(a) and (6)(b), above, if, rather than converting the property to a tenancy-in-common, Grandparent and Child transfer it retaining a joint life tenancy?
(7) **Community Property Question**: Recently married clients who live in a community property state ask your advice on whether they should take title to their newly acquired residence as joint tenants or as community property. What do you advise?
CHAPTER 1

An Overview of the Federal Taxes Imposed on Gratuitous Shifting of Interests in Property

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1.01 INTRODUCTION

Squander it! Be not only generous but a spendthrift. That is the way to beat the federal taxes imposed on gratuitous shifting of interests in property. For what one has at death may be subject to the estate tax as it passes to one’s survivors; and what is given away during life may not only be subject to the gift tax, but also taken into account in computing taxes on one’s estate. Even if during life or at death beneficial interests or expectancies in others are created, taxes may be imposed as they accede to enjoyment of those interests. This book is addressed, however, to those who do not heed this advice, to those who do indeed accumulate some wealth and undertake thoughtfully to pass it on to survivors, and to those who assist others in such thoughtful transmission.

The federal statutes imposing taxes on the gratuitous transmission of wealth present a highly intricate body of law. Its complexity is often increased rather than diminished by numerous and sometimes surprising administrative and judicial interpretations of the statute. Logic is an uncertain guide to understanding, except perhaps a kind of sophisticated logic within the matrix of the overall legislative plan. It is therefore risky to generalize about these important federal taxes. At the same time, however, it is not possible to appreciate the function of a cog in this legislative machine without some understanding of its relationship to the other moving parts. Therefore, risky or not, this chapter seeks to provide a panoramic picture of the whole machine. This must be a narrative outline of most of the following chapters, in which a zoom lens is used for close examination.¹

Can something simple be said about a subject that is itself far from simple?

1.02 THE ESTATE TAX

[1] Introduction

Since 1916, Congress has imposed a death duty in the form of an excise tax on the transfer of a decedent’s taxable estate. A multipurpose graduated rate

¹ All the footnote references in this chapter are to paragraphs (¶) in subsequent chapters of this book, where general observations made here are presented in detail. This overview disregards the federal transfer taxation consequences to nonresident noncitizens that are considered in the book. See especially ¶¶ 6.01–6.08, dealing with the federal estate taxation of such persons, and ¶¶ 7.01–7.07, dealing with treaties.
table is provided,\(^1\) which is used as well in the computation of taxes on lifetime gifts and, to a limited extent, on generation-skipping transfers. Congress has determined that lifetime gifts after 1976 are to be taken into account in determining estate tax rates. A person’s lifetime and death transfers are seen as a continuum rather than as separate transactions. This is the reason for the rather involved two-step computation provided in the Code. As a result of both the integration and the unified credit, generally once the estate tax imposed on an individual’s post-1976 gifts and taxable estate exceeds the amount of the individual’s unified credit,\(^2\) tax is paid on the excess at a flat 40 percent rate.

The taxable estate is determined by subtracting from the “gross estate”\(^3\) certain “deductions” authorized by the statute. Those concepts, both of which involve some artificiality, are discussed below.


### [a] Property Owned at Death

Property that a decedent owns at death is obviously subject to the estate tax, and its value enters into the computation of the value of the gross estate.\(^4\) Such property may encompass one’s home, bank accounts, and investments; but it also extends to amounts owing to the person as, for example, the principal of a loan one may have made to another during life (plus interest accrued on the loan); salary due from one’s employer, if not paid at the time of death; and amounts still to be paid for property that the decedent may have sold on a deferred-payment basis during life. Property need not be owned solely by the decedent or owned outright to have an impact on one’s gross estate. Thus, one’s share of community property or one’s interest in property owned as a tenant in common with another, or of a future interest, such as a remainder interest in a trust, or of an undistributed share in a prior decedent’s estate, all may have to be valued for inclusion in the value of the gross estate. Even property that is subject to a surviving spouse’s claim for dower, courtesy, or similar interest does not escape inclusion in the decedent’s gross estate.\(^5\) However, property that is subject to a qualified conservation easement is permitted an exclusion from the gross estate.\(^6\)

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\(^1\) See ¶ 2.01[3].
\(^2\) See ¶ 3.02.
\(^3\) See ¶ 4.01.
\(^4\) See ¶ 4.05.
\(^5\) See ¶ 4.06.
\(^6\) See ¶ 4.02[7].
The question may be raised as to whether an item of value that in some manner owes its origin to the decedent’s death and that is enjoyed thereafter by others must be included. The answer, not anticipated here in detail, will depend upon whether the statute itself provides a special rule for such an item (as it does for the proceeds of insurance on the decedent’s life) and, if not, whether it can correctly be said that the decedent had an interest in the item at death. For example, if the decedent had no interest in a worker’s compensation award paid to others by reason of the decedent’s service-connected death, the amount of the award will not enter into the determination of the decedent’s gross estate.

The general principle and subordinate concepts just suggested carry no special surprises. A tax on the transmission of property at death can quite appropriately be measured by the value of property rights that the decedent passes on at the time of death. However, the gross estate for tax purposes is by no means so restricted. Numerous statutory rules pull into the gross estate the value of property in which the decedent had little or no interest at death.

[b] Artificial Aspects of the Gross Estate

[i] Transfers near death. A death duty measured only by what the decedent owned at death could be easily avoided, at least in the usual case in which death is preceded by reminders of mortality. To protect against such avoidance, Congress initially, and for many years, treated as subject to the death tax the value of property interests that the decedent transferred gratuitously during life in contemplation of death. The fact that at death the decedent had no interest in the property was considered immaterial in taxing these substitutes for testamentary disposition.

After many years, Congress abandoned the awkward subjective contemplation-of-death intent test for includibility, replacing it with an objective nearness-to-death (three-year) test. Under the integrated tax system, very little additional revenue was generated by including all near-death transfers in the gross estate, usually at a high income tax cost to the government because of the income tax basis provisions. Congress has limited inclusion of near-death transfers to those certain transfers that have substantial potential for estate tax avoidance.\(^7\)

Of course, a lifetime transfer for full consideration in money or other property carries no threat to the estate tax. So Congress expressly made the near-death rule (as well as the rules relating to transfers with retained interests, transfers taking effect at death, and revocable transfers, all discussed here) inapplicable to the extent that the lifetime transfer was a bona fide sale for an

\(^7\) See ¶ 4.07[2].
adequate and full monetary consideration.\(^8\) A receipt of partial consideration for a lifetime transfer operates to reduce the amount otherwise includible in the gross estate by the amount of the partial consideration received.\(^9\)

A gross-up provision includes gift tax paid on all lifetime transfers made within three years of death.\(^10\)

**[ii] Transfers with enjoyment retained.** The right to enjoy property or to receive the income it produces is one of the attributes of outright ownership, and so is the right to designate which other person shall have such enjoyment or income. Either of these rights may be the only attribute of ownership in which a person is interested for the person’s life, if one has had the opportunity to say who shall ultimately receive property in which one once held all the interests. So it might seem that the person could avoid estate taxes by gratuitously transferring property during life, retaining only interests in it or controls over it that expire at death. In such circumstances, there would seem to be no transmission at death subject to estate tax.

However, Congressional power to impose a tax carries with it authority to assure that a properly adopted taxing plan will not be thwarted by artful devices. In the enactment of the very first estate tax, Congress required that there be included in the gross estate the value of interests in property transferred during life by the decedent if the nature of the transfer was such that possession or enjoyment of the transferred interest would not take effect until or after the decedent’s death. When the Supreme Court gave this seemingly comprehensive language a restrictive reading, Congress more explicitly provided for the estate taxation of lifetime transfers where for one’s life (or for some period tied to one’s life) the decedent kept enjoyment or control either by means of a retained income interest, the enjoyment of non-income-producing property, or a power to determine who will receive income or enjoyment during one’s lifetime.\(^11\) Congress has extended the concept of “enjoyment” to certain transfers with a retention of a right-to-vote stock of a controlled corporation.\(^12\) This is, of course, not to say that one should never make a transfer of the type first suggested in this paragraph, but only that if one does, one continues to be treated as the owner of the transferred property for estate tax purposes. It will be interesting later to examine the height of this and other congressional fences that protect the estate tax and to consider whether, as viewed by the courts, they are overprotective. Meanwhile, it should be observed that the rule discussed here applies in an objective way to what was done. In contrast to the now abandoned contemplation-of-death provision, it is not at all dependent on

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\(^8\) See \¶\ 4.07(2)[b][i], 4.08[1][a], 4.09[2], 4.10[2].

\(^9\) See \¶\ 4.15[2].

\(^10\) See \¶\ 4.07[3].

\(^11\) See \¶\ 4.08.

\(^12\) See \¶\ 4.08[6][d].
the decedent’s motivation for the lifetime transfer. Nor does any three-year or other cutoff period shield such transfers from the tax.

[iii] **Transfers conditioned upon survival.** A third provision artificially drawing property values into a decedent’s gross estate applies where, even though the decedent has retained no current enjoyment or income rights, nor any power to confer such enjoyment on another, the decedent has nevertheless made the transferee’s possession or enjoyment of the transferred property conditional upon surviving the decedent.\(^\text{13}\) Thus, if \(D\) places property in a trust generally for \(A\)’s benefit but requires the trustee to accumulate the trust income for \(D\)’s life and to distribute the corpus and accumulated income to \(A\) or \(A\)’s estate only upon \(D\)’s death, \(A\) cannot gain either possession or enjoyment of the property except by surviving \(D\). With an important qualification soon to be mentioned, Congress views such a transfer, taking effect as it does only on \(D\)’s death, as essentially a substitute for testamentary disposition of property and, accordingly, as a transfer that should be subject to the estate tax. This is so even though an independent trustee may have been appointed and \(D\) has relinquished both enjoyment and continuing control over the property. In contrast, if the income were to be accumulated for \(B\)’s life (someone other than \(D\)), perhaps because \(B\) would support \(A\) while living, and then corpus and accumulated income were to be paid to \(A\) at \(B\)’s death, the statute would not apply. In such circumstances, \(A\) would get possession and enjoyment when \(B\) died, and without regard to whether or not \(A\) survived \(D\).

Actually, a second qualification makes the statute inapplicable even in the first circumstance mentioned (accumulation for \(D\)’s life and then distribution to \(A\)), unless a further circumstance is supposed. The statute taxes the transferred property only if the decedent transferor has retained a reversionary interest in the property that has a significant value at the time of the decedent’s death. Thus, to bring this supposed transfer within the statute, it might be amended to say that the income was to be accumulated during \(D\)’s life and paid, along with the corpus, to \(A\) upon \(D\)’s death, but that if \(A\) predeceased \(D\), the trust was to terminate and the trust assets were to be returned to \(D\). Now, up to the time of \(D\)’s death, even though \(A\) survived \(D\), \(D\) would have a significant chance of getting the property back and both requirements of the statute are met; \(A\)’s interest is conditional on \(D\)’s death, and \(D\) has retained the requisite reversionary interest in the property. It should be noted that in such a case the statute taxes the value of the property transferred in which \(D\) had a possible reversion, not the value of the interest retained by the decedent, and it determines that value as of the date of \(D\)’s death. Thus, again, ownership of

\(^{13}\) See ¶ 4.09.
property is artificially attributed to a decedent for purposes of determining the value of D’s gross estate.

[iv] Revocable transfers. Finally, lifetime gratuitous transfers that are revocable leave the value of the transferred property in the decedent transferor’s gross estate.¹⁴ In some settings, this is more a realistic than an artificial concept. Suppose, for example, that D places property in a trust, the income to be paid to A for life, remainder to B or B’s estate, but retains the power at any time to revoke the trust and take back the property. Even though the trustee holds legal title to the property and A and B hold the beneficial interests, the title and beneficial interests both occupy a precarious perch subject to any whim of D; thus, it is more realistic to consider D the owner of the property. The statute does so. Moreover, even if D’s power does not extend to restoring any beneficial rights in D (the power reserved might be only to direct the trustee to pay the trust property over to C), the statute still applies. And it applies selectively to any interest in the transferred property that was subject to change by D at the time of D’s death. Thus, if A’s income interest was secure but D could substitute C for B as the remainderperson, and if D dies before A, the value of the remainder interest at the time of D’s death would form a part of D’s gross estate.

In recent years, a revocable trust (commonly referred to as a “living trust”) under which the transferor is generally both the trustee and the income beneficiary of the trust is often used as a device for avoiding probate. It can indeed accomplish that objective, although it is never suggested that a revocable trust can also avoid the estate tax. As far as that exaction is concerned, the settlor’s estate is left in the same position as it would have been if the trust had not been established.

The protective estate tax provisions concerning lifetime transfers may often overlap. Obviously, when they do, the gross estate is determined by applying the provision or combination of provisions that yields the largest inclusion in the gross estate.

[v] Annuities. Outside the area of lifetime transfers just discussed, Congress has laid down some other express rules for determining whether and to what extent the value of property interests forms a part of a decedent’s gross estate. These rules are now considered.

If during one’s lifetime a person purchases an annuity solely for the benefit of another, no special statutory rule applies. One has, of course, made a lifetime transfer, and whether the annuity will have estate tax significance will depend upon whether the transfer falls within the scope of the rules discussed earlier. There is no special gross estate rule either, in the case of an annuity purchased after a decedent’s death by one’s executor in accordance with the

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¹⁴ See ¶ 4.10.
terms of the will; funds used for the post-death purchase of an annuity will, however, have had their full estate tax impact as property the decedent owned at death.

A special statutory rule applies to so-called self-and-survivor or joint-and-survivor annuities a decedent purchased for the decedent’s benefit and for that of another. Many of these annuities are various forms of deferred compensation arrangements that are allowed some tax relief under the income tax, but not under the estate tax. If the decedent has been receiving, or at least has had a right to receive, payments under the policy at death and payments are to be made to others who survive after the decedent’s death, the circumstance may be similar to that in which the decedent made a lifetime transfer of property, retaining enjoyment until death, which, as already explained, renders the decedent’s estate taxable. The special rule on annuities taxes the decedent’s estate on the value of payments to be made to survivors, but only in an amount commensurate with the decedent’s contribution toward the consideration paid for the annuity policy or agreement. For example, if the decedent paid three quarters of the cost of acquisition of the policy, then three quarters of the value of the survivor’s rights are taxed in the decedent’s estate. If the annuitant who dies made no contribution to the cost of acquiring a self-and-survivor or joint-and-survivor policy, no portion of the value of amounts payable to survivors need be included in the decedent’s gross estate. Thus, in keeping with the nature of the estate tax, the annuity rule seeks to tax only values that can be said to have been transmitted to others by the decedent.

[vi] **Jointly held property.** Property that is held jointly by a decedent and others is the subject of specific estate tax legislation applicable to joint bank accounts and other joint tenancies and tenancies by the entirety (not tenancies in common where, as earlier suggested, a decedent’s actual interest is taxed) under which the death of one tenant causes that person’s full interest in the property to pass to the survivors. Because such property does not pass through the probate estate, laymen are prone to assume that it is not a part of the gross estate upon death of one of the tenants. An equally erroneous view is that the extent to which such property is taxed at death is invariably measured by the decedent’s lifetime interest, i.e., one half the value of the property in the usual joint tenancy. For a long time, Congress has measured the estate tax significance of property owned jointly with survivorship rights by reference to the decedent’s contribution to the cost of acquiring the property. Thus, the entire value of the property jointly owned, only a portion of it, or none of it may be included in the gross estate of the first joint tenant to die. The entire value is included if the tenant furnished all the consideration; none is included if the

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15 See ¶ 4.11.
16 See ¶ 4.12.
tenant contributed nothing; and a ratable portion is included if each tenant made a contribution to the acquisition of the property. If joint tenancy property was acquired by gift or bequest from another party (so that no joint tenant contributed to the cost of its acquisition), estate tax recognition is accorded the ratable interests of the joint tenants at their deaths, as if they were equal tenants in common. Under a significant exception, interspousal joint tenancies and tenancies by the entirety, however, are treated differently; only one half of the value of the property generally is included in the predeceasing spouse’s gross estate, regardless of the surviving spouse’s proportionate contribution to the cost of the property.\footnote{See ¶ 4.12[10].}

[vii] General powers of appointment. Under time-honored doctrine, a power of appointment over property is not itself property or an interest in property. Thus, if \( X \) creates a trust with the income payable to \( A \) for life and the remainder payable to \( B \) or \( C \), as \( D \) may appoint by deed or will, and \( D \) dies possessed of the power, \( D \) is not deemed to have any “interest” in the trust property. Indeed, on these facts there would seem small reason for taxing \( D \) if \( D \) never owned and transferred the property; and \( D \)’s rights extend only to preferring one remainderperson over another, and \( D \)’s estate is not subject to estate tax in this situation. Suppose, however, \( D \) could appoint the property to \( D \) or could otherwise appoint it less directly for \( D \)’s own benefit. Such a power then approaches actual ownership of the affected property. In effect, Congress has expressly provided that it shall be treated as ownership for estate tax purposes.\footnote{See ¶ 4.13.} Thus, possession of a “general” power of appointment at death is equated with ownership of the affected property. Provisions dealing in this manner with general powers of appointment should not be confused with others that also may rest on some kind of continuing control by the decedent over property. If the property involved is property that the decedent once owned and transferred while retaining certain powers, much less significant control in the decedent at death may leave the value of the property in the decedent’s gross estate. Instead, this rule concerns property that the decedent may never have owned, the decedent’s connection with it being only the power of appointment conferred on the decedent by another.

A lifetime exercise (or even a release or lapse) of a “general” power may be accorded the same estate tax treatment as if it were a lifetime transfer of the affected property by the decedent. A lifetime exercise (and sometimes the release or lapse) of a general power is tested for estate tax significance by the nature of the exercise: whether the nature of the mythical transfer by the decedent was such that if the decedent had made an actual transfer of the property, it would be brought into the decedent’s gross estate as a lifetime transfer with proscribed interests retained, a transfer conditional upon the decedent’s death,
or a revocable transfer. As in all these matters, there are details to consider later, but again, the main thrust of the special rule on powers is to equate a general power over property with actual ownership of the property.

[viii] Life insurance. If the decedent owned a policy of insurance on the decedent’s life and the proceeds were payable to the decedent’s estate, it would probably require no special rule to render the proceeds includible in the decedent’s gross estate. Whether that is so or not, the statute expressly taxes the proceeds of insurance on the decedent’s life that are “receivable by the executor,” and this expression is deemed broad enough to apply if the proceeds may be used for the benefit of the estate.\(^{19}\)

If, however, the proceeds are payable to others who survive the decedent, a different rule controls. Here, if the decedent at death had no incidents of ownership whatever in the policy (and had transferred no interest in it within three years of death), the proceeds escape taxation in the decedent’s estate. Thus, life insurance on the decedent is treated somewhat like any other property that the decedent might own, except that any ownership attribute in the policy in the decedent at the decedent’s death taints the entire proceeds for estate tax purposes.\(^{20}\) A power to change the beneficiaries of a policy, even though the change may not be made directly or indirectly to benefit the decedent, is one among many proscribed incidents of ownership that can cause estate tax liability.

[ix] Qualified terminable interest property. As previously explained, for gross estate inclusion purposes, sometimes a decedent is treated as owning property in which the decedent has no actual interest at all. This will be either property previously owned or, in the case of powers of appointment, property that the decedent had the power to obtain. However, a decedent spouse’s gross estate may include property even though the spouse never owned it and could not control its disposition. Its inclusion is required simply because the predeceasing spouse’s estate was allowed a marital deduction with respect to the property known as qualified terminable interest property.\(^{21}\)

c] Valuation

Every item included within a decedent’s gross estate must be valued. The value that must be established for estate tax purposes is generally a fair market value.\(^{22}\) Essentially, “fair market value” postulates a sale price that would be agreed upon by informed, willing buyers and willing sellers. In some in-

\(^{19}\) See ¶ 4.14[3].
\(^{20}\) See ¶ 4.14[4].
\(^{21}\) See ¶¶ 4.16, 5.06[8][d].
\(^{22}\) See ¶ 4.02[2].
stances, valuation is very nearly automatic. For example, the balance in a checking account is its own expression of value, and securities actively traded on a stock exchange may be valued in accordance with prices paid on the valuation date. At other times, an appraisal is necessary. Who can say at any point in time precisely what the value of 100 acres of unimproved land is, particularly if neither it nor substantially similar land has recently been bought or sold? What is the value of unlisted securities that have not recently been traded? Of stock in a closely held corporation? Of an interest in a limited liability company or a partnership? Of a sole proprietorship? Once such interests are initially valued, that valuation may be adjusted for premiums or discounts for such things as control or lack of control over the property or for its lack of marketability. Whatever the difficulties, the statute requires that a value be set for property and property interests that make up the gross estate.

All or a part of the decedent’s realty may sometimes be valued with reference to its actual use rather than according to its highest or best use. This rule attempts to accord tax relief for farms and small businesses. As property values are not static, the other aspect of the valuation question is the time at which, or as of which, evaluation is to be made. The general rule here, which accords with the nature of the tax, is that property is to be valued as of the date of death. Even for property transferred during life, the time of valuation is the same date of death if the value of the property is included in the value of the gross estate because it was the subject of an includible near-death transfer, or because it falls within one of the other rules relating to the artificial gross estate, which were previously discussed here.

The statute provides an elective alternative to the usual date-of-death rule for valuation. In general, all the assets of the estate (not just some) may be valued as of a date six months after death. The alternative, enacted after the great stock market crash of 1929, is a relief provision that takes account of a possible hiatus in the value of property that was owned by the decedent. It is obviously harsh to impose taxes at date-of-death values if, even before the estate assets can be marshaled and the taxes paid, the estate’s value has declined.

Congress has enacted various provisions dealing with the valuation of property interests. One section provides that the value of an interest subject to a buy-sell agreement or other contract or arrangement is, in general, to be determined without regard to the terms of the agreement. This provision

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23 See ¶ 4.02[4].
24 See ¶ 4.04.
25 See ¶ 4.02[2][a].
26 See ¶ 4.07[2].
27 See ¶ 4.03.
28 See ¶¶ 19.02–19.05.
29 See ¶¶ 19.02–19.05.
would have the effect of taxing the value of the interest at its full fair market value, even though the interest has to be sold at a lower amount. The section, however, provides an exception if the following three requirements are satisfied: (1) The agreement is a bona fide business arrangement; (2) it is not a device to transfer property to natural objects of one’s bounty at a discount price; and (3) its terms are “comparable to similar” arm’s-length arrangements. The regulations add a nonfamily arrangement that is treated as satisfying the foregoing exception requirements.

A second section provides that a lapse of a voting right or a liquidation right in a corporate or partnership entity shall be treated either as a transfer includible in the gross estate or as a gift (whichever is applicable) if the holder of such right and family members control the entity immediately before the lapse. The section also disregards an applicable restriction in valuation of an interest in a corporate or partnership entity where there is a transfer of the interest to a family member and family members control the entity. An applicable restriction is not disregarded if the restriction is commercially reasonable and arises out of financing provided by an unrelated party or if it is imposed by federal or state law.

[d] Summary

In very broad outline, the foregoing comments suggest the nature of the gross estate for federal estate tax purposes. The gross estate is generally comprised of property the decedent owned or effectively owned at death, property the decedent transferred inter vivos in a gratuitous manner but over which the decedent retained some degree of dominion and control, and property the decedent transferred inter vivos, but in an essentially testamentary manner. Congress, of course, does not purport to prohibit any property disposition or arrangement that one may choose to make. The tax may, however, inhibit some arrangements that would otherwise make sense. An arrangement that is expensive taxwise may certainly be the best, but usually not unless the tax cost is understood and weighed along with other considerations in advance.

30 See ¶ 19.04[3].
31 See ¶ 19.04[4].
32 See ¶ 19.05[2].
33 See ¶ 19.05[3].
34 See ¶ 19.05[3][b].
1.02

[3] Deductions

Authorized deductions must next be considered, for the measure of the tax is the “taxable estate,” a net figure, which is not the “gross estate.” Some deductions authorized by the statute rest directly on the notion that the estate tax exaction should be measured by only the net amount that the decedent can pass on at death or, more precisely, the net amount that the decedent is treated as able to pass on, keeping in mind the artificialities involved in the determination of the gross estate. Other deductions are authorized by the statute for policy reasons.

[a] Expenses, Indebtedness, and Taxes

To appropriately reflect the net value that a decedent passes on to others, Congress permits deductions for funeral and administration expenses. Such charges diminish what a decedent can transmit and are appropriately taken into account in measuring the death tax. Some will also see that administration expenses may give rise to income tax deductions as amounts expended for the management or conservation of income-producing property. An estate is an income tax-paying entity that may be entitled to these income tax deductions; and the same deductions may bear on the determination of estate tax liability. Congress imposes some restrictions, rightly or wrongly, on the use of some of these deductions for both purposes. Questions regarding the scope of these restrictions and their propriety may suitably be reserved for later examination.

The claims of one’s creditors obviously reduce what may be passed on, and any indebtedness that is a charge on one’s property has a like effect, even if the decedent has no personal liability with respect to the debt. Appropriately, Congress permits those obligations to enter into the computation of the net or “taxable” estate.

[b] Losses

Sometimes estate assets are destroyed during the administration of an estate. Where not insured or otherwise compensated for, such casualties do reduce the amount received by beneficiaries, and Congress has permitted such post-death occurrences to be taken into account in determining the net amount that a decedent is seen to transmit in the computation of the taxable estate.

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35 See ¶ 5.02.
36 See ¶¶ 5.03[2], 5.03[3].
37 See ¶¶ 5.03[6][a], 5.03[6][b].
38 See ¶¶ 5.03[4], 5.03[5].
39 See ¶ 5.04.
will come to mind, however, that the income tax also allows deductions for casualty losses and again there are restrictions on the use of the deduction for both taxes.\footnote{40}

[c] Charitable Deductions

As in the case of the income tax, Congress encourages philanthropy by way of an estate tax charitable deduction.\footnote{41} No dollar or percentage limitations are imposed on the amount of testamentary philanthropy that is deductible under the estate tax. To the extent that billions of dollars qualify for income, estate, and gift tax charitable deductions, the government forgoes a share of earnings or other wealth that might increase its tax revenues. A supporting assumption is that but for such beneficences, the government itself would have to expend sums to accomplish the works done by the charitable recipients. However, there are offsetting worries that generate a running criticism of the charitable deduction provisions and sporadic tinkering with their terms. This is especially so where a decedent seeks to mix private or individual benefits with philanthropy. Congress keeps a tight rein on such transfers, and detailed requirements of the statute must be carefully observed.\footnote{42}

[d] Marital Deduction

Subject to restrictions that disqualify many “terminable” interests in property, the amount of a bequest or devise to a spouse who survives the decedent is deducted in determining the taxable estate.\footnote{43} Although its objective is to allow tax-free interspousal transfers, Congress does impose some limitations on such transfers.\footnote{44} In general, the transfer of an interest in property to a spouse that may terminate does not qualify for the marital deduction. However, there are several exceptions to this terminable interest rule where, in effect, even though an interest is terminable, the government is certain that the property will become taxable either in the surviving spouse’s gross estate or upon an inter vivos transfer by the surviving spouse to a third party.\footnote{45} The most frequently used terminable interest exception is related to qualified terminable interest property. Another limitation on tax-free interspousal transfers applies if a surviving spouse is not a citizen of the United States. A marital deduction is

\footnote{40} See ¶ 5.04[4].
\footnote{41} See ¶ 5.05.
\footnote{42} See ¶¶ 5.05[4]–5.05[8].
\footnote{43} See ¶ 5.06.
\footnote{44} See ¶ 5.06[7].
\footnote{45} See ¶ 5.06[8].
denied, unless the interspousal transfer occurs through a qualified domestic trust, ensuring the government’s collection of revenue.  

[c] State Death Taxes

A final deduction is allowed for state death taxes. This deduction provides some estate tax relief to a decedent’s estate when the decedent’s property is subject to both federal and state transfer taxes at death.

[f] Summary

In summary, the “taxable estate” to which the tax rates are applied is the gross estate reduced by the amount of deductible funeral and administration expenses, claims and charges against property, casualty losses, charitable bequests, bequests to the decedent’s surviving spouse, and state death taxes paid.


The following steps are taken in the determination of liability for the federal estate tax:

1. Ascertain the total value of the decedent’s gross estate.
2. Ascertain the value of the decedent’s taxable estate.
3. Ascertain the amount of the decedent’s post-1976 taxable gifts that are not included in the decedent’s gross estate. Generally, but not always, this figure is the same amount that is reported for such gifts on the decedent’s prior gift tax returns.
4. Compute a tentative tax on the aggregate of steps 2 and 3 at the Section 2001(c) rates.
5. From this, subtract the amount of gift tax payable on all post-1976 gifts at the Section 2001(c) rates in effect at the date of the decedent’s death. This calculation yields the gross (before credits) estate tax.

Some reflection will reveal that the purpose of this seemingly zigzag plan is to permit the unification of post-1976 lifetime gifts not otherwise of estate tax.

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See ¶¶ 5.06[9], 5.07.

See ¶ 5.08.

See ¶ 2.01.

See ¶ 2.01[1][b].

See ¶ 2.01[2].
significance with testamentary transfers in the imposition of the Federal excise tax imposed on transfers of wealth.

[5] Credits

The term “gross estate tax” used in the description of the fifth item may be unfortunate. It does not, of course, imply an application of rates to the gross estate; instead, it identifies only a figure for tax liability before taking account of credits that may reduce the amount that must actually be paid. The credits that may be available are discussed in the following paragraphs.

[a] The Unified Credit

Traditionally, Congress has always permitted the tax-free testamentary transmission of some wealth and, even when an estate was large enough to incur some tax, at least a portion of all estates escaped tax. The unified credit against the estate tax currently offsets the amount of tax generated by a taxable estate equal to the applicable exemption amount, which is the total of a basic exclusion amount equal to $5 million adjusted for inflation after 2011 and a predeceased spouse’s unused exclusion amount reduced by any inter vivos taxable gifts made by the decedent.51 The credit not only affects tax liability, but also indirectly affects the requirements for the estate to file an estate tax return.52

[b] A Credit for Gift Taxes

If the decedent has paid or incurred liability for taxes on lifetime gratuitous transfers made before 1977 but, under the provisions artificially defining the gross estate, the value of the transferred property is included in the measure of the estate tax, the gift tax payment is treated as part payment of the estate tax. This is legislative expression of a congressional objective to not subject a single transfer to the rigors of both the estate and the gift taxes. Both taxes may be imposed on one transfer, but the credit allowed against the estate tax effectively eliminates the double tax aspect of the dual impositions.53 This credit is of diminishing importance. With respect to post-1976 gifts, the credit is in effect replaced by step 5 in the present computation of the estate tax.

51 See ¶ 3.02[1].
52 See ¶ 3.02[3].
53 See ¶ 3.04.
[c] A Credit for Estate Taxes Paid on Property Transmitted to the Decedent by Another Decedent

This credit, like the others, rests on an identifiable hardship that calls loudly for relief. For example, assume A dies, leaving property to B, who dies shortly thereafter, leaving it to C. The estate tax exactions on A’s and B’s estates might leave significantly less for C. Congress has determined that this type of tax attrition is appropriate only if each decedent enjoys the property for some considerable period. Consequently, if in our example, B dies within two years after A, B’s “gross estate tax” is determined in the conventional manner, but in determining the “net estate tax payable,” B’s executor may be able to claim as a credit the entire amount of estate tax paid by A’s estate on property that B received from A. As the period increases between the death of the decedent and the decedent’s benefactor, the hardship of successive estate taxes is considered to diminish; accordingly, Congress provides for a shrinkage of the credit at two-year intervals. When ten years have elapsed between the respective deaths, no credit is allowed.54

[d] A Credit for Foreign Death Taxes

The gross estate of a decedent who was a citizen or resident of the United States (this summary discussion does not extend to estates of nonresident noncitizens that, along with a discussion of tax treaties, are the subject of later chapters) includes the value of all the decedent’s property wherever situated. Some time ago Congress eliminated a provision that had excluded foreign realty. Consequently, portions of an estate may be subject to not only federal death duties but to those of foreign countries as well. There is nothing unconstitutional about such multiple exactions, but Congress provides relief from the weight of the foreign exaction. The relief is in the form of a credit against the federal tax, in this instance for the amount of foreign death taxes paid on property included in the decedent’s gross estate. This is an expressed statutory rule not dependent upon conventions or treaties with other countries that often do affect the determination of liability for federal taxes when a taxpayer’s interests and activities extend across national boundaries.55

[6] Payment of the Estate Tax

The statute fixes the obligation to pay the tax on the “executor,” which term, in the case of intestacy, is defined to encompass administrators of the dece-
dent’s estate, both de jure and de facto.\textsuperscript{56} If required, an estate tax return generally must be filed and the estate taxes paid within nine months of the decedent’s death, although, as in the case of the income and gift taxes, a six-month extension of time to file is available and in other circumstances both obligations may be extended without a penalty being imposed.\textsuperscript{57} However, interest is imposed on any extension of time for payment. The actual burden of the tax generally will fall on the estate subject to probate and upon that portion that is not subject to specific bequests, i.e., the residuary estate. The obligation of the executor to pay does not amount to personal liability of the executor, except in the case of certain improprieties on the executor’s part.\textsuperscript{58}

Congress could be content with assurances that the tax will be paid without regard to whose purse is actually lightened by the exaction. In general, the primary objective of assuring collection is achieved by authorizing collection out of any property that forms a part of the gross estate. However, the primary burden generally falls on the residuary estate,\textsuperscript{59} subject to specific federal statutory rules that may ultimately fasten liability for a share of the tax on recipients of the proceeds of insurance on the decedent’s life\textsuperscript{60} and property that was subject to a power of appointment in the decedent\textsuperscript{61} if, under the artificial gross estate concepts described here, such insurance or appointive property enters into the measurement of the tax. The federal statutes provide a right of recovery in the case of certain property qualifying for the marital deduction\textsuperscript{62} and certain property involved in a transfer with a retained income interest or a power to alter the income interest.\textsuperscript{63} Beyond this, many states have “apportionment” statutes that often determine the ultimate tax burden.\textsuperscript{64}

\section*{1.03 THE GIFT TAX}

\subsection*{Introduction}

The gift tax is a junior partner of the estate tax. It is junior in age. After a brief flurry of gift taxation in the 1920s, the present gift tax statute originated

\begin{itemize}
\item \textsuperscript{56} See § 2.02, 8.02.
\item \textsuperscript{57} See § 2.02[1][c].
\item \textsuperscript{58} See § 8.03.
\item \textsuperscript{59} See § 8.04.
\item \textsuperscript{60} See § 8.05.
\item \textsuperscript{61} See § 8.06.
\item \textsuperscript{62} See § 8.07.
\item \textsuperscript{63} See §§ 4.08, 8.08.
\item \textsuperscript{64} See § 8.04[2].
\end{itemize}
in 1932, its date of inception following that of the estate tax by some sixteen years. It is no longer junior in stature. Apart from exclusions and deductions, its rates, like those of the estate tax, are currently found in the multipurpose rate table. For most of its life, the tax has been imposed on an annual basis, as it is now.\footnote{1}{See ¶ 9.04[5][c].}

As in the case of the estate tax, the gift tax is an excise, a tax on the transmission of property. Thus, the tax is imposed on the donor and determined with reference to all the donor’s gifts,\footnote{2}{See ¶ 9.03[3].} while identification of the donee is required for certain exclusion and deduction purposes, the gift tax is not, like the income tax, a tax on receipts. Nevertheless, a donee may incur liability for the gift tax if the donor does not pay the tax for which the donor is primarily liable.\footnote{3}{See ¶ 9.04[6][b].}

The gift tax and the estate tax are in pari materia, taxing the gratuitous transmission of wealth either during life or at death. As a result of the unified credit for gift taxes, even though the gift tax rates are found in the multipurpose graduated rate table, the gift tax, like the estate tax, is effectively only imposed at a flat 40 percent rate.\footnote{4}{See ¶ 9.03[2].} The gift tax is determined not just with gifts made in the taxable period for which the return is filed, but with reference to all taxable gifts made by the donor since the inception of the gift tax in 1932.\footnote{5}{See ¶ 9.03[3].}

The current estate tax computation resembles this more seasoned gift tax device. There still may be substantial advantage in spreading gifts to get the benefit of exclusions that recur annually. However, to the extent that gifts are taxable, the rate of tax generally is the same, regardless of whether a very large gift is made all in one year or spread over several years. The accumulative approach of the rate table will produce the same amount of gift tax in either case. Computation is explained at the end of this gift tax summary, but the point will be clearer here if one compares the usual income tax consequences of spreading income over several years.

### [2] Transfers Subject to the Gift Tax

The gift tax is, and is intended to be, comprehensive. While limited to transfers of property (no tax is payable on donated services), anything of value may be the subject of a taxable transfer.\footnote{6}{See ¶ 10.01[3].} The tax applies to cash gifts and to those in the form of realty or tangible or intangible personal property. Nor need gifts...
be made directly; one’s payment of one’s child’s mortgage or interest on the mortgage is a gift to the child. Beyond this, any discernible gratuitous shifting of financial advantage from one to another may constitute a gift.

[a] Dominion and Control

A timing question can arise with respect to gifts that take the form of something less than an outright transfer. The key to answering the question of when a gift is made is the determination of whether the donor has relinquished dominion and control over the property or property interest transferred.\(^7\) For example, a transfer of property into a trust may constitute a gift. However, if the settlor of the trust retains a right to revoke it, the settlor has not relinquished control over the property and no gift has yet occurred. If the settlor should later relinquish the right to revoke, the transfer would then be complete for gift tax purposes. This suggests two related thoughts. First, the time at which a gift becomes complete determines when it must be reported and gift tax paid. Second, valuation of the gift is to be made at the time the gift becomes complete. Thus, if in the year 2000, A placed 100 shares of Apple stock in a revocable trust for others and then in the current year relinquished the power of revocation, the gift tax liability on the transfer would be measured not by the lower value of the stock when it was transferred to the trust, but by its much greater value when the gift became complete.\(^8\) Furthermore, the income tax dominion and control rules do not necessarily mesh with the transfer tax rules; however, this may work to a transfer tax planner’s advantage.\(^9\)

It should not be assumed from the foregoing example that a transfer is incomplete only if the transferor retains a power to take the property back for the transferor’s own benefit. It is likewise treated as incomplete if the transferor retains merely the right to shift the interests of others upon whom a financial benefit is only tentatively conferred. However, for gift tax purposes a transfer is deemed complete if the donor retains only a right to alter the time or manner of the enjoyment of the gift by the donee. Also, a transfer is considered complete if the transferor confers control over the property on a third person while relinquishing all control in the transferor.

In this light, it might seem that the gift tax and the estate tax mesh pretty well, and sometimes they do. That is, a transfer may escape the gift tax as not yet complete for the very reason that makes it subject to estate tax when the donor dies. However, it must be stated emphatically that a determination that a particular transfer is subject to estate tax upon the transferor’s death is no as-

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\(^7\) See \(\S\) 10.01[4]–\(\S\) 10.01[9].
\(^8\) See \(\S\) 10.02[1].
\(^9\) See \(\S\) 10.01[10][c].
1.03 assurance that the transfer is not subject to gift tax when made. For example, a transfer in trust in which the settlor retains the right to the trust income for life is subject to the gift tax on the remainder, notwithstanding the includibility of the value of the remainder in the settlor’s gross estate. Recall, however, that actual estate tax liability will be diminished either by way of credit for gift tax paid or, as it regards post-1976 gifts, by step 5 in the computation of the estate tax.

Of course, for gift tax as well as estate tax purposes, the interest in property that has been gratuitously transferred must be identified. Thus, if our trust settlor provided that upon the settlor’s death the trust property was to be paid to unrelated R or R’s estate, the gift tax is measured by the value of the remainder interest at the time of the transfer. The life interest retained by the transferor has not been the subject of a gift; and the circumstance is much the same as if a donor owning three acres of land gave away two but kept one.

Other lifetime transfers that are subjected to estate tax because they were intended to take effect only after the transferor’s death may likewise be subject to gift tax. For example, if D transfers property to a trust, income to be paid to unrelated B for life and the corpus to be returned to D if living but, if not, remainder to be paid to unrelated R or R’s estate, D has made a taxable gift of the value of B’s life interest and R’s contingent remainder even though, upon D’s death survived by B, the value of the remainder would be subjected to estate tax. D has relinquished control of the interests of B and R, even though D has retained an interest in the property that might result in D getting it back while D is alive. The gift tax result is not changed if B dies while D is living (so that D does get the property back and R’s remainder is wiped out). A snapshot is taken of the circumstances that exist at the time of the transfer, and the photograph is not to be retouched with the aid of hindsight based on subsequent events.

Congress has enacted a series of special gift tax valuation rules to combat perceived weaknesses in the gift tax structure. Under one such rule, concern with donors using the actuarial valuation tables to their benefit in making transfers to family members has caused Congress in such circumstances to conclusively presume that a donor-retained interest in property is valued at zero. Thus, even though only an income interest or a remainder interest is transferred to a family member with the remaining interests in the property retained by the donor, the value of the transferred interest is equal to the full value of the property. The special valuation rule applies even where adequate and full consideration is received for the transferred interest. This special valuation rule plays havoc with some of the long-standing gift tax concepts dis-

10 See ¶ 10.01[10].
11 See ¶¶ 19.01–19.05.
12 See ¶ 19.03[1].
cussed earlier, although relief is provided when double transfer taxation occurs. Typically, Congress throws in some exceptions to this special valuation rule, including exceptions for qualified personal residence trusts and other qualified retained interests.

A second special valuation of retained interests rule applies where a donor directly or indirectly uses the transfer of a corporate or partnership interest in an attempt to freeze (avoid further appreciation in the value of a retained interest) the value of the donor’s gross estate. If a donor transfers an interest in the entity to a family member and retains an interest in which the donor and/or the family members have the discretion as to whether to make distributions to the donor with respect to the retained interest, the discretionary rights are valued at zero, thereby increasing the value of the transferred interest. This rule also applies even though adequate consideration is received for the transferred interest. Again, there are several exceptions to this special valuation rule, and relief provisions come into play if double taxation occurs.

Under general gift tax principles, if one buys property that one requires to be transferred to oneself and another as joint tenants with right of survivorship, one has made a gift to the other of the value of the other’s interest (or, stated differently, of the value of the property less the value of the interest retained in it by the purchaser). If the property is later sold and the proceeds of sale are divided between them, either joint tenant makes a gift to the other if, in the division, the tenant receives less than the share of the proceeds that represents the value of the tenant’s interest in the property at the time of the sale. Thus, in the case of an ordinary joint tenancy created by a purchase funded by one of the two parties, the purchaser who paid for the property would make a gift of one-half its value at the time of the purchase. An equal division of the proceeds at the time of sale would constitute no gift, but a second gift would occur if the proceeds were not split equally.

[b] Consideration

Consideration received for property interests transferred generally plays about the same role in both estate tax and gift tax matters. A transfer for full money value generally is a neutral event for purposes of either tax. If partial consideration is received in the case of a lifetime transfer, the measure of the gift is the amount by which the value of the property transferred exceeds the

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13 See ¶ 19.03[4][c].
14 See ¶ 19.03[3].
15 See ¶ 19.02.
16 See ¶ 19.02[2][a][i].
17 See ¶¶ 19.02[3], 19.02[5][c].
consideration received. In fact, the courts have viewed the statutory expres-
sion of this rule as a definition of “gift” for gift tax purposes. In general, a
transfer for less than adequate consideration in money’s worth is a gift, with-
out regard for showing of donative intent, such as is required to invoke the in-
come tax gift exclusion. The gift tax approach to the matter of considera-
tion should be viewed against the background of the estate tax. In effect, by the
gift tax Congress seeks to tax the transfer of property that would otherwise be
subject to estate tax when the donor died. To the extent a transferor receives
consideration for a transfer, the property potentially subject to estate tax is not
diminished—it is more a matter of substitution of one asset for another. No
gift tax is needed (and none is imposed) to protect the estate tax in the case of
such substitutions, but it will be necessary later to take a close look at what
can be treated as consideration for these purposes.

The gift tax statute is far less comprehensive than the estate tax statute in
identifying transfers subject to the tax. Consequently, detailed rules in the area
have developed largely by way of administrative and judicial decisions in a
manner similar to the growth of the common law. Nevertheless, Congress has
marked off a few areas for specific legislative treatment. They are briefly
noted in following paragraphs.

[c] General Powers of Appointment

As a power of appointment over property is not an interest in property,
one who exercises such a power, with the effect that there is a shift in owner-
ship of the property subject to the power, has not made a transfer of the prop-
erty. Nevertheless, if the power holder had wide discretion as to its exercise,
even to the point of using the property directly or indirectly for one’s own
benefit, one would have something very close to complete ownership of the af-
acted property. Thus, here, as in the case of the estate tax, Congress has by
statute essentially equated a general power with ownership. The shifting of
property interests, which is occasioned by the exercise (or sometimes the re-
lease or lapse) of a general power of appointment, is artificially treated as a
transfer of property for gift tax purposes. Whether the constructive transfer
constitutes a gift still remains, of course, to be determined under the general
principles of the gift tax. For example, one cannot make a gift to oneself;
therefore, if a person exercises a power by appointing the subject property to
oneself, no gift has occurred, even though the statute expressly treats such an
exercise as a “transfer.” Again, the result should be viewed against the back-
ground of the estate tax. Before exercise, the property was potentially includi-

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18 See ¶ 10.02[3].
19 See ¶¶ 10.02[4]–10.02[6].
20 See ¶ 10.04.
ble in the estate of the power holder by reason of the power holder having the
general power over the property. After exercise, the property is likewise poten-
tially includible, but now because it is property that the power holder actually
owns. There is no policy reason for subjecting the lifetime exercise of the
power to the gift tax, and happily, in some circumstances such as this, the es-
tate and gift taxes do mesh nicely in this respect.

[d] Generation-Skipping Transfer Tax

The third wealth transfer tax is the generation-skipping transfer tax, ad-
dressed in more detail later in this chapter. One type of taxable genera-
tion-skipping transfer is the inter vivos direct skip. An inter vivos direct skip is
also a gift subject to gift tax. To further complicate matters and to make the
transfer more tax inclusive, any generation-skipping transfer tax liability paid
with respect to an inter vivos direct skip is treated as an additional gift transfer
for gift tax purposes.\(^{21}\)

[e] Divorce Transfers

Interspousal transfers upon the occasion of a divorce can be within the
scope of general gift tax principles; but they may also escape the gift tax under
express statutory rules. In general, Congress has said that such transfers in sat-
isfaction of marital rights (and certain support rights of minor children), if
made under a written agreement that is entered into not more than one year
prior to or two years subsequent to a divorce, shall be treated as made for full
consideration, thus avoiding the gift tax.\(^{22}\)

[f] Disclaimers

Usually, a simple “no, thank you” constitutes a polite rejection of an of-
fer. In the tax area, however, the Service has often asserted that a would-be re-
jecting transferee of property in effect accepted the property and then also
made a transfer of it by way of the transferee’s purported rejection. In the case
of the gift tax, this can raise the question of whether there were two gifts, or
one, or none. Congress has supplied potential donee-donors with a statutory
procedure that, if followed, supports a conclusion that no transfer ever oc-
curred.\(^{23}\) Although the procedure is expressed in the gift tax chapter of the

\(^{21}\) See ¶ 10.05.

\(^{22}\) See ¶ 10.06.

\(^{23}\) See ¶ 10.07.
Code, similar problems arising under the estate tax and the tax on generation-skipping transfers are determined according to its terms.24

[g] Qualified Terminable Interest Property

A donor may be treated as owning an interest in property that the donor never owned outright or even had the power to acquire or to dispose of, simply because the donor’s spouse was previously allowed a marital deduction for a transfer of the property. Inter vivos actions on the donor’s part with respect to the income from the property may trigger a taxable transfer by the donor of the interests other than the donor’s own interests for gift tax purposes.25

[3] Exclusions

Another gift tax concept, exclusions, plays a significant role in the computation of the gift tax. It can quickly be seen that the gift tax has the capacity to be an atrocious nuisance. Suppose A takes adult child, B, to dinner the night that B’s first child is born. A makes a gift to B, of course; so must the gift tax be figured more or less along with the state sales tax on the dinner? The next day, A buys a bassinet for the new baby and a week later pays $500 in doctor and hospital bills relating to the birth of the grandchild. Are these gifts subject to tax? Probably not. At this point it might be noted parenthetically that not all payments for the needs and desires of children fall into the gift category at all. A person’s discharge of the person’s obligation to support another is regarded as beyond the reach of the gift tax statute,26 despite the otherwise broad meaning accorded the expression “the transfer of property by gift.” Thus, looking back, it will be seen that the hypothetical questions raised (transfers to or for the benefit of an adult child) were framed so as not to involve the mere discharge of support obligations. What then may remove the transactions from the reach of the gift tax?

Since its inception, the gift tax statute has permitted a donor to make quite substantial tax-free gifts each year. In effect, Congress is saying that birthday, wedding, and other occasional gifts within reasonable limits do not constitute a significant transmission of wealth that would threaten the efficacy of the estate tax, and consequently, such gifts need not be subjected to the gift tax. How generous, then, is this annual exclusion? The answer is: somewhat more generous than its origin and purpose might suggest.

24 See ¶¶ 4.18, 17.04[3].
25 See ¶ 10.08.
26 See ¶ 10.02[5].
The statute excludes entirely from the computation of taxable gifts otherwise taxable transfers by a donor of amounts up to $14,000 to each of any number of donees. This exclusion recurs annually. Thus, there is a $14,000 ($10,000 indexed for inflation after 1998) “annual exclusion.” If gifts are made to five donees, the exclusion for the year amounts to $70,000. Five $14,000 gifts can likewise be made the next calendar year, and so on indefinitely, without incurring any gift tax liability. Moreover, the exclusion does not simply eliminate small gifts; it works as well to reduce the significant amount of large gifts. Thus, if A gives B $100,000 in cash, the “included” gift for the taxable period (the amount taken into account in determining A’s taxable gifts) is only $86,000.

The annual exclusion is not available to reduce all manner of gifts; it applies only to gifts of present interests in property. For example, if D’s only transfer in a year is in trust, the income to be paid to B for life, remainder to C or C’s estate, D has made gifts to both B and C, each of whom receives a beneficial interest in the trust property. Does this gift warrant two annual exclusions? No. Only one is allowed for the present interest transferred to B; the future interest given to C is disqualified. Thus, if the value of the property transferred to the trust is $15,000 and B’s life interest is properly valued at $6,000, and C’s remainder interest at $9,000, then the gift, after taking account of the exclusion, is $9,000 ($15,000 less $6,000, the excludible portion).

The disqualification of future interests for the annual exclusion has created some problems in the making of excludible gifts to minors; current statutory relief from such difficulties is considered in a later chapter.

Also excluded from the clutches of the gift tax, regardless of whom the payments benefit, or the amount of the payments, are tuition payments that are made directly to an educational organization and medical expense payments that are made directly to a provider of medical care.


If one spreads one’s generosity among numerous donees and over a considerable number of years, one can indeed transmit a substantial amount of wealth tax-free. In addition, gift-splitting offers a further ameliorating provision that sometimes has the effect of doubling this advantage.

A married donor can, with the donor’s spouse’s consent, elect to treat the donor’s gifts as if they were made one half by each spouse. Thus, if A makes

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27 See ¶ 9.04[1].
28 See ¶ 9.04[1][f].
29 See ¶ 9.04[2].
30 See ¶ 10.03.
[¶ 1.03[5] OVERVIEW

a $28,000 gift to \( B \) and the requisite election is made, then for computation purposes \( A \)'s gift becomes a $14,000 gift by \( A \) and a $14,000 gift by \( A \)'s spouse, all tax-free because the gifts are within the annual exclusions of the two taxpayers. \( A \) could make $28,000 gifts to each of five donees (or any other number) and, with the advantage of the “split-gift” provision, entirely escape gift tax on gifts amounting to $140,000 (or $28,000 times the number). This, too, could be done annually and indefinitely. The concept is a wholly artificial one; the gifts, in fact, may be made entirely by one spouse and still be “considered” as if made one-half by each. The split-gift provision may have a minimizing effect on tax liability in two other respects, as will subsequently be mentioned.


Gift tax rates apply only to a net figure, “taxable gifts,” analogous to the “taxable estate” or “taxable income,” so it becomes necessary to consider gift tax deductions. The gift tax statute provides for only two deductions in the computation of taxable gifts, and each bears resemblance to the policy-related estate tax deductions previously noted.

[a] Charitable Deduction

Charitable gifts escape gift tax by way of a deduction unrestricted by any dollar or other limitation.\(^31\) However, to be deductible, a charitable contribution must meet certain formal requirements and must be made to a qualified recipient. Philanthropy mixed with private objectives raises gift tax problems similar to those suggested earlier with regard to the estate tax deduction for testamentary philanthropy.

[b] Marital Deduction

Finally, there is a gift tax marital deduction.\(^32\) In general, it removes from taxable gifts the value of property given by one spouse to the other. “Terminable interest” rules and a transfer to a spouse who is not a citizen of the United States sometimes disqualify a transfer for the deduction, just as in the case of the estate tax, but there are again multiple exceptions to the rules. Exceptions to the terminable interest rule are made if the property will return to the donor or will be taxable either in the spouse’s estate or upon an inter vivos transfer by the spouse to a third party. An increased annual exclusion is allowed rather

\(^{31}\) See ¶ 11.02.

\(^{32}\) See ¶ 11.03.
than any deduction for transfers to the noncitizen spouse if the transfer would qualify for a marital deduction if the spouse was a citizen of the United States. The deduction, again, is traceable to a congressional decision to allow interspousal transfers to be made without immediate tax consequences.


The accumulative nature of the gift tax approach to rates fostered a recondite legislative prescription for computation of the tax. Congress has always sought to tax taxable gifts for a particular period at rates determined by taxable gifts made in all previous periods. The gift tax now shares the multipurpose rate table with the estate tax. Like the estate tax, the gift tax is arrived at by a dual computation:

1. Determination of a tax figure under the current rate table for all taxable gifts, aggregating current and past taxable gifts.
2. Determination of a tax figure under the current rate table for past taxable gifts only, excluding those made in the current period. The tax for the period emerges when the second figure is subtracted from the first.33

While it might seem that somehow past gifts are being taxed again, this is clearly not so; subtraction of the second figure nullifies any tax attributable to past gifts in the first figure, and the only effect of taking past gifts into account is to make certain that current gifts, when considered in conjunction with the gift tax credit, are being appropriately taxed.

On the other hand, the split-gift provision should once more be called to mind. Gifts by two taxpayers of $6 million each may attract less tax liability than a $12 million gift by one. Thus, in the case of a married donor, not only may the election of the gift-splitting provision reduce taxable gifts by way of invoking another’s annual exclusion, but also, to the extent that taxable gifts emerge, two unified credits may offset any gift tax liability rather than one.

Under the statutory system, past taxable gifts must be taken into account even if the taxpayer failed to report them or otherwise did not pay tax on them.34 In determining the amount of such prior gifts, the law in effect at the time of the gift controls. Furthermore, if the statute of limitations has run, the taxpayer’s treatment of the amount of such gifts, both valuation and the law involved may determine the amount of such gifts.35 However, even if the amount of the donor’s prior gifts is altered in the computation, this does not

33 See ¶ 9.03[3].
34 See ¶ 9.05[1].
35 See ¶ 9.05[2].
violate the limitations statute, as the effect is not to collect any tax on such prior gifts but only to see that they play their proper role in determining currently applicable rates.

[7] The Gift Tax Credit

A unified credit applies to the gift tax as well as the estate tax.\(^{36}\) Similar to its role under the estate tax, the credit generally offsets the gift tax liability on taxable transfers equal to the applicable exemption amount (the basic exclusion amount of $5 million indexed for inflation and a predeceased spouse’s unused exclusion amount).

Are two free transmissions of that magnitude granted, one during life and the other at death? No. When the gift tax credit takes the place of gift tax payment, it reduces dollar for dollar the reduction for gift tax payable in step 5 of the estate tax computation. Consequently, although it may require some reflection to understand it, the credit is used effectively only once to offset transfer tax liability on all taxable gratuitous transfers by an individual during life and at death.\(^ {37}\)

[8] Payment of the Gift Tax

As previously indicated, the gift tax is computed on an annual basis. Whether a return must be filed for any calendar year depends on whether a taxpayer has made gifts in that year that exceed the taxpayer’s annual exclusions, that are not qualified transfers for tuition or medical care, and generally that do not qualify for the charitable deduction or the marital deduction. This is so even if no tax will be due because of gift-splitting, properly asserted deductions, or the unified credit. If a gift tax return is required to be filed for a year, it generally must be filed by April 15 of the following year, a date familiar to calendar-year income taxpayers, although as in the case of the estate and income taxes, a six-month extension of time to file is available.

Perhaps only implicit in what has been said here, the gift tax is not imposed on an individual gift basis. It may be necessary, of course, to look at a particular gift and to identify the donee for the purpose of asserting the annual exclusion or the right to a deduction. However, the tax is computed on aggregate gifts by the donor during the taxable period, much as the estate tax is imposed, not on individual bequests or inheritances, but on the decedent’s transmission of the decedent’s estate. Just as the tax is figured on the donor’s

\(^{36}\) See ¶ 3.02, 9.06.

\(^{37}\) See ¶ 3.02.
gratuitous transmissions, so is the donor made primarily liable for payment of the tax. However, every good donee should know that the donee may incur gift tax liability if the donor fails to pay the tax. In fact, the donee’s liability may be in an amount equal to the full value of the gift received, not merely the tax attributable to the donee’s gift, as one of possibly many made by the donor in the same taxable period.

¶ 1.04 THE TAX ON GENERATION-SKIPPING TRANSFERS

[1] Introduction

The estate tax and the gift tax apply to gratuitous transmissions of wealth by one who is its owner or by one to whom ownership may reasonably be imputed. Consequently, they generally do not apply to mere shifts in interests, such as occur upon distributions from an existing trust to a beneficiary or upon the termination of a trust or a trust beneficiary’s interest, leaving others in possession of or with the enjoyment of trust property. For many years, therefore, estate planners had used the trust (and equivalent devices) to pass along a person’s wealth, effectively cascading enjoyment among succeeding generations but skipping one or more of the generations as far as the federal estate and gift taxes were concerned.

Initially, Congress imposed a tax on generation-skipping transfers that encompassed certain terminations and distributions from trusts and similar devices. However, Congress repealed its initial effort and enacted a substitute tax expanding the prior tax to include outright generation-skipping transfers to transferees well down the ancestral line. The revised version of the generation-skipping transfer (GST) tax is an attempt to provide greater uniformity in imposition of the tax. As a result of the repeal and revision of the GST tax, the GST tax is subject to some important effective date rules under which trusts created prior to such dates (even with some modifications to such trusts) are exempt from the GST tax.¹

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³⁸ See ¶ 9.04[6][b].
³⁹ See ¶ 9.04[6][b].
¹ See ¶ 18.05.

The terminology of the GST tax is unlike that of other taxes, even other transfer taxes. Thus, an elementary understanding of the key terms is crucial to understanding the taxation of generation-skipping transfers.

The terminology cycle begins with a “transferor,” an individual who is generally either the decedent (if property has been subject to the estate tax) or the donor (if property has been subject to the gift tax). In general, there is a new transferor any time property is subject to a tax imposed by the estate or gift tax.

Assignment of a generation level is important under Chapter 13. An individual’s generation level is determined with reference to the transferor. If the individual is related to the transferor, the relationship to the transferor determines the individual’s generation level. Thus, the transferor’s child, niece, or nephew is assigned a generation level one below that of the transferor; the transferor’s grandchild, grandniece, or grandnephew is assigned a generation level two below that of the transferor. An appropriate special rule applies if a descendant (and sometimes other relatives) of the transferor is dead at the time of the transfer. The rule has the effect of elevating the surviving relative into a higher generation. Thus, if one’s child is deceased at the time of the transfer, the transferor’s grandchildren who are children of the predeceased child are treated as the transferor’s children because, as a practical matter in such circumstances, the transferor is not “skipping” a generation. An individual marrying a person related to the transferor is assigned to the same generation level as that individual’s spouse. Adopted persons are treated as related persons. The generation level assigned to a person unrelated to the transferor is determined by the number of years separating that person in age from the transferor. Persons twelve and one-half to thirty-seven and one half years younger than the transferor are assigned to a generation level one below that of the transferor. Persons unrelated to the transferor and more than thirty-seven and one half years younger than the transferor are assigned a generation level at least two below that of the transferor.

The assignment of generation levels is significant in identifying “skip persons” who are the key to determining whether a generation-skipping transfer has occurred. Skip persons can be natural persons or trusts, including trust
A natural person is a skip-person if the generation level to which the individual is assigned is two or more levels below that of the transferor. A transferor’s grandchildren and great-grandchildren, as well as unrelated persons more than thirty-seven and one-half years younger than the transferor, are usually classified as skip persons. Generally, a trust or a trust equivalent arrangement is a skip person if all persons having an immediate right to receive income or corpus from the trust and all current permissible noncharitable recipients of income or corpus are skip persons. A trust providing income to a transferor’s child for life and a remainder to a grandchild is not a skip person; however, a trust with income to a transferor’s grandchild for life and a remainder to anyone in any generation is a skip person. Sensibly enough, any natural person or trust or trust equivalent arrangement that is not a skip person is treated as a non-skip person.


The GST tax is imposed on three types of generation-skipping transfers: direct skips, taxable terminations, and taxable distributions. A single event may trigger more than one generation-skipping transfer, but only one GST tax will be imposed. To determine which type of generation-skipping transfer occurs, a pecking order has been established. Direct skips prevail. Next in line are taxable terminations. Taxable distributions come last, acting as a backstop when other transfers are not present. The three types of transfers are considered in that order.

[a] Direct Skips

A direct skip is the transfer of an interest in property that is subject to either estate tax or gift tax and is made to a skip person (either a natural person or a trust or trust equivalent arrangement). If one’s child is alive, an inter vivos or a testamentary transfer to one’s grandchild is a direct skip, as is an inter vivos or a testamentary transfer to a trust with income to grandchildren and remainder to their heirs. Because such transfers skip estate and gift taxation at one generation level, the child’s generation, Congress deems it appropriate to impose a generation-skipping transfer tax. In general, inter vivos

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9 See §§ 13.03[2], 13.03[3].
10 See § 13.03[2].
11 See § 13.03[3].
12 See § 13.03[5].
13 See § 13.02[1][b].
14 See § 13.02[4].
direct skip transfers that would be included in the transferor’s gross estate if the transferor died immediately after making the transfer are not treated as occurring until the possibility of estate tax inclusion is removed.\footnote{\textsuperscript{15} See ¶¶ 13.02[4][d], 16.02[7].} Congress is not concerned with how many generations are skipped in a direct skip; an outright gift or estate tax transfer to the transferor’s great-grandchild or great-great-grandchild is treated as a single generation-skipping transfer.

When a direct skip occurs, a GST tax is imposed even though a gift tax or an estate tax is also imposed. If the direct skip is inter vivos, the GST tax paid by the transferor is treated as an additional inter vivos gift, in order to make the transfer more tax-inclusive, with the result that there are two gift transfers\footnote{\textsuperscript{16} See ¶ 10.05.} as well as a generation-skipping transfer.

\textbf{[b] Taxable Terminations}

A taxable termination occurs only with respect to a trust or a trust equivalent arrangement. It occurs upon the termination of the entire interest of a beneficiary who has an immediate right to receive income or corpus from the trust or who is a permissible noncharitable current recipient of income or corpus from the trust and the property held in the trust is not subject to federal estate or gift tax at the time of the termination, when immediately thereafter there is either (1) no non-skip person having such an interest in the trust, or (2) no one having any such interest in the trust but a subsequent distribution may be made to a skip person.\footnote{\textsuperscript{17} See ¶¶ 13.02[2][a]–13.02[2][d].} In simpler terms, this generally means that if the entire interest of a current actual or permissible interest holder terminates, the property held in the trust is not subject to federal estate or gift tax at the termination, and that interest is acquired by a beneficiary who is a skip person in relation to the transferor of the trust, there is a taxable termination.

The classic taxable termination occurs when transferor, \(T\), creates a trust with income to child, \(C\), for life, then income to grandchild, \(GC\) (\(C\)’s only child), for life and a remainder to \(T\)’s great-grandchildren, \(GGCs\). Assuming \(C\) predeceases \(GC\), there is a taxable termination generation-skipping transfer at \(C\)’s death (as \(C\)’s interest terminates without imposition of any gift or estate tax) and another at \(GC\)’s death (as \(GC\)’s interest terminates without any imposition of gift or estate tax). Imposition of the tax is appropriate at each level as a generation is skipped. If \(C\) had held a general power of appointment over the corpus and the power lapsed at \(C\)’s death, the property subject to the power would have been included in \(C\)’s gross estate; as a result, \(C\) would have become the transferor of subsequent generation-skipping transfers from the trust. Because \(GC\) is a non-skip person with respect to \(C\), no taxable termination
would occur with respect to the trust until GC’s death and the termination of GC’s interest.

[c] Taxable Distributions

The catchall in the generation-skipping transfer tax structure is the taxable distribution.\(^8\) If a distribution is made from a trust or a trust equivalent arrangement to a skip person and the distribution is neither a direct skip nor a taxable termination, it constitutes a taxable distribution. For example, if a transferor establishes an inter vivos or a testamentary trust with income to child for life and a remainder to adult grandchildren, but permits the third-party trustee to give income or corpus to any of the grandchildren, a taxable distribution occurs on a distribution of income or corpus to a grandchild if the distribution does not deplete the entire trust corpus (in which case a taxable termination would occur). Such a distribution skips the child’s generation and imposition of a generation-skipping transfer tax is warranted; imposing a tax on taxable distributions effects a backstop to support other generation-skipping transfers in the same manner that the gift tax backstops the estate tax.

Payment out of trust funds of any portion of the GST tax imposed on a taxable distribution is treated as an additional taxable distribution.\(^9\) A taxable distribution occurs because liability for payment of the GST tax is imposed on the skip person transferee, and if the trust satisfies that obligation, in substance the trust is making another taxable distribution to the skip person.

The nature of the GST tax is easily recognized once the three types of generation-skipping transfers are understood. The GST tax imposes a tax on wealth cascading down through generations where the intervening generations escape any imposition of either of the two other types of wealth transfer tax.

[4] Exclusions

A transfer that falls within any of the three classifications of generation-skipping transfers will not be treated as a generation-skipping transfer in two situations. First, a testamentary direct skip, a taxable termination, or a taxable distribution made directly to an educational institution for the tuition of a skip person or to a person providing medical care for the medical expenses of a skip person that, if made inter vivos by the transferor, would have qualified

\(^8\) See ¶ 13.02[3].

\(^9\) See ¶ 13.02[3][c].
for the gift tax exclusion, is not treated as a generation-skipping transfer. Second, as the basic concept of the GST tax generally is to impose a transfer tax where property has not been subject to the estate tax or gift tax at one generation level, Congress imposes the Chapter 13 tax on such property only once at each generation level.


The computation of the GST tax, like that of most taxes, is determined by multiplying the tax base by the tax rate. The tax base is the taxable amount of the generation-skipping transfer and the tax rate is statutorily defined as the applicable rate. The GST tax is essentially a flat-rate tax imposed at the maximum federal estate tax rate. Its sting is partially alleviated by the allowance of a generous exemption to each individual transferor.

[a] The Taxable Amount

The taxable amount borrows the concepts of valuation and deductions from both the estate tax and the gift tax structure. It makes the GST tax a tax-inclusive tax when there is a taxable termination and a taxable distribution, but generally only a tax-exclusive tax when there is a direct skip. The taxable amount is best understood by looking at each of the three types of generation-skipping transfers separately.

[i] Direct skip. The taxable amount of a direct skip transfer is the value of the property received by the transferee. Deductions are disregarded because the amount is based on the amount actually received by the transferee. The tax imposed is tax-exclusive in that the tax is based on the amount received by the transferee after the payment of transfer taxes. In the case of an inter vivos direct skip, however, to make the transfer more tax-inclusive, the amount of GST tax imposed on the transferor is treated as a further gift transfer by the transferor. Valuation occurs at the time that the direct skip occurs, and it is generally the fair market value of the property at that time. How-

\[ \text{20 See } \| 9.04[2]. \]
\[ \text{21 See } \| 13.01[2][a]. \]
\[ \text{22 See } \|\| 17.03[2][a], 13.01[2][b]. \]
\[ \text{23 See } \| 12.02. \]
\[ \text{24 See } \| 15.02. \]
\[ \text{25 See } \| 14.04. \]
\[ \text{26 See } \| 10.05. \]
\[ \text{27 See } \| 14.05[1]. \]
ever, if the property that is the subject matter of the direct skip is included in
the transferor’s gross estate, the estate tax valuation method employed by the
estate is used in the determination of the amount of the direct skip.28

[iii] Taxable termination. The taxable amount of a taxable termination is
the fair market value of all the property with respect to which the termination
has occurred.29 Deductions against the value of the property for claims and
charges against the property similar to those under the estate tax are allowed.30
The tax imposed is tax-inclusive. Valuation is generally accomplished at the
time the interest terminates,31 although, if the termination occurs as a result of
the death of an individual, the alternate valuation date may be used.32

[iii] Taxable distribution. The taxable amount of a taxable distribution is
the amount received by the transferee in the distribution.33 Expenses incurred
with respect to the determination, collection, or refund of the GST tax are de-
ductible in computing the taxable amount.34 The property is valued at its fair
market value at the time of the taxable distribution.35 The transferee is liable
for the GST tax imposed on taxable distributions, and, as a result, the tax is
tax-inclusive.36 If payment of the tax is made by the trust, that payment is
treated as a further taxable distribution.37

28 See ¶ 14.05[2][a].
29 See ¶ 14.03[2].
30 See ¶ 14.03[3].
31 See ¶ 14.05[1].
32 See ¶ 14.05[2][b].
33 See ¶ 14.02[2].
34 See ¶ 14.02[3].
35 See ¶ 14.05[1].
36 See ¶ 12.03[1].
37 See ¶¶ 13.02[3][c], 14.02[4].
[b] The Applicable Rate

The applicable rate establishes the rate of tax imposed on a generation-skipping transfer. It is the product of the maximum federal estate tax rate and the inclusion ratio with respect to the transfer.\(^{38}\)

[i] The maximum federal estate tax rate. The GST tax borrows the maximum federal estate tax rate from the multipurpose rate table.\(^{39}\)

[ii] The inclusion ratio. The “inclusion ratio” is the mechanism by which an individual’s generation-skipping transfer exemption amount (GST exemption) is incorporated into the computation of the generation-skipping transfer tax. The amount of the GST exemption parallels the estate tax basic exclusion amount, but it does not include a predeceased spouse’s unused exclusion amount.\(^{40}\) The individual or the individual’s executor may allocate the GST exemption among the individual’s generation-skipping transfers.\(^{41}\) In addition, the statute provides a variety of inter vivos and testamentary automatic allocation rules attempting to ensure that not only will a transferor’s GST exemption not be wasted, it will be allocated in what is likely the most effective manner.\(^{42}\)

The inclusion ratio is a decimal fraction composed of one minus another fraction, the “applicable fraction.”\(^{43}\) The numerator of the applicable fraction is equal to the GST exemption amount allocated to the generation-skipping transfer and the denominator is generally equal to the value of the property involved in the transfer.\(^{44}\) For example, if a transferor makes a $10 million direct skip and allocates $5 million of GST exemption to it, the applicable fraction is 0.500 and the inclusion ratio is 0.5 (one minus 0.500). Assuming a maximum federal estate tax rate of 40 percent, the applicable rate of tax on the transfer is 20 percent. If an individual transfers $5 million to a trust with income to a child for life, then income to a grandchild for life, and a remainder to the grandchild’s grandchildren, and immediately allocates $5 million of GST exemption to the trust, the applicable fraction is one and the inclusion ratio is zero. As a result, no generation-skipping transfer tax will be imposed on the trust at the death of either the child or the grandchild.

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\(^{38}\) See § 16.01.
\(^{39}\) See § 2.01[1][c].
\(^{40}\) See § 15.02.
\(^{41}\) See §§ 15.03[1], 15.03[2], 15.03[6].
\(^{42}\) See §§ 15.03[3]–15.03[5], 15.03[7].
\(^{43}\) See § 16.02.
\(^{44}\) See § 16.02.
The inclusion ratio is generally recomputed where the transferor allocates additional GST exemption to a trust after the initial transfer,\footnote{See ¶ 16.02[5][b].} where more than one transfer is made to a generation-skipping trust,\footnote{See ¶ 16.02[5][b].} and where a single trust to which a GST exemption allocation has been made is involved in more than one taxable termination with respect to the same transferor.\footnote{See ¶ 17.03[2][a].}


The responsibility for seeing that the tax is paid is the transferor’s in the case of a direct skip not made from a trust, the trustee’s where there is a taxable termination or a direct skip from a trust, and the transferee’s where there is a taxable distribution.\footnote{See ¶ 12.03.} The Service generally requires that the person responsible for seeing that the tax is paid also files the necessary tax returns.\footnote{See ¶ 18.02[3].}

¶ 1.05 CONCLUSION

The foregoing panoramic picture was obviously taken at a very long range. Even the beauties of the Taj Mahal are not apparent from a distance of several miles. Although great beauty may not be discovered in the chapters that follow, their careful consideration is urged, and at least some surprises may be found. This overview is cross referenced in such a way that some of the surprises can be turned up quite quickly.
CHAPTER 2

Imposition of Estate Tax

¶ 2.01 Section 2001. Imposition and Rate of Tax
[1] Computation of the Tentative Tax
[a] Taxable Estate
[b] Adjusted Taxable Gifts
[i] Gifts made through August 5, 1997
[ii] Gifts made after August 5, 1997
[c] Tax Rates

¶ 2.02 Section 2002. Liability for Payment
[1] Estate Tax Returns
[a] In General
[b] Forms
[c] When to File
[d] Where to File

[2] Payment of the Estate Tax

[3] Extension of Time for Payment
[a] Section 6159
[b] Section 6161
[i] Short extensions
[ii] “Reasonable cause” extensions
[c] Section 6166
[i] Introduction
[ii] Qualification for extension
[iii] Period of extension
[iv] Maximum amount of deferral
[v] Interest
[vi] The “gotcha”
[vii] Declaratory judgments with respect to Section 6166

2-1
¶ 2.01 SECTION 2001. IMPOSITION AND RATE OF TAX

The federal estate tax is imposed by Section 2001(a) of the Internal Revenue Code (the Code) on the transfer of the taxable estate of every decedent who is either a citizen or a resident of the United States.1 “Taxable estate” is a term of art defined in Section 2051.2 The term “transfer” has less statutory significance than might at first be supposed; the statutory plan presumes the requisite transfer of a property interest if its value is required to be included in the gross estate of a decedent.4

The method of computing the tax is provided by Section 2001(b) and the rates to be used are presented in a multipurpose rate table provided in Section 2001(c).5 Prior to 1977, computation of the estate tax involved only the application of rates in a graduated rate table to the taxable estate. However, with the enactment of Section 2001(b) in the Tax Reform Act of 1976, Congress took steps toward integration of the gift and estate taxes. The estate tax computation involves essentially figuring a tentative tax on all gratuitous transfers made inter vivos after 1976 or at death. This is a combination of the aggregate value of the taxable estate6 and adjusted taxable gifts,7 terms discussed here.8 The tentative tax is then reduced by subtracting an amount related to tax payable on lifetime gifts after 1976.9 The computation does not tax any gratuitous transfers twice; the taxable estate is still the only amount being taxed. However, the amount of tax imposed on the taxable estate is dependent on the decedent’s post-1976 gratuitous transfers.

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1 The questions of citizenship and residence are discussed at ¶ 6.01[3] in connection with the tax imposed on estates of nonresidents who are not citizens. See IRC §§ 2101–2108; Chapter 6. See also IRC §§ 2208, 2209; ¶ 8.09. Cf. ¶¶ 9.02[1] and 9.02[2], 18.03[2].
2 See ¶ 5.02.
3 However, it is of constitutional significance that the estate tax is imposed on wealth transfers, not on wealth itself. An indirect tax such as a tax on the transmission of wealth is constitutional as long as it is imposed uniformly throughout the United States. In contrast, a direct tax on wealth must be apportioned among the states in accordance with their respective populations. See L. Tribe, American Constitutional Law 841 (3d ed. 2000).
4 IRC §§ 2031–2046, discussed in Chapter 4.
5 The Section 2001(c) rate schedule is multipurpose, because it is used in computing the estate tax, the gift tax, and the tax on generation-skipping transfers. See infra ¶ 2.01[1][c], especially note 46.
6 IRC § 2001(b)(1)(A). See ¶ 2.01[1][a].
7 IRC § 2001(b)(1)(B). See infra ¶ 2.01[1][b].
8 IRC § 2001(b)(1).
9 IRC § 2001(b)(2).
[1] Computation of the Tentative Tax

The first step in computing a decedent’s estate tax liability is to compute a tentative tax on the aggregate amount of the decedent’s “taxable estate” and “adjusted taxable gifts.” The tax is determined by applying the Section 2001(c) rates to that aggregated amount.

[a] Taxable Estate

The term “taxable estate” is discussed in detail in Chapters 4 and 5. It constitutes the decedent’s gross estate, which is made up of property owned by the decedent at death and property that, although not owned by decedent at death, was the subject of some lifetime ownership, benefit, or control resulting from a testamentary-like transfer by the decedent. Property included in a decedent’s gross estate is valued under either the method provided by Section 2031 or Section 2032A at the date of the decedent’s death under Section 2031 or on the alternate valuation date under Section 2032. The gross estate is then reduced by allowable deductions to determine the taxable estate.

[b] Adjusted Taxable Gifts

The term “adjusted taxable gifts,” defined in Section 2001(b), is the total amount of taxable gifts (within the meaning of Section 2503) made by the decedent after December 31, 1976, other than gifts that are taken into account in determining the gross estate. The exclusion of gifts included in the decedent’s gross estate from adjusted taxable gifts prevents the value of the same gift from being included twice in the estate tax computation.

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10 IRC § 2001(b)(1).
11 IRC § 2001(b)(1)(A). See infra ¶ 2.01[1][a].
12 IRC § 2001(b)(1)(B). See infra ¶ 2.01[1][b].
13 See infra ¶ 2.01[1][c]. But see IRC § 2201; ¶ 8.01.
14 IRC § 2033. See ¶ 4.05; but see IRC § 2031(c), ¶ 4.02[7].
15 See ¶¶ 4.07–4.16.
16 See ¶¶ 4.02–4.04.
17 See Chapter 5.
18 Taxable gifts are gifts after gift-splitting under Section 2513, exclusions under Sections 2503(b) and 2503(e), and deductions allowed by Sections 2522 and 2523 as limited by Section 2524. See Chapters 9–11.
19 IRC § 2001(b), flush language. See Chapter 4.
20 See HR Rep. No. 1380, 94th Cong., 2d Sess. 3, 13 (1976), reprinted in 1976-3 CB (Vol. 3) 735, 747. See also Rev. Rul. 84-25, 1984-1 CB 191, which appropriately holds that a legally binding note issued by the decedent during life and subject to the gift tax.
The amount of adjusted taxable gifts is the fair market value of the property gifted at the time the gift tax transfer was completed. However, this does not necessarily mean that the decedent’s lifetime determination of the amount of the property gifted controls its amount in the estate tax computation. The rules governing the amount of adjusted taxable gifts depend on the date that gift was made.

[i] Gifts made through August 5, 1997. The fair market value of property transferred by gift prior to August 6, 1997, may be redetermined in the determination of the amount of adjusted taxable gifts at the time of filing the estate tax return, notwithstanding the expiration of the statute of limitations on the assessment of gift tax on such transfers. In addition, legal issues involving the interpretation of gift tax law (such as deductions and qualification for the annual exclusion) may also be raised even though the gift tax statute of limitations has run.

[ii] Gifts made after August 5, 1997. The amount of adjusted taxable gifts made after August 5, 1997, is not subject to a readetermination adjustment in the estate tax computation if (1) the gift was adequately disclosed; (2) the transferred property’s value is finally determined for gift tax purposes; and

(see ¶ 10.01[3][h], note 164), but unpaid at death, is not included in adjusted taxable gifts, because the assets to satisfy the note are included in the gross estate.

Similarly, the amount of adjusted taxable gifts is reduced by the amount of gifts made by the decedent’s spouse that are included in the decedent spouse’s gross estate under Section 2035 where a Section 2513 election applied to the transfer. IRC § 2001(e). Congress should have applied the Section 2001(e)(2) rule to inclusions of property in the estate of the decedent’s spouse under Sections 2036–2038, as well as Section 2035, especially in view of the limited scope of Section 2035(a). See ¶ 4.07[2][b].

21 Prior to August 6, 1997, there was no statute that required the value of a gift as determined for gift tax purposes be used in valuing adjusted taxable gifts in a decedent’s estate tax computation. Cf. IRC § 2504(c).


24 Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 506(a), 111 Stat. 788, 855 (1997), reprinted in 1997-4 CB (Vol. 1) 1, 386. The regulations provide that these rules apply only if the estate tax return is filed after the date the regulations became final, December 3, 1999. Reg. § 20.2001-1(f).

25 IRC § 2001(f)(2) (flush language); Reg. § 20.2001-1(c)(1). See IRC § 6501(c)(9).

26 IRC § 2001(f)(2).
(3) the statute of limitations with respect to the gift has expired.\textsuperscript{27} Even though the statute refers merely to valuation, the nonadjustment rule applies to adjustments involving all issues relating to the \textit{amount} of the gift, including valuation issues and legal issues involving the interpretation of the gift tax law.\textsuperscript{28} If these requirements are not all satisfied, then the amount of the adjusted taxable gifts may be redetermined in computing the decedent’s estate tax.\textsuperscript{29}

\textbf{Adequate Disclosure.} The rules of adequate disclosure apply for purposes of both the estate tax computation and the limitations period for the gift tax.\textsuperscript{30} Adequate disclosure may be made either on the gift tax return reporting the transfer or on a statement attached to the gift tax return.\textsuperscript{31} Adequate disclosure\textsuperscript{32} essentially requires a description of the nature of the gift and the basis for determining the value of the reported gift.\textsuperscript{33} The regulations provide a safe harbor to satisfy the description and basis of valuation adequate disclosure requirements that must include (1) a description of the transferred property and any consideration received by the transferor;\textsuperscript{34} (2) a listing of the identity of, and relationship between, the transferor and each transferee;\textsuperscript{35} (3) if the prop-

\begin{footnotesize}
\begin{itemize}
\item[29] For example, even though the “adequate disclosure” regulations have been satisfied sufficiently to commence the running of the statute of limitations, the reported amount is not binding for purposes of computing adjusted taxable gifts, unless the “final determination” requirement is also met.
\item[30] IRC §§ 2001(f), 6501(c)(9). See ¶ 9.05[2][b].
\item[31] IRC §§ 2001(f)(2) (flush language), 6501(c)(9).
\item[32] See Reg. §§ 301.6501(c)-1(f)(2), 301.6501(c)-1(f)(3). The adequate disclosure safe-harbor rules apply to gifts made after December 31, 1996, but only if the gift tax return for the gift is filed after the date that the regulations became final, December 3, 1999. Reg. § 301.6501(c)-1(f)(8). See supra note 24; ¶ 9.04[7][a], note 242.
\item[33] Reg. §§ 301.6501(c)-1(f)(2), 301.6501(c)-1(f)(3).
\item[34] Reg. § 301.6501(c)-1(f)(2)(i).
\item[35] Reg. § 301.6501(c)-1(f)(2)(ii).
\end{itemize}
\end{footnotesize}
property is transferred in trust, the trust’s identification number and either a brief description of the terms of the trust or a copy of the trust instrument; (4) either a detailed description of the method used in determining the fair market value of the property, including any relevant financial data (such as balance sheets), and a description of any discounts claimed in valuing the property; or in the alternative, an adequate appraisal of the property by a qualified appraiser; and (5) a statement describing any position taken that is contrary to

36 Reg. § 301.6501(c)-1(f)(2)(iii).

37 Reg. § 301.6501(c)-1(f)(2)(iv). If the transfer is of an actively traded entity on an established exchange, it will be considered adequately disclosed if the description includes the CUSIP number of the security and the mean between the highest and lowest quoted selling prices on the applicable valuation date. Reg. §§ 301.6501(c)-1(f)(2)(iv), 301.6501(c)-1(f)(7), Ex. 1.

If the transfer is of a nonactively traded entity, there is a more detailed requirement. If the valuation is based on the net value of the assets, a statement must be provided as to the valuation of 100 percent of the entity (without discounts), the pro rata portion subject to the transfer, and the fair market value reported on the return. Reg. §§ 301.6501(c)-1(f)(2)(iv), 301.6501(c)-1(f)(7), Ex. 3. The final step takes into consideration any discounting of the value of the property transferred. Id. See ¶ 4.02[4]; IRS Chief Couns. Adv. Mem. 201024059 (May 11, 2010) (inadequate disclosure). If 100 percent of the value of the entity is not disclosed, the taxpayer bears the burden of demonstrating that the fair market value is properly determined by a method other than a method based on the net fair market value of the assets held by the entity. Reg. § 301.6501(c)-1(f)(2)(iv).

Furthermore, if the nonactively traded entity that is transferred owns an interest in another nonactively traded entity or entities, the same analysis must be employed for each such entity, if such information is relevant and material in determining the value of the transferred interest. Reg. §§ 301.6501(c)-1(f)(2)(iv), 301.6501(c)-1(f)(7), Ex. 4. If the appraisal alternative is employed (see infra text accompanying notes 38 and 39), this requirement will be a part of the appraisal. Reg. § 301.6501(c)-1(f)(7), Ex. 5.

38 The appraiser must provide all of the following information in order to meet the safe-harbor requirements: (1) the appraiser’s background and credentials that qualify the appraiser to perform the appraisal; (2) the dates of the transfer and the appraisal, and the purpose of the appraisal; (3) a description of the property; (4) a description of the appraisal process; (5) a description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the valuation reported; (6) the information considered in determining the appraised value, including all financial data used in determining the value of an ownership interest of a business so that another person can replicate the process and arrive at the appraised value; (7) the appraisal procedures used and the reasoning that supports them; (8) the valuation method used, the rationale for its use, and the procedure used in arriving at the fair market value; and (9) the specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc. Reg. §§ 301.6501(c)-1(f)(3)(ii), 301.6501(c)-1(f)(7), Ex. 5.

39 Reg. §§ 301.6501(c)-1(f)(2)(iv), 301.6501(c)-1(f)(3).

The appraiser must not be the donor or the donee of the property, must not be related to the transferor (as defined in Section 2032A(c)(2); see ¶ 4.04[3][b][viii]), must not be employed by any of such persons, and must be qualified to appraise the type of property transferred. Reg. § 301.6501(c)-1(f)(3)(i).
any proposed, temporary, or final Treasury regulations or revenue rulings published at the time of the transfer.\[40\]

Final Determination. The nonadjustment rules for adjusted taxable gifts in the computation of the estate tax also require a final determination of the prior amount of the adjusted taxable gifts.\[41\] A final determination occurs if (1) the amount of the taxable gift as shown by the taxpayer on a gift tax return (or on a statement attached to the return) is not contested by the Internal Revenue Service (the Service) before the period for assessing gift tax on the transfer expires; \[42\] (2) the Service establishes an amount that is not contested by the taxpayer within the limitations period; \[43\] (3) the courts establish the amount in a final determination that is no longer subject to appeal; \[44\] or (4) the amount is established through a settlement agreement between the taxpayer and the Service.\[45\]

[c] Tax Rates

Once the total of the taxable estate and adjusted taxable gifts has been computed a tax is computed using the multipurpose rate table,\[46\] which appears in Section 2001(c).\[47\] Over the years since the 1976 unification of the estate

\[40\] Reg. § 301.6501(c)-1(f)(2)(v).
\[42\] IRC § 2001(f)(2)(A).
\[43\] IRC § 2001(f)(2)(B).
\[45\] IRC § 2001(f)(2)(C). A settlement agreement includes a Section 7121 closing agreement, a Section 7122 compromise, or a settlement of a valuation issue binding on both parties. Reg. § 20.2001-1(d).
\[46\] The table also imposes the tax rates for the gift tax. IRC § 2502(a)(1). See ¶ 9.03[2]. The maximum tax rate imposed by the table is also used in computing the rate of tax on generation-skipping transfers. IRC § 2641. See ¶ 16.01. The table does not apply in limited estate tax circumstances. IRC § 2201. See ¶ 8.01.
\[47\] The maximum rate for years after 2012 is 40 percent. IRC § 2001(c). The basic table as provided in Section 2001(c) was modified in prior years according to the rules of repealed Section 2001(c)(2). Under those modifications, the maximum rates under Section 2001(c) prior to 2013 were as follows:

<table>
<thead>
<tr>
<th>Calendar Years</th>
<th>Maximum Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977–1981</td>
<td>70 percent</td>
</tr>
<tr>
<td>1982</td>
<td>65 percent</td>
</tr>
<tr>
<td>1983</td>
<td>60 percent</td>
</tr>
<tr>
<td>1984–2001</td>
<td>55 percent</td>
</tr>
<tr>
<td>2002</td>
<td>50 percent</td>
</tr>
<tr>
<td>2003</td>
<td>49 percent</td>
</tr>
</tbody>
</table>
and gift taxes, the table has undergone a variety of changes. In 1977, the top rate was 70 percent, which by 1984 was reduced to 55 percent for the years 1984 through 2001.\textsuperscript{48} Both rates also were subject to a 5 percent surtax on transfers in excess of $10 million.\textsuperscript{49} The top marginal rate was 50 percent for the year 2002, and the 5 percent surtax did not apply to estates of decedents dying after 2001.\textsuperscript{50} The top marginal rate was gradually reduced from 50 percent to 45 percent in the years from 2003 through 2009 and to 35 percent in the years from 2010 through 2012.\textsuperscript{51} In 2013 and subsequent years, it is increased to 40 percent.\textsuperscript{52}

However, the rates can properly be analyzed only by examining them in conjunction with the Section 2010 credit.\textsuperscript{53} As a result of both the applicable credit amount,\textsuperscript{54} which offsets tax attributable to the lower rates, and the ceiling on maximum rates, the estate tax is imposed at a flat 40 percent rate for years after 2012.\textsuperscript{55}

<table>
<thead>
<tr>
<th>Year</th>
<th>Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>48 percent</td>
</tr>
<tr>
<td>2005</td>
<td>47 percent</td>
</tr>
<tr>
<td>2006</td>
<td>46 percent</td>
</tr>
<tr>
<td>2007–2009</td>
<td>45 percent</td>
</tr>
<tr>
<td>2010–2012</td>
<td>35 percent</td>
</tr>
</tbody>
</table>

\textsuperscript{48} See supra note 47.

\textsuperscript{49} For years beginning in 1998, the surtax wiped out only the graduated rates but not the unified credit, and, as a result, it was capped at $17,184,000. A flat 55 percent tax on $3 million (where the 55 percent rate kicked in under Section 2001(c)(1) as it applied in years from 1998 through 2001) was $1,650,000, which is $359,200 in excess of the $1,290,800 amount of tax in the tables. Since 5 percent of $7,184,000 equals $359,200, and the surtax applied only to taxable amounts over $10 million, the 5 percent surtax terminated at $17,184,000 ($10 million plus $7,184,000). See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 501(a)(1)(D), 111 Stat. 788, 845 (1997), reprinted in 1997-4 CB (Vol. 1) 1, 59.


\textsuperscript{50} The Section 2001(c)(2) 5 percent surtax was repealed by the Economic Growth and Tax Relief Reconciliation Act of 2001 for years after 2001. Pub. L. No. 107-16, § 511(b), 115 Stat. 38, 70 (2001), reprinted in 2001-3 CB 9, 42.

\textsuperscript{51} See supra note 47.

\textsuperscript{52} IRC § 2001(c).

\textsuperscript{53} The credit also determines estate tax filing requirements. See IRC § 6018, discussed at ¶ 3.02[3].

\textsuperscript{54} See IRC § 2010(c), discussed at ¶ 3.02[1][a].

\textsuperscript{55} In prior years, as a result of the Section 2010 credit, the effective marginal rates of estate tax were as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 2001</td>
<td></td>
</tr>
</tbody>
</table>
2-9 IMPOSITION OF ESTATE TAX ¶ 2.01[2]


The tentative tax on the sum of the taxable estate and adjusted taxable gifts is then reduced by the amount of gift taxes that would have been payable on gifts made after 1976.56 Since gifts made after 1976 are pulled into the estate tax computation,57 a reduction is properly provided for gift taxes on those gifts. Those gifts are not taxed again, but they do affect the amount of tax imposed on the taxable estate.

Over the years there have been reductions in the rates imposed on gratuitous transfers58 and changes in the amount of the gift tax credit.59 Since the taxable estate is taxed at the rates imposed at the date of the decedent’s death, the unified credit.

<table>
<thead>
<tr>
<th>Year</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984–2001</td>
<td>37 to 55 percent</td>
</tr>
<tr>
<td>2002</td>
<td>41 to 50 percent</td>
</tr>
<tr>
<td>2003</td>
<td>41 to 49 percent</td>
</tr>
<tr>
<td>2004</td>
<td>45 to 48 percent</td>
</tr>
<tr>
<td>2005</td>
<td>45 to 47 percent</td>
</tr>
<tr>
<td>2006</td>
<td>46 percent</td>
</tr>
<tr>
<td>2007–2009</td>
<td>45 percent</td>
</tr>
<tr>
<td>2010–2012</td>
<td>35 percent</td>
</tr>
<tr>
<td>2013 and subsequent years</td>
<td>40 percent</td>
</tr>
</tbody>
</table>

The Section 2001(c) table actually shows minimum rates of 18 percent, gradually rising to 40 percent, identified here as the lowest current effective estate and gift tax rates. Forty percent is the lowest current effective rate because all estate and gift taxes imposed at the lower rates are eliminated by the unified credit. As indicated in the table above, when the unified credit increased (see IRC § 2010(c)), the lowest effective rate also increased. The lower part of the table was needed when enacted to compute the tax previously imposed on generation-skipping transfers. The original tax on generation-skipping transfers was retroactively repealed in 1986. See ¶ 18.05.

56 IRC § 2001(b)(2). Even though the reduction for gift taxes payable is not so labeled, it is essentially a credit, because it is a direct reduction of tax liability, and not merely a reduction of the tax base.

As the Section 2001(b)(2) reduction relates only to post-1976 gifts, pre-1977 gifts that become a part of the decedent’s taxable estate identified in Section 2001(b)(1)(A) are still permitted to qualify for the Section 2012 credit for the gift tax paid. The Section 2012 credit will eventually fade away as it is inapplicable to post-1976 gifts. See IRC §§ 2012(a), 2012(c); ¶ 3.04.

While Section 2001(b)(2) applies only to post-1976 gifts, the rate of tax paid on such gifts is affected by pre-1977 gifts (see ¶ 9.03[3]) that must be taken into account in making the Section 2001(b)(2) reduction. TAM 9642001 (Nov. 30, 1994).

57 Post-1976 gifts are part of the amount identified in Section 2001(b)(1)(A), if they are brought within the gross estate. If such gifts are not brought within the gross estate, they appear in Section 2001(b)(1)(B).

58 See ¶ 9.03[2].

59 See ¶ 9.06.
death, the computation of the amount of taxes payable on gifts made after 1976 must also reflect the transfer tax rates at the decedent’s death. Thus in computing the Section 2001(b)(2) reduction, both the gift tax rates and the gift tax credit amounts must reflect the tax rates in effect on the date of the decedent’s death. This recomputation is required to prevent changes in the rate schedule from retroactively affecting the amount of tax effectively paid on prior gifts.

To achieve this result, the Code first specifically requires a reduction for the amount of gift taxes that would have been payable on the post-1976 gifts had the rate schedule in effect at death applied at the time of the gifts. In instances in which taxpayers have not made any pre-1977 taxable gifts and their adjusted taxable gifts do not exceed $500,000, the tentative tax will be reduced by the gift taxes that were payable on gifts made after 1976 without recomputation based on rates effective at death, because the tax rate schedules on those gifts and estates are identical.

The Code also specifically requires a recomputation of the gift tax credit for years after 1976. The amount of the credit allowed in determining the gift taxes payable is determined using the gift tax applicable exclusion amount that was available at the time the gift was made, but with an applicable credit amount determined using the tax rates in effect at the time of the decedent’s death.

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60 IRC § 2001(b)(1).
61 IRC §§ 2001(b)(2), 2001(g).
63 IRC §§ 2001(b)(2), 2001(g)(2).
65 IRC § 2001(g)(1).
67 IRC §§ 2001(b)(2), 2001(g)(2).

Since the applicable exclusion amount in years 1977 through 1986 was less than $500,000, no adjustment is necessary for those years. However, if a decedent died in 2010, 2011, or 2012 when the maximum tax rate was 35 percent, for years 1987–2009, the adjustment to the maximum amount of credit was as follows:

<table>
<thead>
<tr>
<th>Years</th>
<th>Applicable Exclusion Amount</th>
<th>Original Credit Amount</th>
<th>Adjusted Credit Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987–1997</td>
<td>$ 600,000</td>
<td>$192,800</td>
<td>$190,800</td>
</tr>
<tr>
<td>1998</td>
<td>$ 625,000</td>
<td>$202,050</td>
<td>$199,550</td>
</tr>
<tr>
<td>1999</td>
<td>$ 650,000</td>
<td>$211,300</td>
<td>$208,300</td>
</tr>
<tr>
<td>2000–2001</td>
<td>$ 675,000</td>
<td>$220,550</td>
<td>$217,050</td>
</tr>
<tr>
<td>2002–2009</td>
<td>$ 1 million</td>
<td>$345,800</td>
<td>$330,800</td>
</tr>
</tbody>
</table>

Section 2001
The rate and credit computations of Section 2001(b)(2) can become complicated. However, a simple example illustrates how they work. If a donor, having made no prior inter vivos gifts, made a taxable gift of $2 million in the year 2009, the donor would have paid a $435,000 gift tax in 2009. When the donor dies in 2011, since both the rates and the effective credit rates are reduced, the donor’s Section 2001(b)(2) reduction is only $350,000. The amount of reduction is appropriate, because it allows a Section 2001(b)(2) re-

<table>
<thead>
<tr>
<th>Years</th>
<th>Applicable Exclusion Amount</th>
<th>Original Credit Amount</th>
<th>Adjusted Credit Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>$ 1 million</td>
<td>$ 330,800</td>
<td>$ 345,800</td>
</tr>
<tr>
<td>2011</td>
<td>$ 5 million</td>
<td>$1,730,800</td>
<td>$1,945,800</td>
</tr>
<tr>
<td>2012</td>
<td>$ 5.12 million</td>
<td>$1,772,800</td>
<td>$1,993,800</td>
</tr>
</tbody>
</table>

68 For decedents dying after 2012, the adjusted credit computation is unnecessary for the years 1987–2009 and 2013 and subsequent years. However, if a decedent died after 2012, the amount of the Section 2505 credit is adjusted in the computation of the Section 2001(b)(2) reduction as follows:

<table>
<thead>
<tr>
<th>Years</th>
<th>Applicable Exclusion Amount</th>
<th>Original Credit Amount</th>
<th>Adjusted Credit Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>$ 1 million</td>
<td>$ 330,800</td>
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</tr>
<tr>
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<td>$1,730,800</td>
<td>$1,945,800</td>
</tr>
<tr>
<td>2012</td>
<td>$ 5.12 million</td>
<td>$1,772,800</td>
<td>$1,993,800</td>
</tr>
</tbody>
</table>

69 The tax was computed as follows:

- $ 2502(a)(1) tax on $2 million, all gifts, including the current year: $780,800
- $ 2502(a)(2) less tax on gifts in prior periods: -0
- Tax on current year’s gifts: $780,800
- § 2505 Credit reduction: -345,800
- Tax liability in 2009: $435,000

Thus, there was a tax on the second $1 million taxed in part at 41, 43, and 45 percent rates.

70 See supra text accompanying notes 58–67.

71 The amount is computed as follows:

- § 2502(a)(1) tax at 2001(c) rates on $2 million the sum of all gifts including gifts made in the current year: $745,800
- § 2502(a)(2) tax at 2001(c) rates on all gifts in prior years: -0
- § 2502(a) tax: $745,800
- § 2505 credit reduction using current rates (see supra note 68): -345,800
- § 2505 credit reduction: $400,000
duction in the taxes payable on the $1 million of gifts that were taxed, but at the current 35 percent tax rate on such gifts.72

Even if there is no change in the rate schedule, if there is a difference between taxes actually paid and taxes payable, the reduction is based on the latter. Thus, subject to the rules of Section 2001(f),73 an error in prior computation of the gift tax is disregarded and the reduction is based on the amount of tax that should have been paid.74 In addition, if the Section 2505 unified credit under the gift tax, although allowable, was not actually used, the amount of gift tax payable is reduced by the amount of credit that was allowable using the tax rates at the decedent’s death; again, it is tax payable not tax paid that determines the amount to be subtracted.75

The reduction of an amount for gift tax payable may include not only an amount for gift tax payable by the decedent but also, in limited situations, an amount for gift tax payable by the decedent’s spouse. If Section 2513 gift-splitting76 was elected on a lifetime transfer actually made by the decedent and the value of the property transferred was subsequently pulled into the decedent’s taxable estate, then an amount for gift tax payable by the decedent’s spouse is also used to reduce the tentative tax.77 The reduction is proper; as the

72 Another example may be helpful. If a donor made the $2 million gift in 1995, the donor would have paid gift taxes of $588,000, $780,800 (using 1995 rates) less a credit of $192,800 (see supra note 67). If the donor died in the current year, the donor’s Section 2001(b)(2) reduction would be only $553,000—$745,800 (using current rates) less a credit of $192,800 (see supra note 68).

73 See supra ¶ 2.01[1][b][ii].

74 For open years there may be an assertion of a deficiency or a right to a refund if the gift tax liability was improperly determined at the time of the gift. See ¶ 9.04[7].

75 See ¶ 10.03. This result is harsh and was probably not intended by Congress. See J. McCord, 1976 Estate and Gift Tax Reform: Analysis, Explanation and Commentary 23 (West 1977). The taxpayer is not given an opportunity to postpone use of the Section 2505 unified gift tax credit. If it is not used as allowed in post-1976 gifts, it cannot be used against subsequent gifts. Rev. Rul. 79-398, 1979-2 CB 338. The credit allowable in a year is the maximum credit reduced by the credit “allowable” in prior calendar periods. IRC § 2505(a)(2). See ¶ 9.06[1]. Under prior law, the somewhat related Section 2521 $30,000 lifetime exemption was not required to be used at the earliest possible time. Reg. § 25.2521-1(a). See R. Stephens, G. Maxfield & S. Lind, Federal Estate and Gift Taxation ¶ 10-2 (Thomson Reuters/Tax & Accounting, 3d ed. 1974).

76 See ¶ 10.03.

77 IRC § 2001(d). This rule parallels pre-1977 law, which allowed a credit for gift tax under Section 2012 for payment by a donor’s spouse of gift tax on split gifts if the gift was also taxed in the donor’s estate.

Under Section 2001(e), when the consenting spouse dies, the Section 2001(b)(2) reduction of an amount for the gift tax payable is reduced by the amount of the tax treated under Section 2001(d) as payable by the donor spouse, if Section 2035 required inclusion of the gift in the donor spouse’s estate. See supra ¶ 2.01[1][b], note 20. This adjustment, however, should not be greater than the Section 2001(d) amount that actually qualified as a Section 2001(b)(2) reduction in the donor spouse’s estate. In this situation, the total
value of all of the property is being pulled into the decedent’s gross estate, the estate ought to be allowed a reduction in the estate tax computation for gift taxes on the value of the entire property. However, in codifying this rule, Congress expressly approved a complementary rule that in some circumstances is disadvantageous to the decedent’s spouse: Any Section 2505 credit used ineffectively (as it now turns out) by a spouse on the “split” lifetime transfer of the decedent is not restored for further use by the spouse in case of subsequent lifetime transfers.78

As indicated earlier, in addition to a reduction for an amount for gift tax payable, the tentative tax is further reduced by tax credits,79 the most important of which is the unified credit provided by Section 2010.80 Other credits,81 which are discussed in Chapter 3, also reduce the net amount of estate tax payable.82


Lifetime gifts made after 1976 are automatically pulled into the estate tax structure in computing the rate of tax on the taxable estate and are subject to the same multipurpose rate table. An initial reaction might be that inter vivos gifts made after 1976 will not result in any overall tax savings. Although the government, not the taxpayer, has use of any gift tax dollars paid during the

amount of adjusted taxable gifts of the consenting spouse does not include the split portion of the donor decedent’s gift included in the donor decedent’s estate under Section 2035. See ¶ 2.01[1][b].

If the consenting spouse dies before the donor decedent and the gift is included in the donor decedent’s gross estate under Section 2035, the consenting spouse’s federal estate tax return will likely have to be amended. See Rev. Rul. 81-85, 1981-1 CB 452.

If the donor spouse dies within three years and if the consenting spouse pays tax on one half of the gift and lives beyond the reach of Section 2035, it is possible to have payment of the federal estate tax with dollars that are never included in the gross estate.


79 See Chapter 3.

80 That credit replaced the Section 2052 $60,000 exemption, which operated as a deduction under pre-1977 law. Cf. ¶ 3.02[1]. The current credit is generally the tax imposed on a basic exclusion amount of $5 million, adjusted for inflation after 2011. See ¶ 3.02.


82 Although Section 2001(b)(2) largely eliminates the use of the Section 2012 credit for gift taxes, that credit is still applicable with respect to pre-1977 gifts that find their way into the estate tax computation as part of the taxable estate, not as adjusted taxable gifts. See supra note 56.
donor’s lifetime, there are offsetting factors. While lifetime gifts play a part in the computation of the estate tax, appreciation of the transferred property between the date the gift is made and the date of the donor’s death is not included as a taxable amount. This is because adjusted taxable gifts are included in the transfer tax base at their value when the gift is complete.\(^{83}\) Second, income generated by the gift property between the time of the gift and the time of death is not included in a decedent’s gross estate. In addition, assuming a post-gift survival period of more than three years, the amount of any gift tax payable is not included in the transfer tax base.\(^ {84}\) Therefore, federal gift taxes paid on lifetime transfers reduce the tax base in a way that the federal estate taxes do not.


A brief overview of some of the procedural matters covered in subtitle F is provided.\(^{85}\) The estate tax is subject to detailed rules prescribing for the proper assessment\(^ {86}\) and collection of tax,\(^ {87}\) including rules related to liens on property.\(^ {88}\) The deficiency and refund procedures\(^ {89}\); the interest\(^ {90}\) and penalty provisions\(^ {91}\); and the limitations periods on assessment, collection, and refunds that generally govern the income, gift, and generation-skipping transfer taxes are also applicable to the estate tax.\(^ {92}\)

\(^{83}\) Cf. supra ¶ 2.01[1][b][iii].
\(^{84}\) See IRC § 2035(b). See ¶ 4.07[3].
\(^{85}\) Although some procedural matters related to the estate tax are discussed in this treatise, there is no detailed discussion. For a detailed discussion of subtitle F, see M. Saltzman, IRS Practice and Procedure (Thomson Reuters/Tax & Accounting, Rev. 2nd ed. 2009).
\(^{86}\) IRC §§ 6201–6255.
\(^{87}\) IRC §§ 6301–6344.
\(^{88}\) See IRC §§ 6321, 6324, 6324A, 6324B.
\(^{89}\) IRC §§ 6211–6216, 6401–6408.
\(^{90}\) IRC §§ 6601–6631.
\(^{91}\) IRC §§ 6651–6751. For example, Section 6651 imposes a penalty for the failure to file a tax return or to pay a tax when it is due.
\(^{92}\) IRC §§ 6501–6515.
\section*{2.02 SECTION 2002. LIABILITY FOR PAYMENT}

Section 2002 requires the executor to pay the estate tax.\footnote{The term “executor” has a broad meaning that is not confined to one appointed as executor of a will or even to one named as the administrator of an estate. The statutory definition of the term appears in Section 2203. See § 8.02. Cf. IRC § 7701(a)(47).} According to the regulations, the executor’s duty to pay the tax “applies to the entire tax, regardless of the fact that the gross estate consists in part of property which does not come within the possession of the executor.”\footnote{Reg. § 20.2002-1. For an example of such a possibility, see Section 2036, discussed at § 4.08, in part concerning transfers with retained life estates.} Taken literally, the Code and the corresponding regulations state that once one assumes the position of executor, the individual is required to pay the entire estate tax, even though that individual must dig into personal funds to do so. That is, the executor might be looked upon as fully responsible to the government, even if the executor is entitled to reimbursement from others. Although there is some authority for this view,\footnote{Baldwin v. Comm’r, 94 F2d 355 (9th Cir. 1938).} it seems unacceptable in the light of other statutory provisions that fasten personal liability onto the executor only in specified circumstances.\footnote{See the comments on discharge of the executor from personal liability in the discussion of Section 2204, at § 8.03.} A better view is that the executor incurs personal liability only for a fiduciary impropriety\footnote{See Reg. § 20.2002-1; Schwartz v. Comm’r, 560 F2d 311 (8th Cir. 1977); Leigh v. Comm’r, 72 TC 1105 (1979). These cases are considered in Huchberg & Silbergleit, “Recent Cases Narrow Scope of Executor’s Personal Liability for Taxes,” 7 Est. Plan. 2 (1980). See also Bank of the W. v. Comm’r, 93 TC 462 (1989); Estate of Pittard v. Comm’r, 69 TC 391 (1977) (executor was found liable for civil fraud penalty for errors in estate tax return). Cf. Occidental Life Ins. Co. of Cal. v. Comm’r, 50 TC 726 (1968).} and that, except with regard to priorities, the executor’s duty regarding the payment of estate taxes is not appreciably different from the executor’s obligation under state law to other creditors of the estate.\footnote{The problem is elaborately considered in 6 Mertens, Law of Federal Gift and Estate Taxation §§ 43.02–43.12 (1960). See also Alexander, “Personal Liability of Executors and Trustees for Federal Income, Estate and Gift Taxes,” 9 Tax L. Rev. 1 (1953).} The clear thrust of the statute is to centralize responsibility in the executor, and, in the usual case where estate assets available to the executor are sufficient to pay the tax, a simple and orderly method for payment is the result.

Section 6324(a)(1) imposes a lien upon the property in a decedent’s gross estate for a period of ten years from the date of the decedent’s death, if the estate tax is not paid.\footnote{IRC § 6324(a)(1). The lien does not apply to property included in the decedent’s gross estate that is used to satisfy Section 2053 obligations. Id.} The discharge of the executor from
personal liability under Section 2204 does not release the property from the lien.9

[1] Estate Tax Returns

[a] In General

The requirement to file an estate tax return is discussed in detail in other sections of the book.10

[b] Forms

Decedents that are citizens or residents file an estate tax return on Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return.11 A decedent who is neither a citizen nor a resident files Form 706-NA, United States Estate (and Generation-Skipping Transfer) Tax Return.12

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9 IRC § 6324(a)(3). See ¶ 8.03[2].

10 If the decedent is a citizen or resident, Section 6018(a)(1) provides the rules for filing an estate tax return. See also IRC § 6018(a)(3). The rules are closely related to the Section 2010 unified credit under the estate tax and consequently they are discussed in conjunction with that credit. See ¶ 3.02[3].

If the decedent is a nonresident noncitizen, Section 6018(a)(2) provides the rules for filing an estate tax return. See also IRC § 6018(a)(3). The rules are discussed at ¶ 6.01[4].

11 The return is generally revised on an annual basis. See, e.g., Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return (Rev. August 2012). See also Instructions for Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return (Rev. August 2012).

Returns of decedents who were citizens or residents must always be accompanied by a certified copy of the will, if the decedent died testate. Reg. § 20.6018-4(a). Even though this requirement is clearly stated in the Instructions for the return, it is often not observed, which, as the Instructions warn, delays the processing of the return. See Instructions for Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return (Rev. August 2012), Supplemental Documents, at 4. Other documentation may be required or permitted and desirable. Id. See also Reg. § 20.6018-4(a).

12 The return is generally revised on an annual basis. See, e.g., Form 706-NA, United States Estate (and Generation-Skipping Transfer) Tax Return, Estate of nonresident not a citizen of the United States (Rev. July 2011). See also Instructions for Form 706-NA, United States Estate (and Generation-Skipping Transfer) Tax Return, Estate of nonresident not a citizen of the United States (Rev. August 2011). Various documents are required to be filed with the return. See Reg. § 20.6018-4(b).
[c] When to File

Both types of returns generally must be filed within nine months after the decedent’s death. An extension can be obtained for filing the return. Section 6081 grants general authority to the Service to extend the time for filing tax returns required by the Code or by regulations, and it provides for a six-month limit on extensions, except for executors who are abroad. For estate tax returns filed on Form 706 and several other forms, the six-month extension is automatic, if a timely application is made. However, it appears that for other estate tax returns, the regulations indicate that an application for extension will be granted only if “good and sufficient cause” is demonstrated. An extension
of time for filing of the return under Section 6081 does not operate to extend the time for payment of the tax.\textsuperscript{17}

Section 6651(a)(1) imposes a penalty of 5 percent (with a maximum of 25 percent) of the amount of the tax for each month of delinquency in filing (determined with regard to any extension of the time for filing),\textsuperscript{18} unless the delay is “due to reasonable cause and not due to willful neglect.”\textsuperscript{19} Generally, the executor has a nondelegable duty to file the return on time. That duty is not satisfied, that is, reasonable cause is not shown, by the executor’s reliance on an attorney or an accountant who either fails to inform the executor of the correct filing deadline or fails to file the return within that deadline.\textsuperscript{20} However, rea-

\textsuperscript{17} Reg. § 20.6081-1(e). See infra ¶¶ 2.02[2], 2.02[3]; Estate of Baccei, 632 F3d 1140 (9th Cir. 2011) (late payment penalties assessed where Form 4768 filed without completion of Part III notwithstanding accompanying letter requesting an extension of time to pay).

\textsuperscript{18} But see Rev. Rul. 81-237, 1981-2 CB 245 (in computing failure to file penalty, no reduction in amount of tax due for payments made during extension period); Constantino v. United States, 85-2 USTC ¶ 13,629 (ND Cal. 1985) (payment of tax during extension period did not reduce amount of failure-to-file penalties).

\textsuperscript{19} IRC § 6651(a)(1).

\textsuperscript{20} United States v. Boyle, 469 US 241 (1985); United States v. Blumberg, 86-1 USTC ¶ 13,658 (CD Cal. 1985); Estate of Cox v. United States, 637 F. Supp. 1112 (SD Fla. 1986); Constantino v. United States, 85-2 USTC ¶ 13,629 (ND Cal. 1985); Estate of Newton v. Comm’r, 59 TCM (CCH) 469 (1990); Maltman v. Comm’r, 73 TCM (CCH) 2162 (1997); Estate of Hinz v. Comm’r, 79 TCM (CCH) 1289 (2000); Freeman v. United States, 2012-1 USTC ¶ 60,636 (ED Pa. 2012). See Estate of Liftin v. United States, 108 AFTR2d 7108 (Ct. Cl. 2011) (no summary judgment for government on question of reasonable cause). In the Boyle case, the Supreme Court resolved a conflict among several circuits by drawing what it described as a “bright line” to conclude that reliance on a tax expert to file the return or inform the executor when the return was due was not “reasonable cause” under Section 6651(a)(1), because the executor could have easily filed the return himself or ascertained when the return was due. Boyle may draw a “bright line,” but it leaves many “reasonable cause” questions unanswered. See Estate of Campbell v. Comm’r, 62 TCM (CCH) 1514 (1991) (neither the fact that the estate could not obtain appraisal information on its principal asset nor reliance on the attorney’s advice not to file incomplete estate tax return constituted reasonable cause); Estate of Melville v. Comm’r, 66 TCM (CCH) 1076 (1993) (neither reliance on erroneous advice of an attorney that penalty for late filing of estate tax return would be waived nor lack of funds to pay tax constituted reasonable cause); Estate of Landers v. Comm’r, 92 TCM (CCH) 369 (2006) (return preparer’s hip fracture was not a reasonable cause); Estate of Cederloff v. United States, 2010-2 USTC ¶ 60,604 (D. Md. 2010) (difficulties valuing estate and reliance on advice of professional not reasonable cause). See also Brookens, “Section 6651(a)(1) Penalty for Late Filed Returns: Reasonable Cause and Unreasoned Decisions,” 35 Case W. Res. L. Rev. 183 (1985); Newmann, “Supreme Court Holds That Reliance on Attorney Was Not Reasonable Cause for Late Filing,” 13 Tax’n for Law. 266 (1985); Trost, “Supreme Court Rules Reliance on Counsel Is Not Reasonable Cause to Abate Late Filing Penalty,” 12 Est. Plan. 138 (1985).
sonable cause is established and the penalty is inapplicable if the executor relies on substantive advice by a tax adviser that filing a return is not required.\footnote{See United States v. Boyle, 469 US 241, 250 (1985); Estate of Paxton v. Comm’r, 86 TC 785 (1986) (executor relied on advice of counsel that certain trusts were not includible within the gross estate, and, consequently, no return was required to be filed); Estate of Chagra v. Comm’r, 60 TCM (CCH) 104 (1990) (executrix reasonably relied on advice of attorney that a return was not required); Estate of Lennon v. Comm’r, 62 TCM (CCH) 326 (1991) (personal representative reasonably relied on the advice of attorney that the date-of-death value of the estate did not require the filing of a return). Cf. Estate of Buring v. Comm’r, 51 TCM (CCH) 115 (1985) (reliance on advice from accountant that certain gifts were loans, and no gift tax return was required to be filed).}

The reasonable cause test is also met under some other extenuating conditions.\footnote{Brown v. United States, 630 F. Supp. 57 (MD Tenn. 1985) (old, inexperienced executor in ill health was incapable of ordinary business care and prudence when an emergency arose with his attorney); but see Rossman v. United States, 2012-1 USTC \¶ 60,638 (Fed. Cl. 2012) (emotional distress, poor market conditions, and misinformation by accountant did not constitute reasonable cause to avoid penalties); Estate of Lee v. Comm’r, 97 TCM (CCH) 1435 (2009) (executor’s late filing of return reasonable and in good faith where reliance on attorney’s advice that estate received a second extension); Estate of Charania, 608 F3d 67 (1st Cir. 2010) (estate not subject to late-filing penalties where Service had previously abated a separate late-filing penalty for reasonable cause).}

In filing an estate tax return, the executor is treated as providing the requisite notice of qualification as executor.\footnote{IRC § 6036; Reg. § 20.6036-2.} However, anyone who acts in a fiduciary capacity for another, including an executor and an administrator, is required to give notice of the fiduciary relationship.\footnote{IRC § 6903; Reg. § 301.6903-1(a); Estate of McElroy v. Comm’r, 82 TC 509 (1984). Form 56, Notice Concerning Fiduciary Relationship, is provided for this purpose and for notice of termination. Notice of termination must be given to relieve the fiduciary of any further duty or liability. IRC § 6903(a); see Reg. § 301.6903-1(b).}

\[\text{[d] Where to File}\]

Although the statute dealing with the location where a decedent’s estate tax return is to be filed generally provides that the return of a resident decedent is filed with the Service Center of the Service district in which the decedent was domiciled at death, the statute also permits the Service to designate other locations.\footnote{IRC § 6091(b)(3)(A)(ii).} Under this authority, the Service has centralized filing loca-
tions. If a resident or nonresident files using the U.S. Postal Service or a private delivery service, the return is filed at the Service Center in Cincinnati, Ohio. In the alternative, a resident may hand deliver the return to the Service Center in the Service district where the decedent was domiciled at death.

[2] Payment of the Estate Tax

In general, Section 6151 requires that the estate tax be paid at the time and place fixed for the filing of the return. Section 6651(a)(2) imposes a penalty of 0.5 percent (with a maximum of 25 percent) of the amount of tax shown on the estate tax return for the first month and for each additional month or fraction of a month the tax is delinquent determined with regard to any extension of time for payment, unless it is shown that the failure to pay timely is “due to reasonable cause and not due to willful neglect.”

[3] Extension of Time for Payment

The Code presents several provisions that permit deferral of payment of the estate tax. The principal sections are 6159, 6161, 6163, and 6166. Each deserves some comment.

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26 To meet the “timely mailing as timely filing/paying” rule for tax returns and payments the Instructions permit use of a specific service offered by DHL Express, Federal Express, or United Parcel Service. Instructions for Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return (Rev. August 2012) at 3.


28 IRC § 6091(b)(4); Reg. § 20.6091-1(a). Presumably, the hand-delivery rule is to enable executors to conveniently ensure timely filing without relying on the timely mailing rule of Section 7502.

29 IRC § 6151(a); Reg. § 20.6151-1(a).

30 See infra ¶ 2.02[3].

31 IRC § 6651(a)(2). See supra ¶ 2.02[1][c], text accompanying notes 19–22.

32 If extension of time to pay the estate tax is granted, the Secretary may require the taxpayer to furnish a bond not exceeding double the amount of tax with respect to which the extension is granted. IRC § 6165. Cf. Estate of Roski v. Comm’r, 128 TC 113 (2007); infra ¶ 2.02[3][c], note 123.

33 Section 6163, permitting extension for tax on remainders, is discussed at ¶ 3.07.

34 Potential estate tax savings derived from the use of the installment payment provisions of the Code are discussed in several articles that may be useful even if some are not
IMPOSITION OF ESTATE TAX ¶ 2.02[3][a]

[a] Section 6159

This is a general provision applicable to any tax (not just an estate tax) under which the Service is authorized to enter into a written agreement with a taxpayer to satisfy a tax liability by installment payments if the Service determines that such an arrangement will facilitate collection of the tax liability. The agreement generally remains in effect for the term specified therein. However, the Service may terminate the agreement if the taxpayer provides inaccurate or incomplete information, or if the Service determines that collection of any tax to which an agreement relates is in jeopardy. In addition, the Service may alter, modify, or terminate an agreement if the taxpayer fails to pay an installment when it is due, fails to pay any other tax liability when it is due, or fails to provide any updated financial information requested by the Service. If the Service makes a determination that there is a significant


35 IRC § 6159(a). See Reg. § 301.6159-1. Interest would be due on any deferral. See IRC §§ 6601, 6621. Section 6159(a) applies to installment agreements entered into after November 10, 1988. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 6234(c), 102 Stat. 3342, 3736 (1988), 1988-3 CB 1, 396. A user fee of $105 is imposed for entering into an installment agreement under Section 6159, except that the fee is $52 when the taxpayer pays by way of direct debit from the taxpayer’s bank account. Notwithstanding the method of payment, the fee is $43, if the taxpayer is a low-income taxpayer. 26 CFR § 300.1(b) (2010). See Reg. § 301.6159-1.

36 IRC § 6159(b)(1).

37 IRC § 6159(b)(2)(A).

38 IRC § 6159(b)(2)(B); Reg. § 301.6159-1(e)(1).

39 IRC § 6159(b)(4)(A); see Reg. § 301.6159-1(e)(2). A user fee of $45 is imposed for restructuring or reinstating an installment agreement entered into under Section 6159. 26 CFR § 300.2(b) (2010).

40 IRC § 6159(b)(4)(B). See Reg. § 301.6159-1(e)(2).


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¶ 2.02[3][b]  change in the financial condition of the taxpayer, the Service may also alter, modify, or terminate the agreement.

[b] Section 6161

[i] Short extensions. The general rule of this long-standing provision complements the Section 6081 extension of time for filing returns. Here, extension of the time for payment may be made by the Service for up to twelve months. Section 6161(a)(1). To the statutory rule expressed in terms of discretion, the regulations add a requirement of “reasonable cause.” Routine requests for brief extensions of time for filing may encompass a companion request for deferred payment of up to six months or a year. Of course, as there is no contrary special rule, normal interest will be payable from the date prescribed for payment without regard to the extension.

[ii] “Reasonable cause” extensions. Section 6161(a)(2) permits a much longer extension of the time for payment, up to ten years. In this instance, the interest rate fluctuates and approximates the prime rate. The interest is generally deductible by the estate under Section 2053(a)(2). Estate of Bahr v. Comm’r, 68 TC 74 (1977); Estate of Buchholtz v. Comm’r, 70 TC 814 (1978); Rev. Rul. 81-154, 1981-1 CB 470. Cf. Rev. Rul. 80-250, 1980-2 CB 278, allowing a Section 2053 deduction for interest only when it accrues on extensions to pay under Sections 6161 and 6163. See ¶ 5.03[3][c], text accompanying note 119. A Form 706 with the supplemental information must be filed to annually deduct interest and recompute the estate tax as authorized in Rev. Proc. 81-27, 1981-2 CB 548, where an estate has been granted an extension of time to pay estate tax under Section 6161. Priv. Ltr. Rul. 9241002 (July 23, 1992). But see IRS Chief Couns. Adv. Mem. 200836027 (May 12, 2008) (interest on extension to pay estate tax Section 6161 nondeductible personal interest under Section 163(h)(2)).

IRC § 6159(b)(3). This action may be taken only if the Service notifies the taxpayer of its determination at least thirty days prior to the date of the action and provides in the notification an explanation of why it intends to take such action. These requirements do not apply if the Service believes that the collection of tax covered by the agreement is in jeopardy. IRC § 6159(b)(5). See Reg. § 301.6159-1(e)(4).

Reg. § 20.6161-1(a)(1). See infra note 51, for discussion of examples involving “reasonable cause.”

See Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes. See supra ¶ 2.02[1][c], note 14.


The interest is generally deductible by the estate under Section 2053(a)(2). Estate of Bahr v. Comm’r, 68 TC 74 (1977); Estate of Buchholtz v. Comm’r, 70 TC 814 (1978); Rev. Rul. 81-154, 1981-1 CB 470. Cf. Rev. Rul. 80-250, 1980-2 CB 278, allowing a Section 2053 deduction for interest only when it accrues on extensions to pay under Sections 6161 and 6163. See ¶ 5.03[3][c], text accompanying note 119. A Form 706 with the supplemental information must be filed to annually deduct interest and recompute the estate tax as authorized in Rev. Proc. 81-27, 1981-2 CB 548, where an estate has been granted an extension of time to pay estate tax under Section 6161. Priv. Ltr. Rul. 9241002 (July 23, 1992). But see IRS Chief Couns. Adv. Mem. 200836027 (May 12, 2008) (interest on extension to pay estate tax Section 6161 nondeductible personal interest under Section 163(h)(2)).

IRC §§ 6601(a), 6601(b)(1).

See comments on extensions and on installment payments under Section 6166, infra ¶ 2.02[3][c]. See also supra note 46.

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however, the statute itself requires a showing of “reasonable cause.” The reasonable cause requirement in Section 6161(a)(2) replaced a required showing of “undue hardship.” Congress intended to provide estates with greater relief from liquidity problems, and the term “reasonable cause” here should be interpreted in line with the meaning given it in the regulations applicable to Section 6161(a)(1). If an extension of time for payment is granted under Section 6161(a)(2) other than with regard to installment payments under Section 6166 discussed in the following section, interest is payable for the usual time at normal rates.

[c] Section 6166

[i] Introduction. In effect, Congress has long held that it can identify some situations that are res ipsa loquitur payment deferral cases. Section 6166 is one of those situations, providing deferral of estate taxes attributable to certain interests in closely held businesses. Estate tax within Section 6166 gen-

51 HR Conf. Rep. No. 1515, 94th Cong., 2d Sess. 399, 611 (1976), reprinted in 1976-3 CB (Vol. 3) 807, 961. Compare Regulations Section 20.6161-1(a)(1), Exs. 1 – 4, of reasonable cause, involving the following:

1. Difficulty in marshaling adequate liquid assets scattered in several jurisdictions;
2. Substantial portion of assets in the form of royalty or similar rights to future payment against which estate cannot borrow upon reasonable terms;
3. Substantial estate assets not collectible without litigation; and
4. Lack of funds or reasonable accessibility thereto to pay estate tax and to provide survivors’ support during administration and to pay claims that are due;

with Regulations Section 20.6161-1(a)(2)(ii), now obsolete, because of a change in Section 6161(a) by Technical Amendments of 1958, Pub. L. No. 85-866, § 206(c), 72 Stat. 1606 (1958), reprinted in 1958-3 CB 254, 332, which stated that “undue hardship” means more than inconvenience and that a sale of estate assets at fair market value is not undue hardship. See Reg. § 20.6161-1(a)(2)(ii), Exs. 1 and 2 (illustrated “undue hardship”).


52 IRC §§ 6601(a), 6621. See supra note 46. There is no “reasonable cause” exception for the payment of interest. Church v. United States, 79-2 USTC ¶ 13,306 (EDNY 1979).

erally may remain entirely unpaid for five years, after which the tax generally may be paid over a maximum of ten installments, one each year with the first due at the end of year five, thus extending the time to pay the estate tax attributable to the value of the interest for up to fourteen years.\footnote{54} Interest is charged on the unpaid tax, but it is charged at preferential rates.\footnote{55} Section 6166 may work in combination with other provisions providing estate tax assistance to closely held businesses such as Sections 303\footnote{56} and 2032A.\footnote{57}

[ii] Qualification for extension. A variety of technical requirements must be satisfied to permit a decedent’s estate to defer payment of part of a decedent’s estate taxes under Section 6166. The decedent must have been a citizen or resident of the United States at the date of the decedent’s death.\footnote{58} In addition, an election to employ Section 6166 must be made by the decedent’s executor.\footnote{59} Finally, the section applies only when the value of certain closely held business interests constitute more than 35 percent of the decedent’s adjusted gross estate.\footnote{60}

\footnotetext[54]{IRC §§ 6166(a)(1), 6166(a)(3).}
\footnotetext[55]{See infra ¶ 2.02[3][c][v].}
\footnotetext[57]{See ¶ 4.04.}
\footnotetext[58]{IRC § 6166(a)(1).}
\footnotetext[59]{IRC § 6166(a)(1).}
\footnotetext[60]{IRC § 6166(a)(1).}
Election. An election under Section 6166 is made with the decedent’s
return at the time of filing the return. Further, a timely but unsuccessful
election made in good faith under Section 6166 is treated as a timely reason-
able cause application for extension under Section 6161. If the decedent’s
estate has a deficiency and the other requirements of Section 6166 are satisfied,
the section allows an executor to pay the deficiency attributable to the qualify-
ing closely held business interests in installments, even if no election was
made when the return was filed.

Value of Interests in Closely Held Businesses Must Exceed 35 Percent of
the Decedent’s Adjusted Gross Estate. The value of the closely held active
business assets must constitute a significant portion of the value of the dece-
dent’s gross estate in order to defer the payment of estate tax related to those
assets. The determination whether this requirement is met is a three-step pro-

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61 See Rev. Proc. 79-55, 1979-2 CB 539, for Service procedures in processing re-
quests.

“No news is good news!” If the executor’s request is proper, it is likely no com-
unication will be received. But see Rocovich v. United States, 1989-2 USTC ¶ 13,819 (Cl.
Ct. 1989), aff’d, 933 F2d 991 (Fed. Cir. 1991) (Service not equitably estopped from disal-
lowing taxpayer’s Section 6166 election upon audit nearly three years after return was
filed, because of failure to deny the deferral earlier; silence was not a misrepresentation of
fact).

(election must be attached to timely filed estate tax return, not a request for an extension).

63 IRC § 6166(d). See Priv. Ltr. Rul. 8512003 (Nov. 30, 1984) (election invalid, be-
cause not attached to timely filed return where request for extension of time to file de-
exception exists for denial of election if election made on untimely filed estate tax return);
Priv. Ltr. Rul. 200721006 (Feb. 14, 2007) (estate denied an extension of time to file elec-
tion under Regulations Section 301.9100-3, because election is prescribed by statute not
regulations); Priv. Ltr. Rul. 201015003 (Oct. 26, 2009) (no reasonable cause exception
where filing delegated to party who failed to make Section 6166 election).

If an election was made with the return, deficiencies are also covered. IRC § 6166(e);
Reg. § 20.6166-1(c)(2). See also Section 6166(f)(3) with regard to interest on the assess-
ment of the deficiency.

A protective election may be made to defer payment of any portion of tax remaining
unpaid at the time the values are finally determined and any deficiencies attributable to
the closely held business interest. Reg. § 20.6166-1(d).

64 Reg. § 20.6161-1(b). See discussion of Section 6161, including its regulatory re-
quirements, supra ¶ 2.02[3][b].

65 IRC § 6166(h)(1); Reg. § 20.6166-1(c)(1). If an election was not made with the re-
turn and there is a deficiency, an election is timely if made within sixty days after notice
and demand for payment. IRC § 6166(h)(2). The election will cause a proration of the
amount of the deficiency among all past and future installment dates created by an ex-
isting election or those that would have been created had a timely election occurred with
the return. All amounts allocated to installment dates that preceded the election will be
due at the time of the deficiency election. IRC § 6166(h)(3).
cess: (1) the decedent must own an interest in a closely held business; (2) the active business assets in the closely held business must be separated from the other business assets; (3) the value of such active assets in the closely held business must exceed 35 percent of the decedent’s adjusted gross estate.

Closely Held Business. A decedent’s interest in a sole proprietorship qualifies as a closely held business under Section 6166. If the decedent was a partner in a business, the decedent’s partnership interest in that business qualifies as a closely held business under Section 6166, if at least 20 percent of the total capital interests in the partnership are included in the decedent’s gross estate or if the partnership has no more than forty-five (fifteen for years prior to 2002) partners. The decedent’s ownership in a corporation similarly qualifies if at least 20 percent of the voting stock is included in the decedent’s gross estate or if the corporation has no more than forty-five (fifteen for years prior to 2002) shareholders.

The 20 percent ownership and forty-five-member tests applicable to partnership or corporate interests are determined immediately before the decedent’s death. Several special rules apply in measuring the ownership or membership tests. First, stock and partnership interests held by spouses as community property or in any form of joint ownership with or without survivorship rights are treated as if they are held by one shareholder or one partner for purposes of the forty-five-member limitation. Second, ownership by an entity is attributed to the owners of the entity. Third, stock or a partnership

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66 IRC § 6166(b)(1).
67 IRC § 6166(b)(9).
68 IRC § 6166(a)(1).
69 IRC § 6166(b)(1)(A).
70 IRC § 6166(b)(1)(B). Seemingly, a limited liability company (which is taxable as a partnership for federal income tax purposes) will be treated as a partnership for purposes of Section 6166.
71 IRC § 6166(b)(1)(C). See supra note 70.
72 IRC § 6166(b)(2)(A).
73 IRC § 6166(b)(2)(B). This rule is not limited to the decedent and the decedent’s spouse but applies to all spousal owners. Thus, if a partnership has ninety partners, consisting of forty-five sets of spouses whose interests are held as community property, then the decedent’s ownership of one half of the community property will qualify for measurement in the 35 percent test, because the statute treats the partnership as if it is owned by only forty-five partners.
74 IRC § 6166(b)(2)(C). These rules attributing ownership from an entity to an owner can be helpful in qualifying the estate for the 20 percent ownership requirement, but they can also operate to disqualify the estate from the forty-five-member requirement. For ex-
interest held by a member of the decedent’s “family” (within the meaning of Section 267(c)(4)) is treated as if it were owned by the decedent.\textsuperscript{75} The government, seemingly inappropriately, contends that the foregoing second and third attribution rules apply only for measurement of the forty-five-member test and that the attribution rules apply in measuring the 20 percent tests only if a Section 6166(b)(7)(A) election is made.\textsuperscript{77} Section 6166(b)(7)(A) treats the decedent’s estate as owning the interests not only for the 20 percent tests of Sections 6166(b)(1)(B)(i) and 6166(b)(1)(C)(i) but also for purposes of Section 6166(c)\textsuperscript{78} and it pulls such attributed property into the decedent’s gross estate for purposes of the 35 percent test\textsuperscript{79} if the decedent’s executor so elects.\textsuperscript{80} However, if the executor makes the Section 6166(b)(7) election, there is a relinquishment of two of the benefits normally provided under Section 6166:

\textsuperscript{75} For these purposes, “family” means brothers and sisters (whether by the whole or the half blood), spouses, ancestors, and lineal descendants. IRC § 267(c)(4). In determining whether any of these relationships exists, full effect is given to a legal adoption. Reg. § 1.267(c)-1(a)(4).

\textsuperscript{76} IRC § 6166(b)(2)(D).

\textsuperscript{77} Priv. Ltr. Rul. 8428088 (Apr. 12, 1984) (involving the Section 6166(b)(1)(D) family attribution rule); Priv. Ltr. Rul. 9644053 (Aug. 1, 1996) (involving the Section 6166(b)(1)(C) entity attribution rule); Priv. Ltr. Rul. 200529006 (Apr. 11, 2005) (involving the Section 6166(b)(1)(C) entity attribution rule). While Section 6166(b)(7) is more specific than Sections 6166(b)(2)(C) and 6166(b)(2)(D) with respect to its interrelationship with Sections 6166(b)(1)(A)(i) and 6166(b)(2)(A)(i), they are not inconsistent and both can operate independently in different situations. As a result, the government’s position based on a very weak legislative history comment (see HR Conf. Rep. No. 1380, 94th Cong., 2d Sess. 62 (1976), reprinted in 1976-3 (Vol. 3) CB 738, 766, which is quoted supra Priv. Ltr. Rul. 9644053) seems incorrect. The Sections 6166(b)(2)(C) and 6166(b)(2)(D) attribution rules should apply to Sections 6166(b)(1)(B)(i) and 6166(b)(1)(C)(i) both where a Section 6166(b)(7) election is not made and where one is made.

\textsuperscript{78} IRC § 6166(c). See infra text accompanying notes 119–121.

\textsuperscript{79} IRC § 6166(b)(7)(A)(i). See infra text accompanying notes 116–118.

\textsuperscript{80} IRC § 6166(b)(7)(A)(i).
namely, the 2 percent interest rate on the tax on the qualifying interest\textsuperscript{81} and the five-year deferral for the payments.\textsuperscript{82}

The Active Business Requirement. The deferral provisions inherently require the closely held business\textsuperscript{83} to be carrying on an active trade or business and not to be a mere holding company.\textsuperscript{84} There is no requirement that the decedent materially participate or even actively participate in the closely held business for the estate to utilize the election.\textsuperscript{85} However, even where an active trade or business is carried on, for purposes of measuring whether the closely held business meets the 35 percent test, the portion of the business attributable to passive assets is disregarded.\textsuperscript{86} This rule precludes the decedent from “stuffing” an otherwise active business with passive assets in order to satisfy the 35 percent test. A “passive asset” is any asset other than an asset used in carrying on a trade or business.\textsuperscript{87}

Lines here can be difficult to draw, especially where the trade or business involves the holding of real estate. In some instances, Section 6166 expressly permits residential property (even if it is a passive asset) to be included in valuing a closely held farming business for purposes of the 35 percent test.\textsuperscript{88} In other situations over the years, there were several private letter rulings some finding and others not finding an active trade or business.\textsuperscript{89} The Service has recently taken a taxpayer-friendlier position in its rulings.\textsuperscript{90}

\textsuperscript{81} IRC § 6166(b)(7)(A)(iii). See infra text accompanying notes 132–136.
\textsuperscript{82} IRC § 6166(b)(7)(A)(ii). See infra text accompanying notes 123–124.
\textsuperscript{83} See IRC § 6166(b)(9)(A).
\textsuperscript{84} See IRC §§ 6166(b)(1)(A), 6166(b)(1)(B), 6166(b)(1)(C) (each subparagraph refers to the “carrying on” requirement).
\textsuperscript{86} IRC § 6166(b)(9)(A).
\textsuperscript{87} IRC § 6166(b)(9)(B)(ii).
\textsuperscript{88} IRC § 6166(b)(3).
\textsuperscript{90} Rev. Rul. 2006-34, 2006-1 CB 1172 (revoking Rev. Rul. 75-365, 1975-2 CB 471, and a part of Rev. Rul. 75-366, 1975-2 CB 472 (involving eight rental homes that were

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Generally the stock of a mere holding company does not qualify for Section 6166 deferral. However, under a special rule, Section 6166 permits the decedent’s executor to elect to have stock of a holding company pierced to determine the extent to which the holding company owns stock in a closely held active trade or business which stock may then qualify for deferral.\(^91\) If all of the pierced stock is non–readily tradable stock, deferral is permitted to any pierced stock that qualifies for deferral.\(^92\) However, in such circumstances, the benefits of both the 2 percent interest rule and the five-year deferral rule are automatically waived.\(^93\) If some of the pierced stock is publicly traded, deferral is permitted to the non–publicly traded pierced stock that otherwise qualifies for deferral.\(^94\) However, in such circumstances, in addition to automatic waiver of the 2 percent interest rule and the five-year deferral rules, the payment period is shortened from the normal ten years to five years.\(^95\)

Similarly, if a business owns stock in another business, that stock will generally be treated as a passive asset for purposes of the preceding rules.\(^96\) However, another special rule allows the subsidiary shell to be pierced and a corporate subsidiary to be treated as part of its parent corporation if (1) the parent owns 20 percent or more of the value of the subsidiary’s voting stock or the parent is one of forty-five (fifteen for years prior to 2002) or fewer shareholders of the subsidiary;\(^97\) (2) 80 percent or more of the value of each corporation’s assets (excluding the value of the subsidiary’s stock held by the

treated as passive). See also another part of Rev. Rul. 75-366, 1975-2 CB 472 (operation of farm realty by decedent with tenant farmers was active, because the decedent was operating the farm for a gain based on production rather than securing a return as fixed rental income). Rev. Rul. 2006-34, 2006-1 CB 1172, lists six nonexclusive factors to be considered in determining whether a real estate activity was an active trade or business and it presented five situations and concluded that four of the five constituted an active trade or business.

\(^91\) IRC § 6166(b)(8). In measuring voting rights for purposes of the Section 6166(b)(1)(C)(i) 20 percent voting control test (see supra text accompanying note 71), the pierced stock is treated as voting stock to the extent that the voting stock in the holding company owns directly (or through voting stock of one or more other holding companies) voting stock in the business company. IRC § 6166(b)(8)(C).

\(^92\) IRC § 6166(b)(8)(B)(i).


\(^96\) IRC § 6166(b)(9)(B)(i).

\(^97\) IRC § 6166(b)(9)(B)(ii). See supra text accompanying note 71.

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parent) is used in carrying on that corporation’s trade or business; and (3) the decedent’s executor makes an election under the holding company rule discussed earlier.

A third special rule treats certain stock in a “qualifying lending and finance business” as an active trade or business if the executor so elects. A lending and finance business is a business that makes loans, purchases or discounts financial obligations, engages in the rental and leasing of property, and renders services or makes facilities available in the regular course of a lending and financial business and its own business. The business is a “qualifying” business if it satisfies either a “facts and circumstances” test or a mechanical test, both of which in essence require it to be an active trade or business. If the executor elects to use this special rule, there is no five-year deferral of payments and the payments must be paid over a five- (rather than a ten-) year period.

The 35 Percent Test. The value of the active business interests in a closely held business that meets the requirements described earlier must exceed 35 percent of the value of the decedent’s adjusted gross estate. The val-

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98 IRC § 6166(b)(9)(B)(iii)(II).
99 IRC § 6166(b)(9)(B)(ii)(I). See supra text accompanying notes 93–95, discussing the costs of such election.
101 IRC § 6166(b)(10)(A).
102 IRC § 6166(b)(10)(B)(ii). The services and facilities made available in connection with its own business may be carried on by another corporation that is a member of the same affiliated group (as defined in Section 1504 without regard to Section 1504(b)(3)). The definition of “qualifying lending and finance business” does not include an interest in an entity if the stock or debt of the entity (or a controlled group of which the entity was a member) was readily tradable on an established securities market or secondary market at any time in the three years preceding the decedent’s death. IRC § 6166(b)(10)(B)(iii).
103 IRC § 6166(b)(10)(B)(ii)(I). The test concerns whether, based on all the facts and circumstances, immediately before the decedent’s death there was substantial activity with respect to the business. Id.
104 IRC § 6166(b)(10)(B)(ii)(II). The test requires that, for at least three of the five taxable years preceding the decedent’s death, the business had (1) at least one full-time employee of whose services substantially all were the active management of such business; (2) ten full-time, nonowner employees of whose services substantially all were directly related to such business; and (3) $5 million in gross receipts from the lending or finance business. Id.
106 IRC § 6166(b)(10)(A)(iii). See infra ¶ 2.02[3][c][iii].
valuation used for testing purposes is expressly identified as the estate tax value.\[^{108}\] This contemplates possible use of the alternate valuation under Section 2032,\[^{109}\] as well as special real property valuation under Section 2032A.\[^{110}\]

The term “adjusted gross estate” is defined as the gross estate less the allowable\[^{111}\] Sections 2053 and 2054 deductions.\[^{112}\] Although the statute seemingly does not require it, the legislative history indicates that for purposes of measuring the numerator of the 35 percent test, the value of the active assets in the closely held business is reduced by allowable expenses, losses, and indebtedness related to those assets.\[^{113}\]

In measuring the adjusted gross estate, the gross estate computation\[^{114}\] differs from the normal computation in several ways. First, the estate must satisfy the 35 percent test both by including and by not including in the decedent’s gross estate all property gratuitously transferred within three years of the decedent’s death that is included in the decedent’s gross estate under Section 2035(a).\[^{115}\] Second, if the family attribution election is made under Section 6166(b)(7) to qualify for the 20 percent closely held business requirement,\[^{116}\] that election triggers the attribution of ownership of interests for purposes of

The interrelationship of the Section 2031(c) qualified conservation easement exclusion and the 35 percent test is discussed at ¶ 4.02[7][c], notes 431–440.

\[^{108}\] IRC § 6166(b)(4).

\[^{109}\] See ¶ 4.03.

\[^{110}\] See ¶ 4.04.

\[^{111}\] Even if Section 2053 or Section 2054 deductions are forgone under the estate tax and are instead deducted under the estate’s income tax pursuant to Section 642(g), a reduction occurs in computing the adjusted gross estate, because such amounts are “allowable” under Section 2053 or Section 2054.

\[^{112}\] IRC § 6166(b)(6). As the amount of the adjusted gross estate is partially dependent upon post-death occurrences, a timing rule is supplied that is not very satisfactory and leaves much to the regulations. IRC § 6166(b)(6). See IRC § 6166(j).

\[^{113}\] HR Conf. Rep. No. 201, 97th Cong., 1st Sess. 38, 181 (1981), reprinted in 1981-2 CB 352, 388. A net business value is consistent with its comparison to the net figure, the adjusted gross estate; but the statute itself speaks only of “the value…included in…the gross estate.” IRC § 6166(a)(1). Cf. Rev. Rul. 80-202, 1980-2 CB 363 (only the net value of a sole proprietorship (seemingly reduced by Section 2053 or Section 2054 deductions) is used in measuring the test). See infra text accompanying note 120 where the net value test should be applied.

\[^{114}\] Property included within the gross estate under Section 2044 is eligible for Section 6166 deferral. Reg. § 20.2044-1(b). Under the Bonner line of cases, Bonner Estate v. United States, 84 F3d 196 (5th Cir. 1996), the value of interests included in the gross estate under Section 2044 may be eligible for discounts that could affect the availability of Section 6166. See ¶¶ 4.02[4][b], text accompanying notes 157, 158, 4.16, text accompanying notes 19–23.

\[^{115}\] IRC § 2035(c)(2). See ¶ 4.07[2][d].

\[^{116}\] See supra text accompanying notes 77–82, especially notes 81 and 82, discussing the relinquishment of benefits when making such an election.
the 35 percent test as well. In measuring the amount of the decedent’s gross estate, the attributed family-owned stock is also treated as owned by the decedent.

Generally, each closely held business interest is treated separately under the 35 percent test. However, interests in two or more closely held businesses may be aggregated and treated as interests in a single business under the 35 percent test, if the decedent’s gross estate includes 20 percent or more of the total value of each separate business. Solely for purposes of determining the 20 percent aggregate requirement, business interests held by a spouse as community property or in any form of joint ownership with or without survivorship rights are treated as included in the decedent’s gross estate.

[iii] Period of extension. If an estate qualifies under Section 6166, the executor generally may elect to defer payment of all or a portion of the estate tax attributable to the qualifying interest for a period of up to five years, after which the unpaid tax may be paid in up to ten annual installments. The first installment is due on or before the date selected by the executor, which may

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117 IRC § 6166(b)(7)(A)(i).
118 IRC § 6166(b)(7)(A)(i). For example, assume decedent D owns a 10 percent interest that is worth $100,000 in a widely held partnership, that D’s sibling S also owns a $100,000, 10 percent interest in the partnership, and that D’s actual adjusted taxable estate is $300,000. Only the 10 percent interest D actually owns is used in measuring the Section 6166(b)(1)(B)(i) 20 percent test and the Section 6166(a)(1) 35 percent measurement, and D is unable to elect Section 6166, because D’s $100,000 interest does not meet the 20 percent or 35 percent tests. Assume D’s executor elects to use Section 6166(b)(7). That subsection attributes S’s interest to D’s gross estate for purposes of the Section 6166(a)(1) 35 percent test as well as for the Section 6166(b)(1)(B)(i) 20 percent test. Now D is treated as owning a $200,000, 20 percent interest in the partnership. The attributed interest meets the 20 percent test of Section 6166(b)(1)(B)(i) and it exceeds 35 percent of D’s now $400,000 adjusted gross estate. Thus, D’s actually owned $100,000 interest qualifies for Section 6166 deferral.
119 IRC § 6166(a)(1).
120 IRC § 6166(c).
121 IRC § 6166(c) (last sentence). Except for these interspousal rules, attribution is inapplicable here. Thus, actual ownership is required for the 20 percent test. If a decedent owned 25 percent of X corporation and 22 percent of Y sole proprietorship, the values of both are combined for the 35 percent test of Section 6166(a)(1). If both of the interests mentioned previously are held in joint tenancy with decedent’s spouse, then under the last sentence of Section 6166(c), the interests qualify for the 20 percent test of Section 6166(c). But attribution is limited to that test as the statute provides “for purposes of the 20 percent requirement of the preceding sentence.” Thus, the decedent’s Section 6166(b)(6) adjusted gross estate includes only the value of a 12.5 percent interest in X and 11 percent in Y for computation of the Section 6166(a)(1) 35 percent test.
122 IRC §§ 6166(a)(1), 6166(a)(3). See IRC § 6503(d) (extending the limitations period on collections when Section 6166 applies); United States v. Kulhanek, 755 F. Supp. 2d 659 (WD Pa. 2010).
not be more than five years after the regular filing and payment date provided by Section 6151(a) (nine months after death), with subsequent installments due on the anniversaries of the first payment, thus extending the time to pay the tax to up to fourteen years. In limited circumstances, the estate may not use the five-year period and must immediately make payments for the maximum ten-year period.

**[iv] Maximum amount of deferral.** Section 6166 does not necessarily permit installment payments of the entire estate tax. Generally, the section limits deferral to the tax attributable to the value of the active business assets of the closely held business interest. The balance of the tax is payable in a lump sum on the usual date. The formula for this limitation makes use of the adjusted gross estate figure as follows:

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123 IRC § 6166(a)(3). Generally, a lien for estate taxes, including taxes deferred under Section 6166, is imposed on the property in the decedent’s gross estate. IRC § 6324(a). See supra ¶ 2.02, text accompanying notes 7–9. In the alternative, Section 6324A allows the executor to elect a special lien for the payment of estate tax where the time for payment is extended under Section 6166. IRC § 6324A(d)(4). The maximum value of property subject to a lien is the amount of the deferred estate tax liability under Section 6166 plus interest for the first four years of a deferral period. IRC § 6324A(b)(2). See IRS Chief Couns. Adv. Mem. 200909044 (Dec. 2, 2008). Cf. ¶ 8.03[2] for consideration of the executor’s release of personal liability where a Section 6166 election is made. The Section 6324A lien is in lieu of the Section 6324(a) lien with respect to property identified in the lien. IRC § 6324A(d)(4); Reg. §§ 20.6324A-1(a), 301.6324A-1(e). See IRS Chief Couns. Adv. Mem. 200645027 (July 31, 2006) (interrelationship of Sections 6324(a) and 6324A liens).

In addition, with respect to any tax extension, Section 6165 allows the Secretary discretion to require a bond not to exceed double the amount with respect to which the extension is granted. IRC § 6165. See supra ¶ 2.02[3], note 32. However, no bond is required to the extent there is a Section 6324A lien. IRC § 6324A(d)(6). See IRS Chief Couns. Adv. Mem. 200747019 (Oct. 11, 2007) (forms of property interests as collateral).

The Tax Court has held that the Service has discretionary authority to require a bond or a Section 6324A election, but it does not have blanket authority to do so. Estate of Roski v. Comm’r, 128 TC 113 (2007). See Notice 2007-90, 2007-2 CB 1003, issued in response to the Roski opinion.

If inadequate security for a Section 6166 extension is provided, a Section 6166 election may be denied or terminated at any time. IRS Chief Couns. Adv. Mem. 200627023 (May 19, 2006).

125 Seemingly, the business could be included in the gross estate and make up 50 percent of the adjusted gross estate and could also fully qualify either for a charitable deduction under Section 2055 or a marital deduction under Section 2056 and thus generate no estate tax liability. Nevertheless, the numerator of the Section 6166(a)(2) fraction uses the amount of the business included in the gross estate (reduced by Sections 2053 and 2054 deductions) and not the net amount included in the taxable estate.
Qualified amount of tax\textsuperscript{126} = \frac{\text{closely held business amount}\textsuperscript{127}}{\text{adjusted gross estate}^{\text{128}}} \times \text{tax less credits}\textsuperscript{129}

[v] \textbf{Interest.} Although Section 6166 permits deferred payment of the estate tax, interest must be paid annually for the first five years, or any shorter period of outright deferral.\textsuperscript{130} Subsequently, interest is paid along with and as a part of annual tax installments.\textsuperscript{131} However, the interest imposed on a Section 6166 deficiency is substantially lower than the interest required on most tax deficiencies. Interest is generally imposed at a 2 percent interest rate on the “2 percent portion” of the deferral and at a rate of only 45 percent of the normal interest rate on any deferred amount in excess of the “2 percent portion.”\textsuperscript{132} The “2 percent portion” is the deferred tax due on the lesser of the entire amount of extended tax or the first $1 million (adjusted for inflation)\textsuperscript{133} of estate tax liability attributable to the qualifying closely held business interest.\textsuperscript{134}

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|}
\hline
Year & 2 percent portion & Authority \\
\hline
2009 & $1,330,000 & Rev. Proc. 2008-2 CB 1107 \\
2010 & $1,340,000 & Rev. Proc. 2009-50, 2009-2 CB 617 \\
2011 & $1,360,000 & Rev. Proc. 2010-40, 2010-2 CB 663 \\
2013 & $1,430,000 & Rev. Proc. 2012-41, 2012-2 CB 539 \\
\hline
\end{tabular}
\caption{2 percent portion of adjusted gross estate for estate tax deferral.}
\end{table}

\textsuperscript{126} IRC § 6166(a)(2).
\textsuperscript{128} IRC § 6166(b)(6). See supra text accompanying notes 111–118.
\textsuperscript{129} Although this formula determines the amount of tax that may be deferred for five years and then paid in ten annual installments, as previously explained, only a portion of the deferred tax may qualify for the favorable 2 percent interest rate. See infra text accompanying notes 132–136.
\textsuperscript{130} IRC §§ 6166(f)(1), 6166(f)(4); see IRC § 6601(a).
\textsuperscript{131} IRC § 6166(f)(2).
\textsuperscript{133} IRC § 6601(j)(3). The inflation adjustment applies to estates of decedents dying after 1998. Id. The adjustment uses the Consumer Price Index (CPI) for a base year of 1997. IRC § 6166(j)(3)(B). However, upward adjustments of the $1 million amount are made only in increments of $10,000, and are rounded down to the next lowest multiple of $10,000. IRC § 6166(j)(3) (flush language). An explanation of a similar adjustment is found at ¶ 9.04[1][a], text accompanying notes 6–9.
\textsuperscript{134} IRC § 6601(j)(2). Thus, the 2 percent rate of interest applies to the amount of deferred estate tax attributable to the first $1 million (adjusted for inflation) in taxable value of the closely held business (i.e., the first $1 million in value in excess of the applicable

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If the deferred amount of tax bears interest at both the 2 percent and 45 percent of normal rates, any payments of the deferred tax reduce the 2 percent and the 45 percent interest portions ratably. In limited circumstances, an estate may not be eligible for the 2 percent interest rate.

The benefit of both of the low interest rates applicable to the tax on Section 6166 property comes at a cost. The interest paid under the special low interest rates is neither deductible under the estate tax as a Section 2053 administrative expense nor deductible as interest under the income tax. The interest rates were reduced and the interest made nondeductible to eliminate the necessity to file annual supplemental estate tax returns and to make complex mathematical computations to claim an estate tax deduction for the interest paid.

[vi] The “gotcha”. In several situations, an estate may lose its right to defer the payment of taxes with the result that the payment of the taxes will be accelerated. For example, in order to properly police the statute, Congress

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137 IRC § 2053(c)(1)(D).

136 IRC § 163(k). See Priv. Ltr. Rul. 9903038 (Oct. 2, 1998) allowing a potentially appealing alternative to the use of Section 6166 in a situation where the entire amount of interest on a loan to pay estate taxes was deductible as an administrative expense under Section 2053(a)(2) where there was fixed interest on a seven-year loan with no possible prepayment of interest.

138 IRC § 6166(g). See IRC § 6324A(d)(5), which also triggers Section 6166(g). Section 6324A is discussed supra note 123.
provides a first rule that penalizes tardy payment of any principal or interest installment. If any installment is not paid when due or within six months following the due date, the entire unpaid portion of the tax must be paid upon notice and demand.\textsuperscript{141} If payment is made within six months of the due date, the unpaid portion of the tax is not subject to payment on demand\textsuperscript{142}; however, the late payment is not eligible for the special reduced interest rates\textsuperscript{143} and a penalty is assessable on the payment.\textsuperscript{144}

Under a second rule, the time for the payment of deferred installments is accelerated and any unpaid tax becomes due if the reason for deferral ceases. Expressed in general terms, the reason may cease to exist if: (1) any portion of the qualified business interest is “distributed, sold, exchanged, or otherwise disposed of,”\textsuperscript{145} or money or other property is withdrawn from the qualifying closely held business,\textsuperscript{146} and (2) the aggregate amount of distributions, sales, exchanges, or other dispositions and withdrawals of money or other property from the qualifying closely held business interest equals or exceeds 50 percent of the value of the qualifying interest.\textsuperscript{147} In such circumstances, the entire unpaid portion of the tax must be paid upon notice and demand.\textsuperscript{148}

A series of special rules apply in determining whether or to what extent a distribution, sale, exchange, disposition, or withdrawal of money or property accelerates the tax. A distribution to a legatee or to one entitled to the property under local laws of descent and distribution is placed outside the scope of the acceleration rules.\textsuperscript{149} In general, a Section 303 redemption (and sometimes a


\textsuperscript{142} IRC § 6166(g)(3)(B)(i).

\textsuperscript{143} IRC § 6166(g)(3)(B)(ii).

\textsuperscript{144} IRC § 6166(g)(3)(B)(iii). The penalty is equal to 5 percent of the payment that was originally due multiplied by the number of months between the due date and the payment date. In making the computation, a fraction of a month is counted as a full month. Id.; IRS Chief Couns. Adv. Mem. 200628042 (June 15, 2006) (no reasonable cause exception for avoiding late payment penalties as a result of late installment payment where estate did not request a Section 6166 extension of time to pay the installment).

\textsuperscript{145} IRC § 6166(g)(1)(A)(i)(I).

\textsuperscript{146} IRC § 6166(g)(1)(A)(ii). The notion here is that to require tax payment when there have been such significant withdrawals does not menace the business.

\textsuperscript{147} IRC § 6166(g)(1)(A)(ii). The manner in which the 50 percent computation is made is discussed and illustrated in outdated Regulations Sections 20.6166A-3(d)(2) and 20.6166A-3(d)(3) Ex. 1, respectively.

\textsuperscript{148} IRC § 6166(g)(1)(A).

\textsuperscript{149} IRC § 6166(g)(1)(D). A similar rule applies to a subsequent transfer of the property by reason of death as long as the transferee is a Section 267(c)(4) family member. Id. See supra note 75; Priv. Ltr. Ruls. 200043031 (July 26, 2000), 200613020 (Dec. 14, 2005) (involving other transactions related to an entity that were not Section 6166(g) dispositions).
Section 304 redemption) also is not a disqualifying distribution or withdrawal if the redemption proceeds are used to make Section 6166 payments. Further, restructuring of a business does not trigger acceleration. Thus, stock received in a tax-free D, E, or F reorganization under Section 368(a)(1), in a Section 355 tax-free corporate division, or on a Section 351 or Section 721 transfer is not a disqualifying distribution. However, if stock in a holding company is treated as business stock, a disposition of the holding company stock or withdrawal of money or other property from the holding company and any disposition by the holding company of its business company stock or withdrawal of money from the business company are dispositions or withdrawals under Section 6166(g)(1)(A).

Under a third rule, if the estate has undistributed net income for any year in which an installment payment is due and fails to pay an amount equal to such undistributed net income in liquidation of the unpaid portion of the tax, the unpaid portion of the tax generally becomes payable on demand.

Since Congress enacted Section 6166, because it identified a possible liquidity problem, the second and third rules make sense. When the property is disposed of, or when the estate has undistributed net income, there is no longer a liquidity problem and, accordingly, the deferred tax is made due.

Under a similar rule, an elimination of the deferral of an installment of estate tax under Section 6166 may occur when there is an overpayment of estate tax. If an estate makes an overpayment of estate tax, the overpayment must first be applied toward unpaid Section 6166 installments. Any refund

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151 IRC § 6166(g)(1)(C); Reg. § 20.6166A-3(e)(2). See Priv. Ltr. Rul. 200129018 (transfer of assets of a closely held business to a limited liability company (in what would be a Section 721 transfer) was not within Section 6166(g)(1)(A)). The statutory rule does not apply to a Section 368(a)(1) “A,” “B,” or “C” reorganization.

152 IRC § 6166(b)(8)(A). See supra text accompanying notes 91–95.

153 IRC § 6166(g)(1)(E).

154 IRC § 6166(g)(1)(F).

155 IRC § 6166(g)(2)(B).

156 IRC §§ 6166(g)(2)(A), 6166(g)(3). In addition, if stock in a holding company is treated as stock in a business company (see IRC § 6166(b)(8)(A) and supra text accompanying notes 91–95), a dividend paid to the holding company is to be treated as if it were paid to the decedent’s estate for purposes of the undistributed income rule. IRC § 6166(g)(2)(C).

157 IRC § 6403. But see TAM 200648028 (Aug. 4, 2006) (Section 6403 inapplicable to remittance made before the Section 6166 election).
of any estate tax paid by the taxpayer will only be made to the taxpayer under Section 6402 once the total amount of estate tax ultimately owed is eliminated.\footnote{\textsuperscript{158}}

[vii] \textbf{Declaratory judgments with respect to Section 6166.} Prior to the enactment of Section 7479, an estate could not litigate either its qualification for use of Section 6166 or the termination of its qualification for an exclusion without first paying the entire estate tax due. Since this was not in keeping with the deferral policy of Section 6166, Section 7479(a) was enacted\footnote{\textsuperscript{159}} to give the Tax Court authority to issue declaratory judgments in response to either of these questions. The provision allows estates to assert eligibility for Section 6166,\footnote{\textsuperscript{160}} or to argue that such eligibility has not been lost,\footnote{\textsuperscript{161}} without the burden of paying the entire tax due before being eligible for a judicial review of the issue.\footnote{\textsuperscript{162}} A Section 7479 action may be brought by the executor of the estate or any person who has assumed the obligation to make Section 6166 payments.\footnote{\textsuperscript{163}}

\footnote{\textsuperscript{158}} Estate of Bell v. Comm'r, 928 F2d 901 (9th Cir. 1991) (overpaid installment); IRS Chief Couns. Adv. Mem. 200141013 (June 28, 2001) (overpayment of tax due prior to a Section 6166 election reduced amount qualifying for Section 6166 treatment).


\footnote{\textsuperscript{160}} IRC § 7479(a)(1). See supra ¶ 2.02[3][c][ii]. The section also allows a declaratory judgment whether particular property in an estate qualifies for Section 6166 deferral. IRC § 7479(a)(1).

\footnote{\textsuperscript{161}} IRC § 7479(a)(2). See supra ¶ 2.02[3][c][vi]. See also Estate of Roski v. Comm'r, 128 TC 113 (2007) (Section 7479 applied to determine government’s ability to require Section 6165 bond).

\footnote{\textsuperscript{162}} No proceeding may be instituted under Section 7479, unless it is commenced within ninety days of the Service mailing notice by certified or registered mail of its denial of eligibility or continued use of Section 6166. IRC § 7479(b)(3).

\footnote{\textsuperscript{163}} IRC § 7479(b)(1). If more than one person has an obligation to make payments, all such persons must be joined in the action. IRC § 7479(b)(1)(B). The taxpayer must have exhausted its administrative remedies before it is entitled to declaratory judgment. IRC § 7479(b)(2). See Rev. Proc. 2005-33, 2005-1 CB 1231, for guidance on exhausting administrative remedies before seeking declaratory judgment from the Tax Court pursuant to Section 7479 with respect to a Section 6166 election. See also IRS Chief Couns. Adv. Mem. 200915037 (Nov. 25, 2008).
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4.01 INTRODUCTION

This chapter discusses the determination of the decedent’s gross estate for federal estate tax purposes. How this determination relates to the computation of the tax is indicated in broad terms in the Overview Chapter in Part 1. In general, the gross estate is arrived at by:

1. Identifying interests in property that must be taken into account;
2. Ascertaining the time at which the interests must be valued; and
3. Employing an accepted method of valuation to determine the fair market value of the identified assets at the specified time.

Thus, the elements discussed in this chapter are asset identification, time of valuation, and method of valuation.

As will soon be apparent, Section 2031 assigns the job of identifying includible interests to Sections 2033 through 2046. If an interest in property is identified as a part of the decedent’s gross estate, regardless of the reason for its inclusion, the time for its evaluation is invariably the date of the decedent’s death, unless the alternate valuation date is elected. Similarly, all of the valuation methods utilized, with one exception, have as their goal the determination of the fair market value of the many types of property interests included in the gross estate, regardless of the reason for their includability or the time at which they are to be valued. The one exception to market valuation is Section

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1 See IRC § 2031(a); ¶ 4.02.
2 See IRC § 2032; ¶ 4.03.
2032A, which generally values property at its actual use rather than its highest and best use. It is useful, therefore, to present a general analysis of valuation methods in connection with the discussion of Section 2031, which follows in the next section. The methods of valuation discussed are applicable to most interests brought into the gross estate, even if the alternate valuation date is elected under Section 2032. These methods of valuation are essentially nonstatutory, resting as they do primarily on the meaning of the general term “value.”

### ¶ 4.02 SECTION 2031. DEFINITION OF “GROSS ESTATE”

Section 2031 defines “gross estate” to include the value of all property, real or personal, tangible or intangible, to the extent provided by Sections 2033 through 2046, although there is a limited exclusion with respect to land subject to a qualified conservation easement. Thus, other than the specific exclusion, unless property is described in one of these sections, all of which are discussed in this chapter, it is not part of the gross estate. However, the definitional sections will be seen to be quite comprehensive.

It is apparent that Section 2031 lacks much substance; on identification questions, it merely directs attention to other sections, for the gross estate is to be determined by including property “to the extent provided for” by other sections. It does, however, focus attention on the matter of valuation. It is the

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3 Section 2032A provides a limited elective, nonmarket valuation method for certain real property. Section 2032A is examined in detail later in ¶ 4.04. The ensuing discussion assumes that this provision is either inapplicable or not elected.

4 For a more complete discussion of the significance and methods of valuation, see J. Bogdanski, Federal Tax Valuation (Thomson Reuters/Tax & Accounting 1996).

1 Eliminating a time-honored statutory exclusion, the Revenue Act of 1962, Pub. L. No. 87-834, § 18, 76 Stat. 960, 1052 (1962), reprinted in 1962-3 CB 189, 189-190, provided that foreign real estate is included in the gross estate if the decedent died on or after July 1, 1964. If the decedent died before October 17, 1962, the foreign realty was excluded. Transitional rules for death after October 16, 1962, and before July 1, 1964, are set forth in Regulations Section 20.2031-1(c). See also Rev. Rul. 69-165, 1969-1 CB 220.

2 IRC § 2031(c). See infra ¶ 4.02[7].

3 Compare Section 61, which defines “gross income” to include “all income from whatever source derived,” with Section 2033, which includes in the gross estate “all property to the extent of the interest therein of the decedent.”

4 The Internal Revenue Service (the Service) annually releases revisions of its procedures relating to (1) the issuance of rulings and determination letters; (2) closing agreements; (3) the issuance of technical advice to district directors and chiefs, Appeal Officers; and (4) taxpayers’ rights. See Rev. Proc. 2012-1, 2012-1 CB 1. See Rev. Proc. 2012-3, 2012-1 CB 113, regarding areas in which the Service will generally not issue advance rulings on domestic matters, and Rev. Proc. 2012-7, 2012-1 CB 232, regarding ar-
“value” of property that must be taken into account in determining the “value” of the gross estate. Just as school children learn not to add apples and oranges, taxes must be computed in terms of dollars, not objects. Section 2031 also expresses the presumptive date-of-death rule for the time of valuation. The remainder of this discussion addresses the nonstatutory meaning of “value,” along with the fundamental principles and methods of valuation for estate tax purposes.

[1] Introduction

After determining what interests in property are to be included in the gross estate, the importance of valuation becomes obvious; actual tax liability is highly sensitive to variation in valuation, just as it is to variation in the tax rates, inclusion in or exclusion from the gross estate, or allowance or disallowance of deductions or credits. Viewed in this light, it is surprising that so little on valuation appears in the statute. In fact, Section 2031(a) provides only that the “value” of property shall be included in the gross estate. The method of valuation is left to the administrative regulations, rulings, and judicial decisions. The general lack of statutory rules and the infinite variety of property interests that may form a part of the gross estate make it impossible to present adequately here even a survey of valuation problems. Instead, some general principles will be presented, and some concrete approaches will be illustrated.

[2] Fair Market Value

[a] Introduction

The “value” spoken of in Section 2031(a) is fair market value, which is the main guidepost for estate tax valuation. A long-standing regulation defines the fair market value of an asset as “the price at which the property would change hands between a willing buyer and a willing seller, neither being under
any compulsion to buy or sell and both having reasonable knowledge of relevant facts.’ The determination of fair market value is a question of fact.

The factual nature of the valuation question has important overtones. An executor may well hope to resolve valuation difficulties with the examining agent. Undoubtedly, most such controversies are settled in the administrative process, although litigation involving valuation is certainly common. As may be expected, the final determination of value often represents a compromise between the figure asserted by the taxpayer and that asserted by the Commissioner. However, if a controversy is not settled in the administrative process, the Commissioner’s determination of value is prima facie correct, leaving the taxpayer with the accustomed burden of proof, whether the taxpayer litigates in a refund suit or in the Tax Court. Moreover, the taxpayer’s chances of upsetting a valuation finding by the Tax Court, the court of federal claims, or a district court, the possible courts of original jurisdiction, are limited.

Cash on hand and checking and savings accounts carry their own indicia of value. For liquid and other regularly traded assets, valuation is not an es-

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7 Reg. § 20.2031-1(b).


13 See First Nat’l Bank v. Comm’r, 125 F2d 157 (6th Cir. 1942). See also Estate of Berg v. Comm’r, 976 F2d 1163 (8th Cir. 1992) (Tax Court’s adoption of Service’s experts over estate’s experts valuation was not clearly erroneous even though both calculations were valid). But see Estate of Mitchell v. Comm’r, 250 F3d 696 (9th Cir. 2001) (circuit court reversed the Tax Court requiring it to adequately explain any valuation conclusions reached).

14 See Rev. Rul. 78-360, 1978-2 CB 228 (coins or paper currency with a fair market value in excess of face amount, such as in a collection, are valued at fair market value).

Cf. ¶ 4.05[3], note 28, for a discussion of whether outstanding checks are included in a decedent’s gross estate.
especially difficult issue. The fair market value of such assets can be determined by reference to comparable sales in the open market.\(^\text{15}\)

Fair market value is a more problematic issue for assets that are not commonly sold in the open market.\(^\text{16}\) In some cases, the asset to be valued is unique and irreplaceable in the market.\(^\text{17}\) In other cases, the value of an asset is affected by too many factors to make any one valuation method authoritative. In general, any factor that would reasonably be considered in determining at what price property would be purchased or sold is relevant in determining fair market value for estate tax purposes.\(^\text{18}\) These factors include income yield, appraisals, sales prices of similar property near the date of death, bids made for the asset, and general economic conditions. Even the location of an asset may be a factor in determining its value; a snowmobile located in Miami, Florida, is less valuable than the same snowmobile located in Bangor, Maine.\(^\text{19}\)

Because the definition of “fair market value” sets forth an objective standard for computation, it requires consideration of both a hypothetical willing buyer and a hypothetical willing seller. Accordingly, if an appraisal considers only the perspective of the willing buyer, for example, a court may give the appraisal little weight.\(^\text{20}\) Moreover, an appraisal should present the price that would be agreed to between hypothetical parties, not the price the actual parties to a transfer would agree on.\(^\text{21}\) Still, an appraisal should consider the iden-

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\(^\text{15}\) For example, the regulations state that the fair market value of an automobile is equal to the retail price for a used vehicle of the same make, model, and condition. Reg. § 20.2031-1(b).

\(^\text{16}\) Valuation can also be difficult where the asset is traded only in the black market. For example, the Service advised that marijuana should be valued according to “the price an ultimate consumer would pay in the illicit marketplace,” meaning its retail street value where the decedent, a drug smuggler, was in possession of the marijuana at the time of a fatal plane crash, and the property was included in the decedent’s gross estate under Section 2033. FSA 1999-1132 (undated).

\(^\text{17}\) See, e.g., Estate of Pascal v. Comm’r, 22 TCM (CCH) 1766 (1963) (valuation of rights to produce one play and two motion pictures); Goodall v. Comm’r, 391 F2d 775 (8th Cir. 1968) (valuation of oil and gas interests); Donehoo v. United States, 1968-1 USTC ¶ 12,519 (WD Pa. 1968) (valuation of rights to compensation); Estate of Lennon v. Comm’r, 62 TCM (CCH) 326 (1991) (valuation of interest in decedent’s personal injury claim); Estate of Biagioni v. Comm’r, 42 TCM (CCH) 1663 (1981) (allowing a discount for attorney fees in valuing decedent’s interest in litigation); Estate of Tompkins v. Comm’r, 13 TC 1054 (1949), acq. 1950-1 CB 5 (valuation of growing crops).

\(^\text{18}\) See Estate of Smith v. Comm’r, 57 TC 650, 658 n.7 (1972), aff’d on other grounds, 510 F2d 479 (2d Cir. 1975).

\(^\text{19}\) Estate of Swan v. Comm’r, 24 TC 829 (1955), acq. 1956-2 CB 8, rev’d on other issues, 247 F2d 144 (2d Cir. 1957) (valuation of securities held abroad and subject to wartime restrictions).

\(^\text{20}\) See, e.g., Estate of Lehmann v. Comm’r, 74 TCM (CCH) 415 (1997).

tity of other owners. In one case, the court chastised the Internal Revenue Service’s (the Service’s) expert for not taking into account the fact that a hypothetical buyer would be entering into a family corporation and thus, in effect, would have little influence over management.\(^{22}\)

Assets included in the gross estate are generally valued (other than valuation under Section 2032) at the moment of the decedent’s death. This rule is consistent with the fact that the federal estate tax is a tax imposed on the transfer of wealth. The focus is not on the value of the asset in the decedent’s hands, but instead on the value of the asset that is available for transfer. For valuation purposes, the moment of death is a very brief, perhaps immeasurably small, instant.\(^{23}\) Accordingly, any restrictions that apply solely to the decedent’s own ability to transfer or enjoy any beneficial interest in an asset should be ignored, as such restrictions necessarily lapse at the decedent’s death.\(^{24}\) Likewise, any value added to an asset by the decedent’s presence, like goodwill, should be disregarded in computing the value of the asset included in the gross estate.\(^{25}\) Further, because the interests of the decedent’s beneficiaries have not yet vested in the assets at the moment of death, valuation does not consider the ultimate disposition (or recipient) of the assets.\(^{26}\)

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\(^{22}\) Mandelbaum v. Comm’r, 69 TCM (CCH) 2852 (1995), aff’d, 91 F3d 124 (3d Cir. 1996). This brings to mind words of caution from the Tax Court: while the willing buyer and willing seller are hypothetical persons and not the actual parties, “otherwise, the process of valuation considers actual conditions as they exist at the time of valuation.” Estate of Dunn v. Comm’r, 79 TCM (CCH) 1337, 1341 n.3 (2000), rev’d on another issue, 301 F3d 339 (5th Cir. 2002). See also Estate of Simplot v. Comm’r, 249 F3d 1191 (9th Cir. 2001) (reversing a Tax Court decision that constructed particular possible purchasers).

\(^{23}\) United States v. Land, 303 F2d 170, 171 (5th Cir. 1962).

\(^{24}\) Estate of McClatchy v. Comm’r, 106 TC 206 (1996) (restrictions on the decedent’s stock ownership under Rule 144 of the Securities Act of 1933 ignored in valuing stock because restrictions did not carry over to decedent’s estate), rev’d, 147 F3d 1089 (9th Cir. 1998) (the stock’s value did not increase until stock was actually owned by the estate, which could not occur until the personal representatives had letters testamentary; therefore, the Rule 144 restrictions should have been considered in valuing stock at the moment of death). The guiding principal of the Tax Court decision—that restrictions applicable only to the decedent should be ignored—is still viable, even after the Ninth Circuit’s reversal.

\(^{25}\) However, any goodwill not attributable to the decedent should still be considered. Estate of Sharp v. United States, 97-1 USTC ¶ 60,268 (ED Tenn. 1997).

\(^{26}\) Estate of McClatchy v. Comm’r, 147 F3d 1089 (9th Cir. 1998); Estate of Che- noweth v. Comm’r, 88 TC 1577, 1582 (1987); Estate of Curry v. United States, 706 F2d 1424 (7th Cir. 1983); Ahmanson Found. v. United States, 674 F2d 761 (9th Cir. 1981). But see Estate of Nowell v. Comm’r, 77 TCM (CCH) 1239 (1999) (limited partnership interests that would under local law generally become less valuable assignee interests were treated as partnership interests under partnership agreement because they passed to a general partner).
Valuation should not be affected by events occurring after death unless such events were known or reasonably foreseeable at the moment of death.\textsuperscript{27} This is not to say that after-death events may never be considered in establishing the original value of an interest. For example, the value of an illiquid asset can be determined with reference to the price at which the asset, or a similar asset, was sold after death.\textsuperscript{28} However, the longer the period between death and sale, the less probative the sale is of the asset’s value.\textsuperscript{29}

When the Service and the taxpayer disagree as to the value of an asset, both parties typically obtain appraisals from qualified valuation experts. Technically, the taxpayer has the initial burden to prove that the Service’s valuation in the deficiency notice is wrong, unless the Service’s valuation is shown to be arbitrary and capricious\textsuperscript{30} or the Service’s own trial experts demonstrate that the value used in the deficiency notice is wrong.\textsuperscript{31} But once the taxpayer submits a qualified appraisal, the burden is met\textsuperscript{32} and the dispute often becomes a battle of the experts. While a court may be reluctant to determine the value, it will do so when necessary.\textsuperscript{33} In many cases, a court will simply follow the bet-


\textsuperscript{29} Estate of Spruill v. Comm’r, 88 TC 1197 (1987) (sale fourteen months after death did not establish fair market value); Morton v. Comm’r, 73 TCM (CCH) 2520 (1997) (prospectus two years after death not relevant, but valuation by accounting firm fifteen months after death held admissible); Estate of Sharp v. Comm’r, 97-1 USTC ¶ 60,268 (ED Tenn. 1997) (price paid for business sixteen months after death irrelevant, but value of goodwill based on purchase offer five months after death held relevant).

\textsuperscript{30} Tax Ct. R. 142(a) (Jan. 1, 2010); Helvering v. Taylor, 293 US 507, 514–515 (1935). See infra ¶ 4.02[6][d].

\textsuperscript{31} Estate of Mitchell v. Comm’r, 250 F3d 696 (9th Cir. 2001). But see AOD 2005-01.

\textsuperscript{32} Estate of Sharp, Jr. v. United States, 97-1 USTC ¶ 60,268 (ED Tenn. 1997).

\textsuperscript{33} The U.S. Tax Court has signaled its hope to limit the number of valuation disputes, claiming “[w]e continue to believe that valuation disputes are better settled than litigated.” Estate of Mueller v. Comm’r, 63 TCM (CCH) 3027, 3029 (1992). But see Estate of Scanlan v. Comm’r, 72 TCM (CCH) 160 (1996), aff’d, 116 F3d 1476 (5th Cir. 1998) (court derived a 30 percent discount on its own after both sides submitted inadequate expert testimony as to the value of the decedent’s undivided community property share).
ter of the appraisals; other times, the court will balance or even average the competing determinations. Courts will carefully consider all appraisals submitted by parties, and courts do not hesitate to critique inadequate or self-interested valuations; it is clear that the courts are requiring experts to have a sound basis to their appraisals and to explain them thoroughly.

While appraisals should determine the value of the asset at or near the subject valuation date (date of death or alternate valuation date for the federal estate tax), the date on which the appraisal is actually performed does not matter. Thus, a court will not automatically suspect an appraisal performed after the Service issues a notice of audit; in determining value on the appropriate valuation date, the courts will look at appraisals of value at a date close to the subject valuation date.

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35 See, e.g., Estate of Fleming v. Comm'r, 74 TCM (CCH) 1049 (1997) (court held value of decedent’s interest in closely held finance company was $875,000, not the $1,100,000 value presented by the Service or the $604,000 value advocated by the taxpayer); Estate of Wright v. Comm'r, 73 TCM (CCH) 1863 (1997) (court determined the value of decedent’s stock at $45 per share, rejecting Service’s appraisal at $50 per share and the petitioner’s appraisal at $38 per share); Estate of Lauder v. Comm’r, 68 TCM (CCH) 985 (1994) (court set value of stock at $7,474 per share, nearly the average between the taxpayer’s per share value of $4,300 and the Service’s asserted value of $10,890 per share); Estate of Mueller v. Comm’r, 63 TCM (CCH) 3027 (1992) (court valued decedent’s minority interest at $1,700 per share, not $2,000 as advocated by the Service nor $1,505, as claimed on the estate tax return).

A court will also disregard the appraisals from both sides where circumstances merit such action. Estate of Kaufman v. Comm’r, 77 TCM (CCH) 1779 (1999) (Service’s appraisal not admitted into evidence and taxpayer’s appraisal generally unpersuasive; consequently, because the taxpayer bears the burden of proof, Service’s original determination of value accepted). See also Rabenhorst v. Comm’r, 71 TCM (CCH) 2271 (1996) (Service’s expert appraisal disregarded when expert admitted unfamiliarity with minority interest discounts and taxpayer’s evidence given little consideration where taxpayer’s expert demonstrated poor analysis of comparables).


37 Rabenhorst v. Comm’r, 71 TCM (CCH) 2271 (1996). But see Estate of Kaufman v. Comm’r, 77 TCM (CCH) 1779 (1999) (Service’s expert appraisal as of December 8, 1993, not close enough to valuation date of April 14, 1994); Estate of Necastro v. Comm’r, 68 TCM (CCH) 227 (1994) (petitioner’s environmental audits were rejected by
General Valuation Methods

There is no set formula for valuing an asset included in the gross estate. Instead, one or more of several different valuation methods are employed to determine value. As a result, the choice of valuation method sets the paradigm. Where more than one valuation method is applicable to an asset, each applicable method should be considered, though the weight given to each method can (and should) vary.

[i] Income approach. For rental property and other income-producing assets, value can be determined with reference to the present value of the expected future income and other benefits to be derived from the subject property. This “income approach” begins with a determination of the anticipated return from the subject property. The return is best measured by the asset’s actual return in prior years, with greater weight given to more recent years. A capitalization rate is then applied to the anticipated return to compute the final value. For many assets, a capitalization rate based on the yield of modern conservative investments, such as government bonds, is suitable where appropriately adjusted for risk. For closely held businesses, a capitalization rate can be derived by taking the inverse of the price-earnings ratios of comparable, publicly traded business entities and, appropriately, adjusting for the amount of risk.

[ii] Market approach. In valuing an illiquid asset, reference can be made to comparable assets that are publicly traded. This “market approach” is most often used with closely held business interests and real property not held for rent. Once comparable publicly traded assets are found, the market ap-
proach then requires some adjustment to reflect the illiquid nature of the subject property.\textsuperscript{42}

Not surprisingly, the greatest disputes in the use of the market approach relate to the selection of comparable assets and the adjustment made to the comparable price. The Tax Court once criticized an expert retained by the Service to value a minority interest in a closely held corporation that operated several grocery stores. Although the expert considered comparable grocery store chains in computing the value of the decedent’s stock, the expert failed to take into account the local economies relevant to the subject corporation and the increased competition in those economies.\textsuperscript{43}

[iii] Asset-based (cost) approach. The “asset-based approach” (sometimes called the cost approach) is more suitable for holding companies and other non-income-producing assets that have no reliable comparables with known values.\textsuperscript{44} The asset-based approach simply aggregates and nets the value of underlying assets and liabilities.\textsuperscript{45} If the subject property represents an interest in several assets, the multiple valuation necessarily becomes more difficult, being based on multiple valuations of underlying assets.

[iv] Combinations. It is quite common for an appraisal to consider a variety of valuation approaches. The relative weight of each approach should vary according to the nature of the subject property. For example, in one case,\textsuperscript{46} the gross estate included a 25.235 percent interest in a limited partnership that owned an apartment complex. The court used both the income approach and the net asset approach to value the apartment complex, but so publicly traded companies in similar lines of businesses were taken into consideration); Estate of Heck v. Comm’r, 83 TCM (CCH) 1181 (2002) (since no adequate comparables for winery, income approach adopted). In Heck, the court stated: “As similarity to the company to be valued decreases, the number of required comparables increases in order to minimize the risk that the results will be distorted by attributes unique to each of the guideline companies.” Id. at 1187.

\textsuperscript{42} See infra ¶ 4.02[4][d].

\textsuperscript{43} Estate of Brookshire v. Comm’r, 76 TCM (CCH) 659 (1998).

\textsuperscript{44} Estate of Ford v. Comm’r, 66 TCM (CCH) 1507 (1993), aff’d, 53 F3d 924 (8th Cir. 1995) (investment assets held by a corporation); Estate of Kelley v. Comm’r, 90 TCM (CCH) 369 (2005) (cash and certificates of deposit held by family limited partnership (FLP) and limited liability company (LLC)); Estate of Jameson v. Comm’r, 77 TCM (CCH) 1383 (1999) (net asset value of timber property held by a corporation), vacated and remanded on other grounds, 267 F3d 366 (5th Cir. 2001).

\textsuperscript{45} The net asset value generally does not take into account liquidation costs and taxes. Estate of Dunn v. Comm’r, 79 TCM (CCH) 1337 (2000) (net asset value represents the aggregate, preliquidation asset values, not after-tax values), rev’d, 301 F3d 339 (5th Cir. 2002). But see Estate of Jephson v. Comm’r, 87 TC 297 (1986) (government allowed reduction for liquidation costs where liquidation was imminent); infra ¶ 4.02[4][e][iii].

\textsuperscript{46} Estate of Weinberg v. Comm’r, 79 TCM (CCH) 1507 (2000).
weighed the income approach more heavily (75 percent) than the net asset approach (25 percent).47

[c] **Valuation Determined by Agreements**

Closely held business owners often enter into agreements that spell out the consequences of an owner’s retirement, withdrawal, expulsion, death, disability, or other event leading to the transfer of an ownership interest. These “buy-sell” agreements typically require the exiting owner to offer the ownership interest to be transferred to the other owners at a price determined under the agreement. In some cases, the agreement provides a fixed price for the ownership interest, but in most cases, the agreement contains a formula for valuing the ownership interest. Section 2703 generally provides that for estate, gift, and generation-skipping transfer tax valuation purposes, buy-sell agreements will not be considered in the valuation of property unless certain statutory tests are met.48 Even where the buy-sell agreement survives Section 2703 and is taken into consideration, various factors may cause a court to discount or disregard the agreement’s stated price.

Where Section 2703 is inapplicable and the buy-sell agreement is negotiated at arm’s length between unrelated owners, courts have given considerable deference to the valuation method contained in the agreement because the par-

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47 From this computation, the court then applied the minority and marketability discounts discussed infra ¶¶ 4.02[4][c] and 4.02[4][d]. The court also rejected the Service’s argument that no weight should be given to the building’s net asset value because the decedent’s limited partnership interest restricted the decedent’s ability to compel the sale of the building. Estate of Weinberg v. Comm’r, 79 TCM (CCH) 1507, 1515 (2000).

See also Estate of Dunn v. Comm’r, 79 TCM (CCH) 1337 (2000), rev’d, 301 F3d 339 (5th Cir. 2002) (directing Tax Court on remand to assign a weight of 85 percent to earnings approach and 15 percent to the asset approach); Estate of Smith v. Comm’r, 78 TCM (CCH) 745 (1999) (value of stock in corporation that owned and operated a farm based 70 percent on net asset value approach and 30 percent on income approach because the corporation served as both a holding company for valuable property and a going concern); Anderson v. United States, 2006-1 USTC ¶ 60,516 (WD La. 2005) (value of minority mineral interests in LLCs determined with net asset approach 2/3 and market approach 1/3).


49 See ¶ 19.04[6].
ties are involved in a bona fide arm’s-length agreement. The exiting owner will usually want the highest possible valuation, and the other owners will likely want the lowest possible valuation. In these cases, it is fair to assume that the agreed formula represents a compromise between the parties whose interests are economically adverse to one another.

Section 2703 is more likely to be applicable and courts are more apt to discount the formula price contained in a buy-sell agreement where the parties are related, where there is evidence that the owners did not negotiate the formula at arm’s length, or where the formula is simply unreasonable given recent developments in the business. Furthermore, no respect is afforded to unilateral restrictions imposed by the decedent or transferor. Section 2703 and agreements that pass muster under Section 2703 are considered in detail later in the treatise.

[3] Basic Valuation Approaches to Property Interests

[a] Tangible Personal Property

Most decedents leave behind a number of miscellaneous personal effects—televisions, lamps, area rugs, and the like. Generally, each item should be valued separately, although the nuisance of this rule is partially alleviated by the Treasury’s willingness to accept a single value for a group of items (provided each is of relatively small value) or a single, unitemized figure given

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51 Bommer Revocable Trust v. Comm’r, 74 TCM (CCH) 346 (1997) (buy-sell agreement disregarded in valuing stock because agreement was held to be a device to transfer decedent’s stock to beneficiaries for less than full consideration). Cf. Reg. § 25.2703-1(a)(3).

52 Estate of Lauder v. Comm’r, 64 TCM (CCH) 1643 (1992) (valuation fixed by buy-sell agreement disregarded in part because there was no evidence that owners negotiated the valuation formula to be used upon death or termination). Cf. IRC § 2703(b).

53 Citizens Bank & Trust Co. v. Comm’r, 839 F2d 1249 (7th Cir. 1988) (court rejected a 90 percent discount claimed because the subject property was held in an irrevocable trust with a ninety-seven-year term).

54 See ¶ 19.04.

55 Ownership of furniture and personal items may be uncertain. Some may be owned by a surviving spouse or may be merely on loan from relatives. Records should be kept regarding the ownership of items such as valuable antiques and paintings. Here, of course, includability in the decedent’s gross estate is simply assumed.

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by an expert appraiser. The value of personal property generally is determined with reference to the retail price at which the item would sell to the general public. The detail required in preparing an inventory of household and personal effects, a headache for the casual personal representative, is a fairly routine matter for professional and other experienced personal representatives. Where an item’s primary value lies in its utility to the owner (a bed’s value typically is based on keeping the owner off a hard floor at night), the range of possible values is fairly limited and not subject to much controversy. But a work of art, by nature, often has a wide range of values, depending on the beholder. Consequently, any such item with a value in excess of $3,000 must be listed separately and supported with an appraisal from a competent professional, and valuation disputes over works of art are common.

[b] Real Property

Generally, real property is valued according to “the highest and best use of the property” on the valuation date. This rule causes the focus to shift away from the owner’s actual use of the property and toward the objectively reasonable possible uses. Thus, for example, if an orange grove worth $2,000

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56 See Reg. § 20.2031-6(a). Appraisal usually entails relatively small cost, saves much time and effort, and may help avoid controversy. Although where the property value is relatively small and the property qualifies for the marital deduction, the likelihood of controversy is slight.


58 Reg. § 20.2031-6(b). The regulation lists the items most likely affected by this requirement as “jewelry, furs, silverware, paintings, etchings, engravings, antiques, books, statuary, vases, oriental rugs, [and] coin or stamp collections.” Id.

59 See Estate of O’Keeffe v. Comm’r, 63 TCM (CCH) 2669 (1992); Estate of Smith v. Comm’r, 57 TCM (CCH) 650 (1972), aff’d on other grounds, 510 F2d 479 (2d Cir. 1975) (estate initially valued decedent’s metal sculptures at $714,000, but the Service ultimately contended that the value was over $5.2 million—the court fixed the value at $2.7 million); Estate of Scull v. Comm’r, 67 TCM (CCH) 2953 (1994) (different valuation methods used for different pieces of art in a collection); Estate of Murphy, 2009-2 USTC ¶ 60,583 (WD Ark. 2009) (estate’s experts more credible than the Service’s expert); Estate of Mitchell v. Comm’r, 101 TCM (CCH) 1435 (2011) (same).

For a more comprehensive discussion, see Lerner, “Valuing Works of Art for Tax Purposes,” 28 Real Prop., Prob. & Tr. J. 593 (1993). Referral to the Service’s Art Appraisal Services is mandatory in an audit for each piece of art valued at $50,000 or more. IRM 4.25.1.5.8.2(2) (Jan. 27, 2011).


an acre as such could be sold for $5,000 an acre for use as a residential subdivision, its value would be $5,000 an acre for estate tax purposes.\footnote{62} While a parcel will be valued at its highest and best use, courts are hesitant to assume away any zoning changes that would be required to make the highest and best use of the subject property.\footnote{63} Indeed, courts will discount the value of real property by the costs that an owner would incur in converting the parcel to its highest and best use, including costs of rezoning the property.\footnote{64}

The assessed value of real property for local tax purposes is given little weight in computing fair market value\footnote{65} unless the assessed value bears a fixed, known relationship to the fair market value of the property.\footnote{66} Instead, an appraisal is necessary for all parcels and interests included in the gross estate. As seen before, courts will give greater weight to professional appraisals than mere guesses and will often choose between competing appraisers’ values or select a midrange value.\footnote{67} The appraisal should consider all of the following factors—and perhaps others, if relevant—in valuing the subject property:

1. Recent attempts to dispose of the property,\footnote{68} perhaps including offers made after death;
4.02[3][b] THE ESTATE TAX

2. Sales of similar property nearby; 
3. The condition of the property; 
4. Assessed value for local tax purposes, assuming the relationship between assessed value and fair market value is ascertainable; 
5. The existence of an outstanding lease for a term of years that may either depress or increase the value of the decedent’s interest in the property; 
6. The amount of a nonrecourse mortgage loan secured by the property; 
7. A capitalization of current rentals; 
8. The prospect of proposed favorable or unfavorable zoning changes; 
9. The existence of easements on the property;

cedent’s death), rev’d, 250 F3d 696 (9th Cir. 2001) (Tax Court failed to adequately explain rationale for its valuation conclusion).

70 Estate of Pattison v. Comm’r, 60 TCM (CCH) 471 (1990) (court rejected taxpayer’s appraisal, which found the highest and best use of the subject property to be for agricultural pursuits, for failing to consider the parcel’s location was across the street from a residential development; court accepted Service’s appraisal using comparable sales of nearby parcels). See Crane v. Comm’r, 49 TC 85 (1967), acq. 1968-2 CB 2; Jones v. Comm’r, 25 TCM (CCH) 1066 (1996); Estate of Whitt v. Comm’r, 46 TCM (CCH) 118 (1983), aff’d on other grounds, 751 F2d 1548 (11th Cir. 1985); Morris v. Comm’r, 761 F2d 1195 (6th Cir. 1985); Estate of Dunia v. Comm’r, 87 TCM (CCH) 1353 (2004); Estate of Langer v. Comm’r, 92 TCM (CCH) 376 (2006). See Rev. Proc. 79-24, 1979-1 CB 565, for a detailed discussion of factors.


72 Estate of Cary v. Comm’r, 7 TCM (CCH) 731 (1948). 

74 Van Dyke v. Kuhl, 78 F. Supp. 698 (ED Wis. 1945).
75 Reg. § 20.2053-7. See ¶ 5.03[5].
76 Van Dyke v. Kuhl, 78 F. Supp. 698 (ED Wis. 1945).
10. The price of a post-death sale of the subject property, absent evidence of changes in value after death;
11. Any cloud on the property’s title or other associated legal risks;
12. The decedent’s interest in the real property; and
13. The highest and best use of the property, including any special uses for which the property may be realistically suited.

Most certainly, these thirteen factors are not intended as an exhaustive list of considerations that might apply in valuing real property. As with any asset included in the gross estate, the valuation is affected by all factors that would influence the hypothetical willing buyer and the hypothetical willing seller.

[c] Publicly Traded Securities

While artwork and real estate frequently pose valuation problems, publicly traded securities—typically held in a brokerage account—usually pose few, if any, problems for the personal representative. Because of the ready market for such securities, value is usually ascertainable with reference to accessible reports of actual market transactions. Indeed, the regulations state that the fair market value of marketable securities is “the mean between the

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79 See First Nat’l Bank of Kenosha v. United States, 763 F2d 891 (7th Cir. 1985); Cobb v. Comm’r, 49 TCM (CCH) 1364 (1985); Estate of Keller v. Comm’r, 41 TCM (CCH) 147 (1980); Estate of Ballas v. Comm’r, 34 TCM (CCH) 506 (1975); Levy v. United States, 402 Fed. Appx. 979 (5th Cir. 2010), cert. denied, 131 S. Ct. 2914 (2011).
80 See Estate of Keitel v. Comm’r, 60 TCM (CCH) 425 (1990); Estate of Hillebrandt v. Comm’r, 52 TCM (CCH) 1059 (1986); Estate of Ridgely v. United States, 1967-2 USTC ¶ 12,481 (Ct. Cl. 1967); Estate of Loewenstein v. Comm’r, 17 TC 60 (1951), acq. 1951-2 CB 3; Estate of Spruill v. Comm’r, 88 TC 1197 (1987).
81 Estate of Sharp v. Comm’r, 68 TCM (CCH) 1521 (1994).
82 For the applicability of minority interest and fractional interest discounts, see infra ¶¶ 4.02[4][c], 4.02[4][e][i].
83 Again, however, attention should be given to the possibility of a Section 2032A election, if available. See ¶ 4.04.
84 See Estate of Lloyd v. Comm’r, 71 TCM (CCH) 1903 (1996) (court reduced the value of the subject property to take into account its difficult topography and limited road access available to make the highest and best use, in this case, commercial, of the property); Estate of Sirmans v. Comm’r, 73 TCM (CCH) 2846 (1997) (court considered several facts in computing the value of 56.5 acres of Florida land, including environmentally sensitive wetlands on the property, a condemnation proceeding affecting five acres, and several appraisals on the property performed for different purposes). See also IRM 4.25.1.5.8.3(2) for instances where referral to Engineering Services for valuation is appropriate or required.
85 If the securities serve as collateral for a third-party loan, this fact will likely reduce the value of the securities. Estate of Hall v. Comm’r, 46 TCM (CCH) 479 (1983).
86 Actual market transactions may reflect the value of some intangibles other than stocks or bonds, such as options, puts, calls, and commodity futures contracts; indeed,
highest and the lowest quoted selling prices on the valuation date.”87 If no trades occurred on the valuation date, Treasury requires the personal representative to use a weighted average of the mean trade figures for dates before and after the valuation date.88 If there are no actual trades close to the valuation date, the personal representative can resort to taking the mean between the bid and asked prices for the securities on the valuation date.89

When the gross estate includes a large number of shares in one corporation’s publicly traded stock, a blockage discount may come into play.90 At this point, the mechanical formulas in the regulations give way to the expert appraisal.91 Of course, other discounts may also apply.92

[d] Open-End and Closed-End Funds

Investors frequently seek to diversify their investments through the purchase of shares in investment companies or mutual funds. The fund investor generally has no influence over the securities purchased and sold by a fund; those decisions are left to the fund’s managers. But the expertise of the fund’s managers is one of the attractions for these funds, along with owning a

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87 Reg. § 20.2031-2(b)(1). See Rev. Rul. 68-272, 1968-1 CB 394 (the mean price is used even though the security may sell only in fractional amounts). In most cases, the “valuation date” will be the date of death, although the alternate valuation date six months later may be elected. IRC §§ 2031(a), 2032. See ¶ 4.03.

88 The approach is described in Regulations Sections 20.2031-2(b)(2) and 20.2031-2(b)(3). See Rev. Proc. 84-17, 1984-1 CB 432, for similar methods used to value trust funds.

89 Reg. § 20.2031-2(c). See also Reg. §§ 20.2031-2(d), 20.2031-2(e), and 20.2031-2(f) for even more indirect valuation methods.

90 See infra ¶ 4.02[4][e][iii].

91 Cf. infra ¶ 4.02[4][e], note 207.

92 See infra ¶ 4.02[4][e][iv] regarding possible application of securities laws discounts. Neither a minority discount nor a marketability discount is an applicable discount for marketable securities. But where the decedent merely owns an interest in a nonmarketable entity that holds marketable securities, the marketability discount may also apply. See infra ¶¶ 4.02[4][c], 4.02[4][d].
slice of the fund’s investment portfolio. The estate tax valuation issues for these funds depend upon the nature of the investment company.

So-called closed-end funds have a fixed number of shares outstanding and are traded on stock exchanges. Closed-end funds tend to have specialized portfolios, limiting their investments to certain types of securities. Because the shares in closed-end funds are easily traded on an established market, the estate tax value is the mean between the highest and lowest selling prices on the valuation date, just as in the case of any other publicly traded security.93

An open-end fund, by contrast, constantly issues new shares to purchasers. Open-end funds also stand ready to redeem their outstanding shares at net asset value. Usually, shares in open-end funds are not traded on stock exchanges. There are two types of open-end funds: “no-load” funds, which impose no fee to purchase or redeem shares, and “load” funds, which impose fees upon purchase, redemption, or both.

Estate tax valuation of no-load funds is not especially problematic. Because the shares are always purchased and redeemed at net asset value, the net asset value provides an easy mechanism for valuation. Load funds present more complex issues. In a “front-load” fund, for example, the investor pays a premium (usually between 3 percent and 9 percent of net asset value) to acquire shares. The shares are then redeemed at net asset value, as no additional charge is imposed. The Service originally argued that estate tax valuation of load funds should be based on replacement cost, which of course would include the premium required to purchase a number of shares equal to the number of shares included in the gross estate. But personal representatives argued that the redemption price (net asset value without any premium) was a more proper measure of the wealth transferred at death. In Cartwright v. United States,94 the Supreme Court properly embraced the taxpayer view for reasons expressed at some length in an earlier edition of this book.95 Load funds are thus valued at the redemption price.

93 See supra ¶ 4.02[2][c]. In the market, closed-end funds tend to sell at a discount from their net asset value because of the perception that managers of closed-end funds are less responsive to considering other profitable investments, unlike the managers of open-end funds. J. Downs & J. Goodman, Dictionary of Finance and Investment Terms (Barron’s, 8th ed. 2010).


[e] Bonds

Corporate bonds that are traded actively are valued in the same manner as stock. The marketplace values such bonds with an eye to the financial position of the obligor, the interest rate paid, the date of maturity, and sometimes the bonds’ convertibility into stock. Except for convertibility, government bonds that are actively traded are accorded their marketplace value, which is determined in the same manner as other securities.

Some types of federal government bonds are not traded on the market and may merely be redeemed or reissued. In general, their redemption value at the date of the decedent’s death establishes their estate tax value.

Series EE U.S. Savings Bonds can be redeemed at gradually increasing prices prior to their maturity date; the increase reflects interest. If held beyond maturity, they stop earning interest after thirty years. Whether held to maturity or not, their estate tax value is their redemption value at the date of decedent’s death.

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96 Reg. § 20.2031-2(b). See supra ¶ 4.02[3][c]. For a consideration of the valuation of untraded bonds in closely held businesses, see Reg. § 20.2031-2(f)(1) and infra ¶ 4.02[3][f], note 101.

97 One type of government bond, however, was valued differently. So-called federal redeemable bonds or flower bonds could be submitted at par value in payment of federal estate taxes and, for that reason, they were valued at par to the extent they could be so used. However, such bonds are no longer issued and all have matured. Such bonds are discussed in detail in R. Stephens, G. Maxfield, S. Lind & D. Calfee, Federal Estate and Gift Taxation ¶ 4.02[3][e], text accompanying notes 68–71 (Thomson Reuters/Tax & Accounting, 7th ed. 1996). Bonds that were issued after March 3, 1971, could not be used to pay federal estate taxes. See IRC § 6312, prior to repeal by an Act, Pub. L. No. 92-5, § 4(a)(2), 85 Stat. 5 (1971), reprinted in 1971-1 CB 553. All such bonds have now matured.

98 These include Series EE and Series I U.S. Savings Bonds. For a discussion of transferability of ownership of U.S. Savings Bonds, see discussion of Section 2040 at ¶ 4.12[2].

99 Rev. Rul. 55-301, 1955-1 CB 242. But compare Estate of Brown v. Comm’r, 21 TCM (CCH) 1321 (1962), and Estate of Haupfuhrer v. Comm’r, 9 TCM (CCH) 974 (1950), aff’d on another issue, 195 F2d 548 (3d Cir.), cert. denied, 344 US 825 (1952) (par value used), with Collins v. Comm’r, 216 F2d 519 (1st Cir. 1954) (employing a lower value). The Collins opinion seems to put misplaced reliance on the fact that the bonds were not required to be redeemed at death; but note that shares of stock need not be sold at death, either. See also United States v. Simmons, 346 F2d 213 (5th Cir. 1965).

100 TAM 200303010 (Sept. 19, 2002) (rejecting argument for adjustment owing to built-in income tax liability).
[I] Closely Held Corporations

Valuation is especially significant when the asset is an equity ownership interest\(^\text{101}\) in a closely held business. In the absence of a public market, stock in a corporation is valued by reference to many factors. The regulations state only that the value of such stock is to be determined with reference to “the company’s net worth, prospective earning power and dividend paying capacity, and other relevant factors.”\(^\text{102}\) Almost fifty years ago, the Service issued Revenue Ruling 59-60\(^\text{103}\) to provide more comprehensive guidance in valuing closely held stock. This ruling continues to be the seminal authority for valuing closely held corporations that actively conduct a trade or business. In the ruling, the Service lists eight factors to consider in valuing the closely held business:

1. The nature of the business and the history of the enterprise from its inception\(^\text{104}\);
2. The economic outlook in general and the condition and outlook of the specific industry in particular\(^\text{105}\);

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\(^{101}\) Where the decedent owned a debt obligation of a closely held business, the regulations generally indicate that the value of bonds in close corporations is to be arrived at by giving consideration to “the soundness of the security, the interest yield, the date of maturity, and other relevant factors.” Reg. § 20.2031-2(f)(1). A question may arise whether such bonds are in substance stock to determine various income tax consequences. Gooding Amusement Co. v. Comm’r, 236 F2d 159 (6th Cir. 1956). Even though a purported bond may in substance be stock for income tax purposes, it should nevertheless still be considered a bond for estate tax valuation purposes. Under the vague criteria of the regulations, all the factors that caused it to be labeled as stock under the income tax will be considered in determining its estate tax value.


\(^{103}\) Rev. Rul. 59-60, 1959-1 CB 237.

\(^{104}\) This factor is discussed in more detail in Rev. Rul. 59-60, § 4.02(a), 1959-1 CB 237, 239. See also Estate of Lauder v. Comm’r, 68 TCM (CCH) 985, 987 (1994); Estate of Smith v. Comm’r, 9 TCM (CCH) 907 (1950); Holrick v. Kuhl, 62 F. Supp. 168 (ED Wis. 1945); Holmes v. Comm’r, 22 BTA 757, acq. X-1 CB 29 (1931). For guidelines applicable to the radio and television broadcasting business, see Rev. Proc. 75-39, 1975-2 CB 569.

\(^{105}\) This factor is discussed in more detail in Rev. Rul. 59-60, § 4.02(b), 1959-1 CB 237, 239. See also Estate of Newhouse v. Comm’r, 94 TC 193 (1990), acq. 1991-1 CB 1; Estate of Titus v. Comm’r, 57 TCM (CCH) 1449 (1989); Zanuck v. Comm’r, 149 F2d 714 (9th Cir. 1945); Bishop Trust Co. v. United States, 1950-1 USTC ¶ 10,764 (D. Haw. 1950).
3. The book value of the stock and the financial condition of the business; 
4. The earning capacity of the company; 
5. The dividend-paying capacity; 
6. Whether the enterprise has goodwill or other intangible value; 
7. Sales of the stock and the size of the block of stock to be valued; and 
8. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter.

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106 This factor is discussed in more detail in Rev. Rul. 59-60, § 4.02(c), 1959-1 CB 237, 240. See also Estate of Lauder v. Comm’r, 68 TCM (CCH) 985, 997 (1994); Estate of Hogan v. Comm’r, 3 TCM (CCH) 315 (1944); True v. United States, 51 F. Supp. 720 (1943); Brooks v. Willcuts, 78 F2d 270 (8th Cir. 1935). But see Estate of Maxcy v. Comm’r, 28 TCM (CCH) 783 (1969), rev’d on other grounds, 441 F2d 192 (5th Cir. 1971).

107 This factor is discussed in more detail in Rev. Rul. 59-60, § 4.02(d), 1959-1 CB 237, 240. See also Estate of Dooly v. Comm’r, 31 TCM (CCH) 814 (1972); Harrison v. Comm’r, 17 TCM (CCH) 776 (1958); Wishon v. Anglim, 42 F. Supp. 359 (ND Cal. 1941); Laird v. Comm’r, 38 BTA 926 (1938), acq. and nonacq. 1939-1 CB 20, 53.

108 This factor is discussed in more detail in Rev. Rul. 59-60, § 4.02(e), 1959-1 CB 237, 241. See also Poley Estate v. Comm’r, 6 TCM (CCH) 288 (1947), aff’d per curiam, 166 F2d 434 (3d Cir. 1948); Estate of Cook v. Comm’r, 9 TC 563 (1947), acq. 1947-2 CB 2; Northern Trust Co. v. Comm’r, 87 TC 349 (1986); Barnes v. Comm’r, 76 TCM (CCH) 881 (1998). But see Driver v. United States, 76-1 USTC ¶ 13,155 (WD Wis. 1976) (lack of dividends unimportant because compensation in close corporation is taken in other ways); Estate of Hogan v. Comm’r, 3 TCM (CCH) 315 (1944) (consideration of dividend payments improper for valuing stock in highly competitive business); Estate of Smith v. Comm’r, 78 TCM (CCH) 745 (1999) (dividend paying capacity not ignored in valuing corporation).


110 This factor is discussed in more detail in Revenue Ruling 59-60, § 4.02(g), 1959-1 CB 237, 241. See First Nat’l Bank of Fort Smith v. United States, 85-2 USTC ¶ 13,627 (WD Ark. 1985) (sale of 2 percent of stock sixteen months before decedent’s death); Estate of Noble v. Comm’r, 89 TCM (CCH) 649 (2005) (actual sale price one year after death established value); Huber v. Comm’r, 91 TCM (CCH) 1132 (2006) (independent appraiser value used to value gifts). This factor may be subsequently adjusted for discounts and premiums. See infra ¶ 4.02[4].

111 This factor is discussed in more detail in Rev. Rul. 59-60, § 4.02(h), 1959-1 CB 237, 242. This factor responds to the requirements of Section 2031(b) and Regulations Section 20.2031-2(f). See generally Estate of Hall v. Comm’r, 92 TC 312 (1989); Estate of Stoddard v. Comm’r, 34 TCM (CCH) 888 (1975); Estate of Ewing v. Comm’r, 9 TCM (CCH) 1096 (1950); Estate of Webb v. Comm’r, 3 TCM (CCH) 440 (1944).

Because publicly traded companies tend to be larger in size, one should not blindly apply the price-earnings ratios of comparable publicly traded companies to the closely held stock under examination. Estate of Smith v. Comm’r, 78 TCM (CCH) 745 (1999).
The ruling states that the weight of each factor varies according to each particular corporation,\footnote{Rev. Rul. 59-60, § 5, 1959-1 CB 237, 242.} and the Tax Court agrees, refusing to ascribe a fixed weight to any one factor.\footnote{Estate of Andrews v. Comm’r, 79 TC 938 (1982); Messing v. Comm’r, 48 TC 502 (1967); Estate of Thompson v. Comm’r, 88 TCM (CCH) 48 (2004), vacated to correct a calculation error, 499 F3d 129 (2d Cir. 2007), cert. denied, 128 S. Ct. 2932 (2008).} Sometimes the courts have modified the factors as needed.\footnote{Mandelbaum v. Comm’r, 69 TCM (CCH) 2852 (1995) (factors modified to determine discount for lack of marketability). See infra ¶ 4.02[4][d], note 186.}

Closely held partnerships and limited liability companies (LLCs) that conduct an active trade or business activity are valued in the same manner as active closely held corporations.\footnote{See Moore v. Comm’r, 62 TCM (CCH) 1128 (1991).} Where the rights and obligations of partners in a partnership or the members of a limited liability company differ from those of shareholders in a corporation, some variation in valuation is justified.\footnote{In Adams v. United States, 99-1 USTC (CCH) 60,340 (ND Tex. 1999), rev’d, 218 F3d 383 (5th Cir. 2000), the district court denied a minority interest discount in valuing the decedent’s 25 percent partnership interest asserting that under state law the decedent’s death caused the partnership to dissolve and entitled the estate as an assignee to have the right to obtain up to 25 percent of the partnership’s assets. The court nonetheless found the strict fiduciary duties of the other partners to the hypothetical buyer prevented any discount. The Fifth Circuit reversed and remanded the case finding that it was not well established that a partner’s assignee has a right to receive his proportionate share of the partnership’s net asset value. On remand, the district court applied substantial discounts for minority interest, portfolio, and marketability discounts. Adams v. United States, 88 AFTR2d 2001-6057 (ND Tex. 2001).}

\[g\] Notes

Notes and similar contractual obligations representing amounts owed to the decedent are includible in the gross estate\footnote{When the obligation is formal, the estate will likely not succeed in arguing that the decedent intended a gift, meaning that the decedent owned no right to any amount at death. This is a Section 2033 issue. See Estate of Hamlin v. Comm’r, 9 TC 676 (1947); Estate of Hodge v. Comm’r, 2 TC 643 (1943), acq. 1943 CB 11; Estate of Lockett v. Comm’r, 103 TCM (CCH) 1671 (2012).} and valued according to the hypothetical willing seller, willing buyer concept.\footnote{Recall that the fair market value “is not to be determined by a forced sales price.” Reg. § 20.2031-1(b). See Estate of Frank v. Comm’r, 69 TCM (CCH) 2255 (1995); Eleanor Lansburgh v. Comm’r, 35 BTA 928 (1937), nonacq. 1937-2 CB 43, withdrawn and acq. 1943 CB 14.} Interest rates and dates of maturity affect their valuation.\footnote{See Estate of Hamlin v. Comm’r, 9 TC 676 (1947) (Service and taxpayer agreed on a commuted value for an interest-free note).} Accrued interest on such obligations is

\footnote{Notes and similar contractual obligations representing amounts owed to the decedent are includible in the gross estate and valued according to the hypothetical willing seller, willing buyer concept. Interest rates and dates of maturity affect their valuation. Accrued interest on such obligations is...}
treated as separate property to be separately stated and valued on the estate tax return. However, the regulations provide that notes owed to the decedent are included in the gross estate at their face amount, or in the amount of unpaid principal, unless the personal representative establishes that the value is lower or that the notes are worthless. This provision in the regulations is intended to encompass all types of notes, including personal debts, obligations under a mortgage, installment sales notes, and mere payments to be made under a contract.

A personal representative, who has the burden of proof in such situations, can establish that an obligation has a value lower than its face amount in several ways. For instance, if the debtor is insolvent, the obligation may be worthless or its value limited to the value of property held as security for the debt. In one case, the insolvent debtor, a beneficiary of the estate, became solvent by way of bequests from the decedent. Nevertheless, the court concluded that in valuing the note, the debtor’s affluence, by reason of the decedent’s death, was not to be considered. The court limited the value of the notes in the decedent’s estate to the value of the assets held as security, plus the net worth of the debtor prior to any bequests from the decedent. However, in an income tax case, the court held that in valuing notes for basis purposes under Section 1014, the debtor’s intestate share of the decedent’s estate was to be included in his net worth to determine his solvency. The notes were valued

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120 Reg. § 20.2031-4; Estate of Sharp v. Comm’r, 68 TCM (CCH) 1521 (1994).
123 Estate of Low v. Comm’r, 2 TC 1114 (1943), nonacq. 1944 CB 43, aff’d per curiam, 145 F2d 832 (2d Cir. 1945); Rev. Rul. 67-276, 1967-2 CB 321.
124 Gump v. Comm’r, 124 F2d 540 (9th Cir. 1941), cert. denied, 316 US 697 (1942).
126 Mulliken v. Magruder, 55 F. Supp. 895 (D. Md. 1944), aff’d on another issue, 149 F2d 593 (4th Cir. 1945).
129 Estate of Harper v. Comm’r, 11 TC 717 (1948), acq. 1949-1 CB 2. See also TAM 9240003 (June 17, 1992) (value of note owed to decedent by insolvent nephew was properly determined by nephew’s ability to pay at date of death without regard to bequest to nephew in will or fact that note was canceled by will).
130 Estate of Hodge v. Comm’r, 2 TC 643 (1943), acq. 1943 CB 11.
at their face amount. The prior approach is preferable because the emphasis of the federal estate tax is on the amount of wealth the decedent could pass on, a question that is unaffected by the fact that a debtor is also a beneficiary.\textsuperscript{131} Likewise, if a statute of limitations bars procedures to collect the obligation, it may have no value\textsuperscript{132} or it may be limited in value to the collateral securing the obligation.\textsuperscript{133} A debtor’s discharge in bankruptcy has about the same effect as the running of a statutory limitation period.\textsuperscript{134} Controversy regarding liability to pay an asserted obligation is certainly relevant; in such cases, the likelihood of success in litigation is a factor in valuing the obligation.\textsuperscript{135} However, value should be determined on the applicable date of valuation and should not be dependent on subsequent recoveries.\textsuperscript{136}

\textbf{[h] Annuities and Life Insurance Policies}

An annuity may be defined generally as a right to a stream of fixed payments over a specified term. Because the specified term is generally keyed to the life of the beneficiary, valuation can be a more complex issue. Fortunately, in the case of commercial annuities and endowment contracts, the issue is made fairly simple. The value of an annuity payable by a company regularly engaged in selling annuity contracts is the price at which comparable contracts are being sold by the company,\textsuperscript{137} obviously an appropriate resort to marketplace valuation.\textsuperscript{138}

\textsuperscript{133} Estate of Walker v. Comm’r, 4 TC 390 (1944), acq. 1945 CB 7.
\textsuperscript{134} Malloch v. Westover, 1951-1 USTC ¶ 10,816 (SD Cal. 1951).
\textsuperscript{135} Mullikin v. Magruder, 55 F. Supp. 895 (D. Md. 1944), aff’d on another issue, 149 F2d 593 (4th Cir. 1945).
\textsuperscript{136} Mullikin v. Magruder, 55 F. Supp. 895 (D. Md. 1944), aff’d on another issue, 149 F2d 593 (4th Cir. 1945). Cf. Estate of Smith v. Comm’r, 57 TC 650 n. 2 (1972). But see Rosskam v. United States, 64 Ct. Cl. 272 (1927), where it was impossible to value the notes at the decedent’s death, so value was based on the amount received on sale five years later. The \textit{Rosskam} result has a certain appeal because of its “wait and see” approach. Cf. Comm’r v. Estate of Shively, 276 F2d 372 (2d Cir. 1960). But while this approach works sometimes for income tax purposes (Burnet v. Logan, 283 US 404 (1931); Dorsey v. Comm’r, 49 TC 606 (1968)), awkward evaluations are not avoided for estate tax purposes. Cf. Smith v. Shaugnessy, 318 US 176, 180 (1943). The usual approach, therefore, is to take a still picture at the applicable valuation date. Ithaca Trust Co. v. United States, 279 US 151 (1929). But see ¶ 5.03[4][c].
\textsuperscript{137} Reg. § 20.2031-8(a)(3), Ex. 1.
\textsuperscript{138} For a discussion of the valuation of an interest measured by the life or lives of terminally ill persons, see infra ¶ 4.02[5], text accompanying notes 268–270.

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Marketplace valuation may also be possible for an insurance policy\textsuperscript{139} on the life of another owned by the decedent.\textsuperscript{140} If the policy is paid up, its value is the amount that the company would charge for a single-premium policy on a person of the same age as the insured.\textsuperscript{141} Policies on which premium payments remain to be paid are generally valued with respect to the company’s interpolated terminal reserve (adjusted with respect to the most recent premium payment), which, in general, identifies the amount designated by the issuing company as needed at the valuation date to fund the death benefit that will ultimately become payable.\textsuperscript{142}

For noncommercial annuity-type arrangements, there is no market to serve as a reference. In these cases, reference is made to mechanical rules under Section 7520, discussed in more detail later.\textsuperscript{143}

[i] Other Property Interests

The list of items previously mentioned for which valuation approaches are discussed is, of course, not exhaustive. Items that must be valued cover the whole range of property interests included under Section 2033 and all other provisions defining the gross estate. Although some of these miscellaneous items, because of their uniqueness, are quite difficult to value, the general principles previously recited are applicable: the “willing buyer, willing seller” test is still applied; difficulty of valuation should not preclude valuation; date of death is the normal valuation date; and, often determinative, the burden of proof is on the taxpayer.

\textsuperscript{139} There may be a question of whether a combination life insurance and annuity contract should be valued as insurance or as an annuity. The regulations note the distinction. Reg. § 20.2031-8(a). Compare Helvering v. Estate of Le Gierse, 312 US 531 (1941), with Fidelity-Philadelphia Trust Co. v. Smith, 356 US 274 (1958).

\textsuperscript{140} For policies on the life of the decedent, see IRC § 2042, discussed at ¶ 4.14.

\textsuperscript{141} Reg. §§ 20.2031-8(a)(1), 20.2031-8(a)(3), Ex. 2. See also Rev. Rul. 78-137, 1978-1 CB 280. The correct mortality tables are now gender-neutral. Should the insurability of the insured be a factor?


\textsuperscript{143} See infra ¶ 4.02[5].
[4] Adjustments for Premiums and Discounts

[a] Introduction

Once the value of an asset is determined, various increasing and decreasing adjustments may be made to such valuation to reflect the decedent’s interest in the asset.\(^{144}\) Upward adjustments are appropriate where the decedent’s interest has special powers or leverage over the interests of others in the same asset.\(^{145}\) Likewise, downward adjustments are required where the decedent’s interest is comparatively weaker than other interests in the same asset or than other assets to which the subject property is compared.\(^{146}\)

In most cases, the preadjustment base price is the "liquidation value" of the decedent’s interest, generally expressed as the decedent’s share of the underlying property to which the decedent’s interest relates. For example, if the gross estate includes an 80 percent interest in a parcel of real property worth $100,000, the liquidation value of the decedent’s 80 percent interest would be $80,000. However, $80,000 is probably not the price that a willing buyer would pay for the decedent’s 80 percent interest.

Because of the importance of the various adjustments, which will be described, where the cost is justified, the personal representative might consider obtaining two separate appraisals—one that provides the unadjusted (or "liquidation") value of the interest included in the gross estate, and one that proves the proper adjustments to the liquidation value. This strategy has been successful,\(^{147}\) although it is certainly not required. One appraisal can determine both the liquidation value and the fair market value.


\(^{145}\) See infra ¶ 4.02[4][b].

\(^{146}\) See infra ¶¶ 4.02[4][c]–4.02[4][e]. Not all possible downward adjustments are considered, of course. See Estate of Jameson v. Comm’r, 77 TCM (CCH) 1383 (1999) (a 97 percent interest in a corporation was not discounted for a "nuisance discount" because local law allowed the 97 percent shareholder near-unfettered control over corporate actions), vacated and remanded on other grounds, 267 F3d 366 (5th Cir. 2001); Rev. Rul. 2008-35, 2008-1 CB 116 (restricted management account (RMA) valued without any reduction for restrictions imposed on account by RMA agreement); IRS Chief Couns. Adv. Mem. 200941016 (Aug. 26, 2008) (discount allowed on RMA for potential damages for breach of contract for transfer tax purposes).

\(^{147}\) See Estate of Williams v. Comm’r, 75 TCM (CCH) 1758 (1998).
[b] Premium for Control

[i] Rationale. When the subject property is a controlling interest in a business entity or some other asset, a willing buyer might indeed pay a premium in addition to the liquidation value of the interest.\(^{148}\) Thus, for example, when the subject property is an 80 percent interest in a closely held business, a willing buyer might pay more than 80 percent of the total fair market value of the business.\(^{149}\) The willing buyer will pay extra to guarantee unfettered control over the business. With an 80 percent interest, the willing buyer would control the election of officers, the timing and amount of distributions including liquidation, all votes of the owners, hiring and salary decisions, and all other aspects of the business.\(^{150}\)

[ii] Absence of attribution. The fair market value of an interest included in the gross estate is determined without attribution to the decedent of interests owned by other individuals. Thus, when a decedent owns a 30 percent interest in a closely held business, no control premium is proper where the decedent’s spouse, children, or other close family members own interests that, when combined with the decedent’s interest, would create a controlling interest. This is true even when the decedent effectively enjoys close relationships with the other family owners and may effectively control the underlying asset because

\(^{148}\) See Reg. § 20.2031-2(e) (last sentence).

\(^{149}\) This premium is frequently combined with a discount for a lack of marketability (see infra ¶ 4.02[4][d]), which can have the effect of partially or totally canceling out the premium. See infra ¶¶ 4.02[4][d], text accompanying notes 191 – 193, 4.02[4][f].

\(^{150}\) See Estate of Murphy v. Comm’r, 60 TCM (CCH) 645, 658–659 (1990), which lists rights associated with control quoting S. Pratt, Valuing a Business: The Analysis and Appraisal of Closely Held Companies 55–56 (Dow Jones—Irwin 1989). The listed rights are as follows: (1) elect directors and appoint management; (2) determine management compensation and perquisites; (3) set policy and change the course of business; (4) acquire or liquidate assets; (5) select people with whom to do business and award contracts; (6) make acquisitions; (7) liquidate, dissolve, sell out, or recapitalize the company; (8) sell or acquire treasury shares; (9) register the company’s stock for a public offering; (10) declare and pay dividends; and (11) change the articles of incorporation or bylaws. See S. Pratt & A. Niculita, Valuing a Business: The Analysis and Appraisal of Closely Held Companies 385 (McGraw-Hill, 5th ed. 2008).
of the close ties. The Service has conceded the issue\textsuperscript{151} after several court defeats.\textsuperscript{152}

Although the Service concedes the attribution issue,\textsuperscript{153} it appropriately maintains that aggregation within the gross estate is proper. Thus, where a revocable trust created by the decedent for the decedent’s sole benefit owns shares in a closely held corporation, any shares in the same corporation owned outright by the decedent will be added to the trust shares\textsuperscript{154} in order to compute value.\textsuperscript{155} Similarly, a minority interest transferred within three years of death in a manner that causes gross estate inclusion under Section 2035(a) will be added to whatever interest the decedent owned outright at the date of death.\textsuperscript{156}

Where the decedent is a surviving spouse and beneficiary of a qualified terminal interest property (QTIP) trust, shares owned by the surviving spouse outright or included in the surviving spouse’s gross estate under other gross estate inclusion sections are not combined with the shares owned by the QTIP trust, even through Section 2044 requires inclusion of the QTIP trust shares in the surviving spouse’s gross estate.\textsuperscript{157} Although Section 2044 treats a surviving spouse as the owner of the shares held in the QTIP trust for purposes of computing the gross estate, such shares are not and have never been actually

\textsuperscript{151} Rev. Rul. 93-12, 1993-1 CB 202. See also TAM 9432001 (Mar. 28, 1994) (decedent’s 49 percent interest in corporate stock still given minority discount even though legatee, decedent’s son, owned remaining 51 percent of stock). The rule against attribution is also recognized in the federal gift tax setting, where a transferor will fracture a controlling interest and give several smaller, noncontrolling interests. See ¶ 10.02[2][c], text accompanying notes 90–92. This technique is successful, as the Service conceded in Revenue Ruling 93-12, and TAM 9449001 (Mar. 11, 1994) (transfer of 9 percent interests to each of eleven children valued as eleven separate gifts, not one gift of controlling interest).

\textsuperscript{152} See Estate of Bright v. United States, 658 F2d 999 (5th Cir. 1981); Estate of Andrews v. Comm’r, 79 TC 938 (1982); Propstra v. United States, 680 F2d 1248 (9th Cir. 1982); Estate of Lee v. Comm’r, 69 TC 860 (1978).

\textsuperscript{153} Rev. Rul. 93-12, 1993-1 CB 202.

\textsuperscript{154} For inclusion in the gross estate of stock owned by a decedent’s revocable trust, see ¶ 4.10.

\textsuperscript{155} See Rev. Rul. 79-7, 1979-1 CB 294; TAM 9403002 (Sept. 17, 1993); TAM 200648028 (Aug. 4, 2006).


\textsuperscript{157} See ¶ 4.16.
owned by the surviving spouse, so the courts consider such aggregation improper.\textsuperscript{158}

[iii] Amounts and cases. There is no fixed adjustment to apply to controlling interests in property or a business.\textsuperscript{159} The proper adjustment depends on the degree of control possessed by the subject interest and on the nature of the underlying assets. For example, the control premium for a 60 percent interest in a business should be less than the control premium applicable to an 80 percent interest, because only the latter has the ability (under most state laws) to unilaterally compel liquidation, merger, or other extraordinary corporate action.

A control premium is not warranted when the interest lacks any voting control. Thus, if the decedent owns 90 percent of the equity in a closely held business but no portion of the business’s voting power, no control premium should apply. Likewise, an interest should not be subject to a control premium simply because it is large enough to elect one member of a board of directors.\textsuperscript{160}

In one case, the Tax Court held that a minority interest with significant voting power may warrant a control premium. In \textit{Estate of Simplot v. Commissioner}, the court applied a premium equal to 3 percent of the total equity value to the 76,445 voting shares in the subject corporation, even though these shares represented only approximately $\frac{5}{100}$ of one percent (0.05 percent) of the total number of shares.\textsuperscript{161} However, the case was reversed on appeal with the Ninth Circuit Court of Appeals finding several errors in the Tax Court’s rationale.\textsuperscript{162}


\textsuperscript{159} Estate of Salsbury v. Comm’r, 34 TCM (CCH) 1441 (1975) (38 percent control premium where decedents owned 51.8 percent voting interest in a corporation); Estate of Trenchard v. Comm’r, 69 TC (CCH) 2164 (1995) (40 percent control premium was applied to the decedent’s 60 percent interest in a family corporation); Dooly v. Comm’r, 31 TCM (CCH) 814 (1972); Anderson v. Comm’r, 31 TCM (CCH) 502 (1972).

\textsuperscript{160} Estate of Wright v. Comm’r, 73 TC (CCH) 1863 (1997).

\textsuperscript{161} Estate of Simplot v. Comm’r, 112 TC 130 (1999). The decedent owned 18 of the voting shares (23.55 percent of the voting shares) and 3,942 nonvoting shares. Although no shareholder held a majority of the voting shares, the court determined that a willing buyer would pay a premium because ownership of any portion of the voting shares would give the willing buyer access to the corporation’s “inner circle.”

\textsuperscript{162} Estate of Simplot v. Comm’r, 249 F3d 1191 (9th Cir. 2001). The Ninth Circuit was critical of the Tax Court finding imaginary scenarios as to potential purchasers, valu-
4.02[4][b]

If the decedent owns a controlling block of stock in a closely held corporation immediately before death, the decedent might be tempted to transfer a fraction of the controlling interest to one or more beneficiaries and die holding a minority interest. For this reason, deathbed transfers of minority interests by a controlling shareholder are suspect, and a court has not only disallowed minority interest discounts (discussed later) but also applied a control premium to the decedent’s interest. The Service continues to be suspicious of any death-time “slicing and dicing” of a controlling interest.

[iiv] Swing vote premium. Suppose a decedent had owned 2 percent of the stock in a closely held corporation, and the other two shareholders, who are unrelated to one another, each owns 49 percent of the stock. A willing buyer might be willing to pay a premium for the decedent’s shares above the price that would normally be paid for a minority interest because the owner of the 2 percent interest will have the opportunity to have a significant say in corporate management and distributions, certainly much more so than most 2 percent shareholders. Further, if the owners of the 49 percent blocks are interested in gaining control of the corporation, the owner of the 2 percent interest will have a ready market unlike that available to many 2 percent shareholders of closely held businesses. This is the underlying theoretical construct that supports the concept of “swing vote premium.” It was the justification for a decision to permit no minority interest discount in a situation in which the decedent owned a 10 percent block of voting stock in a corporation where another 40 percent was owned by members of the decedent’s family and the

163 Estate of Murphy v. Comm’r, 60 TCM (CCH) 645 (1990). The Murphy court stressed the fact that the decedent and her beneficiaries had an informal agreement among them to keep control of the corporation within the family. But see Estate of Frank v. Comm’r, 69 TCM (CCH) 2255 (1995), where a deathbed transfer from the decedent by decedent’s agent under a power of attorney to his spouse was respected and a 20 percent minority discount to the decedent’s share of stock allowed. The Frank court did not cite Murphy, and found the decedent’s motive was not solely tax avoidance. Id. at 2257–2259.

164 See TAM 9719006 (Jan. 14, 1997) (the Service valued a partnership’s assets as if owned outright by the decedent where the decedent’s children created an FLP while the decedent was on life support and sold partnership interests to the decedent’s children under an installment note dated contemporaneously with the creation of the partnership). See also TAM 9723009 (Feb. 24, 1997) and TAM 9725002 (Mar. 3, 1997) (both raising the same issues on similar facts). Outside the context of its own rulings on “death-bed partnerships,” the Service’s attempt to disregard the partnership and instead value its inside assets has been unsuccessful. See ¶ 19.04[2], text accompanying notes 20–26.

165 See discussion of discount for minority interests infra ¶ 4.02[4][c].
other 50 percent was owned by members of another family. That decision was in turn relied on by the Service to conclude that where three 30 percent blocks of stock were the subject of simultaneous gifts, all three blocks could be valued with a premium because of swing vote characteristics. A review of the authorities suggests that such a premium seems most likely to be recognized where the ownership interest being valued can be combined with at least one (and possibly more) other ownership interests to gain control of the business, and where at least one or more of those ownership interests are held by persons who can reasonably be assumed (or proved) to want to gain control. The Service has urged swing vote premium in a number of other cases with limited success. The reasons for declining to apply the analysis in those cases have varied, and on the whole, the cases suggest that the theory is one that will affect value in some situations.

166 Estate of Winkler v. Comm’r, 57 TCM (CCH) 373 (1989) (stating, on the facts of that case, “we conclude that a 10 percent block of voting stock has ‘swing vote characteristics’ and that a minority discount would be inappropriate here”). Id. at 383. A somewhat similar result was reached in Estate of Hendrickson v. Comm’r, 78 TCM (CCH) 322 (1999) (holding that a large minority interest effectively controlled a business and thus was entitled to no minority interest discount, although allowing a marketability discount).

167 Priv. Ltr. Rul. 9436005 (May 26, 1994). The ruling rejected an argument by the taxpayer that had the gifts been made seriatim, a different result would have been reached. The ruling also correctly notes that the swing vote analysis was examined in Estate of Bright v. Comm’r, 658 F2d 999 (5th Cir. 1981), a case better known for rejecting family ownership attribution for valuation purposes. It also included, however, a thoughtful discussion of swing vote concepts (id. at 1007, 1009), but concluded the point had not been timely raised by the government. Id. at 1008.

168 This may explain why swing vote analysis was not raised in Rev. Rul. 93-12, 1993-1 CB 202 (where gifts of five 20 percent interests were made simultaneously to the donor’s children and there was no mention of a swing vote analysis), and TAM 9449001 (Mar. 11, 1994) (involving transfers of eleven 9 percent interests). In neither situation could the owner of one of the interests combine with any other one owner to achieve control. The statement in the text is consistent with the result in Estate of Davis v. Comm’r, 110 TC 530 (1998), where the issue was the value of two 25.77 percent blocks of stock in a holding company given to the donor’s two children. In valuing each gift of 25.77 percent, the court indicated that because the remaining shares were owned by the donor and the donor’s other child, and those two owners were unlikely to seek to acquire control by obtaining the 25.77 percent held by the third shareholder, neither gifted block was likely to be able “to influence management and to be a swing block.” Id. at 559.

169 Estate of Simplot v. Comm’r, 112 TC 130 (1999), rev’d, 249 F3d 1191 (9th Cir. 2001); Estate of True v. Comm’r, 82 TCM (CCH) 27, 87 (2001), aff’d, 390 F3d 1210 (10th Cir. 2004); Estate of Magnin v. Comm’r, 81 TCM (CCH) 1126 (2001) (where the Tax Court stated “we have recognized that a discount may not apply in situations where a minority block of stock has ‘swing vote characteristics’”). Id. at 1138–1139.

170 In Estate of Simplot v. Comm’r, 112 TC 130 (1999), the Tax Court referred to the eventual potential for swing vote power in determining the voting premium to attach to eighteen voting shares comprising a 23.55 percent voting block of a very valuable corporation. Id. at 179. Although the decision was reversed on appeal, Estate of Simplot v.
[c] Discount for Minority Interest

[i] Rationale. The minority interest discount reflects the inability both to compel liquidation of the underlying asset and to control its management. The rationale for allowing a minority interest discount is essentially the inverse of adding a control premium.\(^{171}\) While a willing buyer is prepared to pay a premium for a controlling interest, a willing buyer will insist on paying less than the liquidation value for a noncontrolling interest.\(^{172}\)

[ii] Absence of attribution. As with the control premium, there is no attribution of others’ interests to the decedent.\(^{173}\) In essence, the decedent’s interest is valued in isolation, even though the decedent might have indirectly controlled the interests of others in the same asset or enterprise through the decedent’s influence.\(^{174}\)

[iii] Amounts and cases. Because valuation is a question of fact, there is no fixed minority discount amount.\(^{175}\) As the following summary of important cases shows, the typical minority interest discount ranges from 10 percent to 30 percent.\(^{176}\)

In Estate of Berg v. Commissioner,\(^{177}\) the court sustained the Service’s application of a 20 percent minority interest discount on the decedent’s interest in a closely held corporation that managed unimproved real estate, completely

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\(^{171}\) See the factors listed supra ¶ 4.02[4][b], note 150.

\(^{172}\) See supra ¶ 4.02[4][b][ii].

\(^{173}\) Although attribution will not prevent application of the minority interest discount, a court will not be blind to the identity of other owners in considering the proper discount figure. Moore v. Comm’r, 62 TCM (CCH) 1128 (1991) (court increased minority interest discount because surviving partners were related).

\(^{174}\) In some cases, a court may compute the minority discount with respect to the control premium applicable to a majority interest. Kosman v. Comm’r, 71 TCM (CCH) 2356 (1996) (4 percent minority discount after citing study that controlling rights were worth 2 to 4 percent premium); Rakow v. Comm’r, 77 TCM (CCH) 2066 (1999) (31 percent minority discount based on control premium).

\(^{175}\) See also Estate of Barudin v. Comm’r, 72 TCM (CCH) 488 (1996) (19 percent minority interest discount); Anderson v. United States, 2006-1 USTC ¶ 60,516 (WD La. 2005) (10 percent using net asset approach); Estate of Litchfield, 97 TCM (CCH) 1079 (2009) (14.8 percent and 11.9 percent minority interest in two entities); Estate of Gallagher v. Comm’r, 101 TCM (CCH) 1702 (2011) (23 percent minority interest discount).

rejecting the estate’s expert claim for a higher discount. The Service includes *Berg* in its training guide for appeals officers, apparently to proclaim its victory. Still, a 20 percent minority interest discount is quite significant. The *Berg* case should not be read for the proposition that the Service will concede a 20 percent minority interest discount in all cases, but one can use *Berg* to show that the Service will accept significant minority interest discounts for closely held businesses.

In another case, the Service asserted that the decedent’s 50 percent interest in a closely held corporation should not receive a minority interest discount because the decedent’s interest could block action by the other shareholders. But the court concluded that a 10 percent minority interest discount was proper because a 50 percent interest is not a controlling interest. Similar discounts should apply to a predeceasing spouse’s 50 percent interest in property held as community property.

Still another case sheds light on the minority discount applicable to nonvoting shares in a business enterprise. The subject property in the case was a corporation’s Class B shares. The Class B shares were nonvoting with respect to most corporate matters, but consent of Class B shareholders was required for a corporate merger, liquidation, redemption, or other extraordinary corporate action. The Tax Court concluded that this veto power was significant enough to outweigh the general lack of voting rights; accordingly, it applied no minority discount in valuing the shares. The Ninth Circuit Court of Appeals reversed, finding the veto powers alone insufficient to overcome the presumption that nonvoting shares receive a minority discount.

Finally, it should be stressed that the minority discount is premised on the fact that the other, controlling interest or interests have actual control over the subject property. Thus, where the decedent owned an income interest in real property that was conveyed to a liquidating trust following a dispute between the decedent and the remainder beneficiaries, the decedent’s minority income interest was not entitled to a minority interest discount because the remainder beneficiaries gave up control upon transfer to the liquidating trust.

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179 Estate of Ford v. Comm’t, 66 TCM (CCH) 1057 (1993), aff’d, 53 F3d 924 (8th Cir. 1995) (court accepted Service’s use of a 20 percent minority interest discount).
180 Wheeler v. United States, 96-1 USTC ¶ 60,226 (WD Tex. 1996), rev’d and remanded on other grounds, 116 F3d 744 (5th Cir. 1997).
183 Theophilos v. Comm’t, 85 F3d 440 (9th Cir. 1996).
184 Estate of Casey v. Comm’t, 71 TCM (CCH) 2599 (1996). The estate, however, was entitled to a 15 percent marketability discount because of the anticipated delay in sale.
[d] Discount for Lack of Marketability

[i] Rationale. A readily marketable interest is easily sold by its owner. Where an interest cannot be readily sold because of a limited market of buyers, or because of restrictions on the owner’s ability to transfer the interest, the value of the interest must be less than its liquidation value. The marketability discount reflects the fact that a willing buyer will consider the costs and delay involved in eventually reselling the subject property. The discount for lack of marketability applies to both controlling and minority interests in an asset or business. 185

[ii] Amounts and cases. As with the minority interest discount, there is no fixed discount amount for a lack of marketability. Again, determining the appropriate amount of the discount is a fact-intensive inquiry. 186 Still, one can obtain a sense of the importance of the marketability discount through a review of some of the litigated cases. The following cases suggest that the typical range for a marketability discount will be from 15 percent to 40 percent, with the marketability discount generally falling nearer the high end of that range where the decedent’s interest is a minority interest.

As suggested, many cases have permitted significant marketability discounts where the decedent also held a minority interest in the property. For example, in Estate of Jung v. Commissioner, 187 the court applied a 35 percent marketability discount in valuing the decedent’s 20.74% interest in a closely held corporation. A 40 percent marketability discount was applied in Estate of Lauder v. Commissioner, 188 where the subject property was a minority interest in a successful, industry-leading corporation. A 40 percent marketability discount was also applied to the decedent’s 9.8 percent interest in the stock of a

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185 See infra ¶¶ 4.02[4][d][ii], 4.02[4][f]. Attribution of ownership is again disregarded. See Estate of Andrews v. Comm’r, 79 TC 938, 953 (1982) (minority and marketability discount allowed where decedent and siblings owned 100 percent of a corporation).

186 An in-depth analysis of factors that a court examines in determining the amount of a marketability discount appears in Mandelbaum v. Comm’r, 69 TCM (CCH) 2852 (1995), aff’d, 91 F3d 124 (3d Cir. 1996). The Tax Court considered the following ten factors: (1) private versus public sales figures; (2) financial statement analysis; (3) corporate dividend policy; (4) corporation’s economic outlook; (5) corporate management; (6) control exerted by subject shares; (7) restrictions on transfer; (8) holding periods; (9) corporate redemption policy; and (10) costs of making a public offering.


closely held retail grocery store chain.\textsuperscript{189} And a 26 percent marketability discount was allowed for 1/95 general partnership interest in a partnership that owned depressed real estate in New York.\textsuperscript{190}

Significant marketability discounts have been allowed even where the decedent owned a controlling interest in property. In one case,\textsuperscript{191} the court applied a 20 percent marketability discount to the decedent’s 78 percent interest in an incorporated ranch. The court found the discount appropriate because of restrictions on the decedent’s use of the land under the California Land Conservation Act. A controlling interest received a 15 percent marketability discount where the decedent owned an 82.49 percent interest in a family holding corporation.\textsuperscript{192} A marketability discount of 30 percent was allowed for a minority interest in an entity that was treated as a controlling interest.\textsuperscript{193}

Even where a decedent owns all of the interests in an asset or business entity, a marketability discount may be appropriate. The decedent was the sole beneficiary of a trust that owned 100 percent of the stock of a holding company where the court accepted the 25 percent marketability discount claimed

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\textsuperscript{189} Estate of Brookshire v. Comm’r, 76 TCM (CCH) 659 (1998). Beyond its relatively high percentage discount, Brookshire is interesting for two reasons. First, the corporation’s buy-sell agreement gave the estate the right to compel redemption of the decedent’s shares at book value (or, if less, the total amount of life insurance the corporation held on the decedent’s life). It is therefore curious that the court would approve such a high marketability discount, given the estate’s ability to have the shares redeemed in short order. Second, the book value of the stock was higher than the estate tax value approved by the court. One would expect that the book value in this case would be the minimum value of the stock for estate tax purposes.

\textsuperscript{190} Estate of Barudin v. Comm’r, 72 TCM (CCH) 488 (1996).

\textsuperscript{191} Estate of Luton v. Comm’r, 68 TCM (CCH) 1044 (1994). But in the same case, the decedent’s interest in a private trust holding an unsecured promissory note was given a marketability discount of only 10 percent because of the note’s consistent payment history and the solid financial status of the note’s maker.

\textsuperscript{192} Gray v. Comm’r, 73 TCM (CCH) 1940 (1997). The court upheld a marketability discount despite the Service’s assertion that a marketability discount was inappropriate for a controlling interest in an entity valued according to the net asset method. See Estate of Borgatello v. Comm’r, 80 TCM (CCH) 260 (2000) (82.76 percent interest allowed a 33 percent marketability discount).

\textsuperscript{193} Estate of Hendrickson v. Comm’r, 78 TCM (CCH) 322 (1999) (30 percent marketability discount on 49.97 percent interest in closely held bank treated as a controlling interest). See supra ¶ 4.02[4][b], note 166.

For other marketability discount cases involving controlling interests, see Estate of Ford v. Comm’r, 66 TCM (CCH) 1507 (1993), aff’d, 53 F3d 924 (8th Cir. 1995) (10 percent marketability discount given to decedent’s 92.4 percent interest in a corporation); Estate of Newhouse v. Comm’r, 94 TC 193 (1990), acq. 1991-1 CB 1 (35 percent blended minority and marketability discount permitted even though decedent held largest outstanding ownership interest in the corporation); Trenchard v. Comm’r, 69 TCM (CCH) 2164 (1995) (40 percent marketability discount).

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by the petitioner’s expert.\textsuperscript{194} A 15 percent marketability discount was approved in another case\textsuperscript{195} that involved the valuation of a wholly owned holding company. Some cases have not allowed a marketability discount, but have reduced the value of a company by the estimated cost of liquidating the company.\textsuperscript{196}

\[\text{[e] Other Significant Discounts}\]

\[\text{[i] Fractional interest discount.}\] Like a minority interest discount, a fractional interest discount recognizes the risks of co-ownership. While the minority interest discount applies to co-ownership of an entity, the fractional interest discount applies to co-ownership of an asset. Thus, assets held by the decedent and another as tenants in common or as community property are eligible for a fractional interest discount.\textsuperscript{197} The fractional interest discount reflects the fact that a willing buyer will not pay liquidation value for an undivided interest in an asset because of the costs to partition the property or sever the interest, not to mention the general headaches and compromises required of co-ownership. While these same risks may be present with respect to property held as joint tenants with rights of survivorship, Section 2040 provides specific rules for inclusion and valuation, and courts will not apply a fractional interest discount to the amount required for inclusion under Section 2040.\textsuperscript{198}

A typical example of the fractional interest discount appears in a case\textsuperscript{199} where the property was an undivided one-half interest in undeveloped Florida

\textsuperscript{194} Estate of Dougherty v. Comm’r, 59 TCM (CCH) 772 (1990).

\textsuperscript{195} Estate of Bennett v. Comm’r, 65 TCM (CCH) 1816 (1993). The discount would be reflected in the value of the asset or business entity under either the market approach or the asset-based approach described earlier.

\textsuperscript{196} Estate of Jephson v. Comm’r, 87 TC 297 (1986) (decedent owned two investment companies holding only cash and marketable securities; the court found it sufficient to merely reduce the net asset value by the costs to liquidate the securities). A marketability discount was also denied in Estate of Cloutier v. Comm’r, 71 TCM (CCH) 2001 (1996), because none of the estate’s appraisals followed an appropriate valuation method, not necessarily because the decedent owned a 100 percent interest in the subject corporation.

\textsuperscript{197} Propstra v. United States, 680 F2d 1248 (9th Cir. 1982). See infra text accompanying notes 199–205. But see Stone v. United States, 2007-1 USTC ¶ 60,540 (ND Cal. 2007) and 2007-2 USTC ¶ 60,545 (2007); aff’d, 2009-1 USTC ¶ 60,572 (9th Cir. 2009) (fractional interest discount disallowed for art collection; however, 5 percent discount allowed on collection for sales fees (2 percent), cost of partition (1.8 percent), and other uncertainties (1.2 percent)); Estate of Adler v. Comm’r, 101 TCM (CCH) 1118 (2011) (no fractional interest discount where all interests included in decedent’s gross estate under Sections 2033 and 2036). Cf. Estate of Bright v. Comm’r, 658 F2d 999 (5th Cir. 1981); Estate of Lee v. Comm’r, 69 TC 860 (1978).

\textsuperscript{198} Estate of Young v. Comm’r, 110 TC 297 (1988); Estate of Fratini v. Comm’r, 76 TCM (CCH) 342 (1998).

\textsuperscript{199} Estate of Williams v. Comm’r, 75 TCM (CCH) 1758 (1998).
timberland. The Tax Court allowed a 30 percent discount because the decedent’s interest lacked control, despite the Service’s contention that a fractional interest discount beyond costs of partitioning the property should be disallowed in the absence of evidence of sales of fractional interests in comparable real property.\(^{200}\) The Service’s argument in the case apparently represented a renewed attack against the fractional interest discount. In an earlier case involving real property, the Service unsuccessfully argued for a fractional interest discount of 5 percent plus the cost of partitioning the property.\(^{201}\) At least in that case, the Service was receptive to a fractional interest discount that reflected more than simply the costs to partition the subject property. But as the former case suggests, the Service more recently will challenge the discount when it exceeds the partition costs.\(^{202}\) To date, however, the Service generally continues to be unsuccessful.\(^{203}\)

The fractional interest discount does create significant planning opportunities. The decedent’s spouse in one case\(^ {204}\) created two inter vivos trusts for the benefit of the decedent. Fractional interests in real property were placed inside each trust. The assets of only one of the trusts were included in the decedent’s

\(^{200}\) Estate of Williams v. Comm’r, 75 TCM (CCH) 1758, 1766 (1998). The very absence of such evidence supported the court’s conclusion that there was no real market for fractional interests in real property. Further, the court rejected the Service’s argument that a fractional interest discount should be limited to the costs to partition the property. See Estate of Baird v. Comm’r, 82 TCM (CCH) 666 (2001) (60 percent discount for two undivided interests in Louisiana timberland, a $14/65$ interest and a $17/65$ interest); Estate of Forbes v. Comm’r, 81 TCM (CCH) 1399 (2001) (30 percent fractional discount for raw farmland).

\(^{201}\) Estate of Cervin v. Comm’r, 68 TCM (CCH) 1115 (1994), rev’d and remanded on other grounds, 111 F3d 1252 (5th Cir. 1997) (Tax Court granted a 20 percent fractional interest discount, noting the fact that a partition action would require agreement among all of the co-owners as to the relative values of each interest—a fact that apparently increases the fractional interest discount).

\(^{202}\) See TAM 199943003 (June 7, 1999).

\(^{203}\) See Estate of Brocato v. Comm’r, 78 TCM (CCH) 1243 (1999) (allowing the 20 percent fractional interest discount claimed by the taxpayer and rejecting the Service’s attempt to limit the discount to costs of partition plus costs of anticipated delays). But see Estate of Busch v. Comm’r, 79 TCM (CCH) 1276 (2000) (the personal representative argued for a 40 percent fractional interest discount where the decedent owned an undivided 50 percent interest in real property, but the court allowed a 10 percent fractional interest discount, an amount based primarily on partition costs, because it was likely that the other co-owner would not resist any effort to sell the land). See Hoffman, “The Tax Court’s Decisions on Undivided Interest Discounts,” Valuation Strategies 19 (May/June 2001).

\(^{204}\) Estate of Pillsbury v. Comm’r, 64 TCM (CCH) 284 (1992).
gross estate, and the court upheld a 15 percent fractional interest discount in valuing the trust’s share of the real property.

[ii] Blockage and market absorption discounts. On some occasions, the size of the property included in the gross estate is so large that a discount is required for the effect of supply and demand on the market for such property. For example, if the decedent owned a significant share of the publicly traded shares of one company and tried to sell the entire block at once, the decedent would not be able to sell each share for the same price. Because of the significant increase in the number of shares available for sale, the price per share will drop as the number of shares in the block increases. In the case of stock or other business interests, this is referred to as a blockage discount. The Service acknowledges that a blockage discount can be proper, but there has been litigation over the amount of the discount. The typical size of the blockage discount for business interests is smaller than the typical minority interest and marketability discounts; the discount often ranges from about 5 percent to 10 percent. A discount at the higher end of the range is usually given to large ownership interests of thinly traded interests.

For assets other than business interests, the corollary term often used is “market absorption discount.” The discount has been approved by courts in cases ranging from real property to art collections. The market absorption

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205 The court distinguished Estate of McMullen v. Comm’r, 56 TCM (CCH) 507 (1998), where a fractional interest discount was disallowed because the real estate was owned by a trust whose governing instrument required any sale of the property to be in the form of a fee simple interest—the entire property. The trusts in Estate of Pillsbury v. Comm’r, 64 TCM (CCH) 284 (1992), did not contain this provision.

206 Reg. § 20.2031-2(e). See also Rev. Rul. 83-30, 1983-1 CB 224 (underwriting fees on marketing a block of stock are not considered in blockage discount, but are allowed as a Section 2053 administrative expense).

207 See, e.g., Estate of Branson v. Comm’r, 78 TCM (CCH) 78 (1999) (20 percent blockage discount applied to decedent’s 62.5 percent stock interest in a small bank); Estate of Wright v. Comm’r, 73 TCM (CCH) 1863 (1997) (court considered the size of decedent’s 23.8 percent block of stock in a holding corporation that owned all of the shares of a New York bank; court ultimately reduced Service’s appraisal from $50 per share to $45 per share); Gillespie v. Comm’r, 23 F3d 36 (2d Cir. 1994) (4.8 percent blockage discount applied to decedent’s 6.54 interest in a class of shares of the Washington Post Company).

208 Estate of Wright v. Comm’r, 73 TCM (CCH) 1863 (1997) (court applied a blockage discount, highlighting the point that valuation considers both sides of a hypothetical sale transaction in responding to the Service’s argument that a blockage discount was inappropriate because the subject property was thinly traded because of the lack of sellers, not any demonstrated lack of buyers).


210 Real property market absorption discounts cases include Estate of Brocato v. Comm’r, 78 TCM (CCH) 1243 (1999) (11 percent market absorption discount applied to several rental properties located in San Francisco’s Marina District); Estate of Rodgers v.
discounts tend to be somewhat higher than the blockage discounts, perhaps because of the unique nature of the assets involved.211

[iii] Built-in gain discount. Generally, expenses incurred to sell property are ignored in computing the fair market value.212 At the decedent’s death appreciated property included in the decedent’s gross estate generally receives a Section 1014 “step-up” in basis so that the fair market value of the property is equal to its basis.213 However, if the decedent’s property is stock in a corporation and the corporation owns property with built-in gain, then as a result of the 1986 repeal of the General Utilities doctrine,214 the corporation would have to pay tax on such gain on its liquidation, reducing the net value of the corporation. Prior to the repeal of the General Utilities doctrine, no tax would have been paid and no discount was allowed.215 However, since the repeal of the doctrine, courts have become receptive to allowing a “built-in gain discount” to reflect the potential tax liability on built-in gain in a corporation’s assets.216

Comm’r, 77 TCM (CCH) 1831 (1999) (permitting an unspecified market absorption discount in valuing real estate holdings of corporation in which decedent was a one-third shareholder, rejecting Service’s position that entity-owned real estate should not be entitled to a market absorption discount; the real estate itself was valued in order to compute the value of the decedent’s stock); Estate of Auker v. Comm’r, 75 TCM (CCH) 2321 (1998) (court approved a market absorption discount in excess of 6 percent for apartment complexes owned by decedent); Estate of Folks v. Comm’r, 43 TCM 427 (1982) (20 percent discount for five lumber yards).

Art collection market absorption discounts cases include Estate of O’Keeffe v. Comm’r, 63 TCM (CCH) 2699 (1992) (court awarded a 25 percent market absorption discount to paintings of decedent, a famous artist, that could be sold within a short time, and a 75 percent market absorption discount to those paintings that would take longer to sell); Estate of Smith v. Comm’r, 57 TC 650 (1972) (reduction in value for 425 sculptures).

211 Compare the results in the cases cited supra note 210 with those supra note 207.


213 See infra ¶ 4.02[6][a]. This would not be the case with gifted property where as a result of Section 1015 the value of appreciated property may exceed its adjusted basis.


216 See infra text accompanying notes 217, 218.

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The first cases addressing the built-in gain discount after the repeal of the *General Utilities* doctrine did not permit the discount absent evidence that, at the moment of death, liquidation was planned in the near term.\textsuperscript{217} More recently, however, courts have been willing to apply a built-in gain discount, even when there is no evidence that a liquidation was contemplated at the valuation date. In allowing a discount for the entire amount of tax on built-in gain that would be incurred if the corporation were liquidated, courts are still mixed as to whether the discount is the full amount of the tax that would be incurred on an immediate liquidation\textsuperscript{218} or whether it should be reduced based on when a liquidation would likely occur.\textsuperscript{219}

No built-in gain discount is allowed for a partnership or limited liability company interest.\textsuperscript{220} Similarly, a discount has properly been disallowed for potential income tax liability incurred by retirement account beneficiaries upon distribution of benefits.\textsuperscript{221}

[iv] **Securities law discount.** Where the securities laws impose restrictions on the trading of the decedent’s stock, a discount is appropriate, and sometimes courts will separately state the discount attributable to securities

\textsuperscript{217} Estate of Luton v. Comm’r, 68 TCM (CCH) 1044, 1050 (1994). See also Estate of Gray v. Comm’r, 73 TCM (CCH) 1940 (1997) (no built-in gains discount because tax gain too speculative); Estate of Davis v. Comm’r, 110 TC 530 (1998) (limited discount allowed for an S corporation).

\textsuperscript{218} Estate of Jelke v. Comm’r, 507 F3d 1317 (11th Cir. 2007), cert. denied, 555 US 826 (2008); Estate of Dunn v. Comm’r, 301 F3d 339 (5th Cir. 2002) (when using an asset-based approach to valuation).

\textsuperscript{219} Eisenberg v. Comm’r, 155 F3d 50 (2d Cir. 1998), acq. AOD 1999-001; Estate of Jameson v. Comm’r, 267 F3d 366 (5th Cir. 2001) (when using an earnings based approach to valuation); Estate of Litchfield v. Comm’r, 97 TCM (CCH) 1079 (2009); Estate of Jensen v. Comm’r, 100 TCM (CCH) 138 (2010). The Service has acquiesced in Eisenberg, conceding that a built-in gain may be proper, but reserving the right to challenge the applicability and amount of the discount in each case. See Bowman, “Built-In Gain Discounts for Transfer Tax Valuation: A Resolution of the Big Debate,” 24 Akron Tax J. 117 (2009).

\textsuperscript{220} Estate of Jones v. Comm’r, 116 TC 121, 136 (2001) (no built-in gain discount, because of the possibility of making a Section 754 election); Temple v. United States, 2006-1 USTC ¶ 60,523 (ED Tex. 2006) (same).

\textsuperscript{221} Estate of Smith v. Comm’r, 391 F3d 621 (5th Cir. 2004) (disallowing a built-in gain discount because a willing buyer would not be saddled with the income tax liability); Estate of Kahn v. Comm’r, 125 TC 227 (2005); TAM 200247001 (Nov. 22, 2002). See IRC § 691(c). Cf. TAM 200444021 (June 21, 2004).
laws assuming the restrictions survive the decedent. The Service has issued guidance for computing the effect of securities laws in valuing stock.

[v] Environmental hazards discount. Where real property is contaminated or used for an activity that may present risks of environmental hazards, a willing buyer will require an adjustment to the purchase price to reflect the extra costs the buyer may incur to clean up or restore the property. Where environmental hazards can be proved, courts are willing to discount the value of real property included in the gross estate.

To claim a discount for environmental hazards, it is not enough simply to prove that an environmental hazard exists or is likely to occur on the property. Instead, one must show that a willing buyer would discover the hazard and, if so, that the willing buyer would demand an adjustment to the purchase price.

[vi] Key person discount. If the decedent was instrumental to the value of a business, it is often appropriate to discount to the value of the decedent’s business interest to reflect the decedent’s death. Courts have recognized and applied a “key person discount,” often in the range of about 10 percent.

[vii] Litigation discount. Courts will also discount the value of an asset that is or will likely be subject to litigation. The risk of litigation and the

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222 Estate of McClatchy v. Comm’r, 147 F3d 1089 (9th Cir. 1998). But see Estate of Davis v. Comm’r, 110 TC 530, 540–544 (1998) (disallowing a securities law discount for valuing shares of corporation that owned just over one percent of the stock of Winn-Dixie Stores’ publicly traded stock).

Sometimes the securities law restrictions are reflected in the marketability discount. See supra ¶ 4.02[4][d]; Estate of Gimbel v. Comm’r, 92 TCM (CCH) 504 (2006).


likelihood of loss greatly affect the size of the discount, making it impossible to describe a typical discount range. Thus, in one case, the Tax Court approved a litigation discount of only 2.5 percent in recognition of the fact that no lawsuit had been filed and that a willing buyer would, after some investigation, conclude that a lawsuit was unlikely. But in another case, the court applied a 25 percent litigation discount because of evidence that the subject property was conveyed to the decedent through undue influence.

**[F] Combinations of Premiums and Discounts**

It is common for several premiums and discounts to apply to the same interest. One combination is a premium for control coupled with a discount for marketability; another more common combination is discounts for a minority interest and for a lack of marketability. The adjustments for premiums and discounts are layered; they are not cumulative. For example, if a minority interest in a closely held business warrants a 20 percent minority interest discount and an additional 30 percent discount for lack of marketability, the total discount is 44 percent, not 50 percent. To illustrate the liquidation value of the minority interest is $100x. After application of the minority interest discount, the value is $80x. The marketability discount is then applied to the reduced figure of $80x to obtain the fair market value of $56x in this case:

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230 See supra ¶ 4.02[4][d], text accompanying notes 191–193.
231 See supra ¶ 4.02[4][d], text accompanying notes 187–190, and the discussion of FLPs and LLCs, infra ¶ 4.02[4][g].
232 Similarly, if there is a combination of a premium and a discount, the adjustments are layered as well. For example, if there is a 40 percent premium for control and a 20 percent discount for a minority interest, the fair market value of the interest is 112 percent of the estate’s unadjusted value: either (1) 40 percent times 100, or 140, reduced by 20 percent of 140, or 28, to 112 percent, or (2) 100 reduced by 20 percent, or 80, which is increased by 40 percent, or 32, to 112 percent.

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$100x \quad \text{Liquidation value of interest}

(30x) \quad \text{Less 20 percent minority interest discount}

$80x \quad \text{Less 30 percent marketability discount}

(34x) \quad \text{Fair market value of interest}

Because the parties are most concerned with the total discount, several reported cases only disclose that number, leaving the reader to guess the composition of the total discount.\textsuperscript{233}

\textbf{[g] Nonbusiness Assets Held in FLPS and FLLCs}

Virtually all the examples and litigated cases involving the minority interest and marketability discounts concern the valuation of ownership interests in active businesses. In order to obtain an enhanced lack of marketability discount for other, nonbusiness assets,\textsuperscript{234} many wealthy taxpayers have created family limited partnerships (FLPs) or family limited liability companies (FLLCs).\textsuperscript{235} Suppose, for example, that a taxpayer owns $6 million in marketable securities, $3 million in investment real property, and another $1 million in artwork. The taxpayer might transfer these assets (or a portion of them) to an FLP or FLLC in exchange for all of the interests in the new entity. The tax-

\textsuperscript{233} See Knight v. Comm’r, 115 TC 506 (2000) (approved a 15 percent combined marketability and minority interest discount in valuing interests in a family partnership that owned a ranch); Furman v. Comm’r, 75 TCM (CCH) 2206 (1998) (awarded a 40 percent combined marketability and minority interest discount in valuing stock in a corporation that owned and operated Burger King franchises); Dockery v. Comm’r, 75 TCM (CCH) 2032 (1998) (40 percent combined marketability and minority interest discount for an interest in a closely held Cayman Islands reinsurance program); Estate of Mitchell v. Comm’r, 74 TCM (CCH) 872 (1997) (allowed a 35 percent combined minority and marketability discount in valuing decedent’s 49.04 percent interest in a closely held company), rev’d on appeal for failure to adequately explain overall valuation of stock. Estate of Mitchell v. Comm’r, 250 F3d 696 (9th Cir. 2001).

\textsuperscript{234} This is not to say that valuation discounts do not apply to assets other than interests in businesses, FLPs, or FLLCs. The fractional interest, minority interest, built-in tax gains, environmental hazards, securities laws, and other discounts potentially apply to nonbusiness, nonentity interests. The estate tax advantage of an FLP or FLLC is to create or enhance a marketability discount and to make it easier to create minority interest discounts as well, while nonetheless maintaining control in the senior generation of the family. These tax advantages are not the only reasons for creating an FLP or FLLC. See the articles cited infra note 240.

\textsuperscript{235} For estate tax valuation purposes, there is little difference between an FLP and an FLLC. As a matter of applicable state law, of course, the FLP is a limited partnership and the FLLC is a limited liability company. Assuming the two entities are treated the same for state income tax purposes, the FLLC may be preferable because no member is personally liable for the debts and obligations (tort or contract) of the entity. In a limited partnership, the way to achieve limited liability for all owners is to name a corporate general partner, which invites unwanted complexity. See ¶ 4.05[7][c].

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payers could then make lifetime transfers of entity interests to children, grandchildren, or other beneficiaries. To the extent the taxpayer transfers minority interests in the FLP or FLLC, the transfers may qualify for the minority interest discount. Further, because the transferred property is an interest in a holding company (and not undivided interests in the inside assets), the interest may qualify for a marketability discount. If, at the death of the decedent-transferor, the gross estate includes a noncontrolling interest in the FLP or FLLC, the estate may also be able to claim a minority interest discount in valuing the included FLP or FLLC interest. In any event, any FLP or FLLC interests included in the decedent’s gross estate may qualify for a marketability discount.

Although these FLPs or FLLCs do not actively conduct a trade or business, the eight factors provided in Revenue Ruling 59-60 apply to the valuation of the FLP or FLLC interest, and the premiums and discounts typically applied to closely held corporations also apply in this context. The Service has vigorously challenged the erosion to the transfer tax base occasioned by the discounts realized on the transfer of interests in FLPs and FLLCs formed with passive assets. From the Service’s perspective, taxpayers create such FLPs and FLLCs solely to obtain higher valuation discounts and for no legitimate business or economic purpose. While it is accepted that FLPs and FLLCs must be more closely scrutinized because of the familial nature of the entities, for many years the Service’s attacks fell on deaf ears. In essence, the courts said that if an entity is recognized under local law and it changes the relationship of the parties to the assets, it has economic substance for fed-

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237 See Estate of Weinberg v. Comm’r, 79 TCM (CCH) 1507 (2000); supra ¶¶ 4.02[4][a]–4.02[4][f].
238 The Service issued Appeals Settlement Guidelines: Family Limited Partnerships and Family Limited Liability Corporations, effective October 20, 2006, which address whether the fair market value of transfers of FLP or FLLC interests is properly discounted from the pro rata value of the underlying assets. The settlement guidelines provide the positions of both the government and the taxpayer and include discussion of the applicable case law.

The Service typically cites Gregory v. Helvering, 293 US 465 (1935), for the proposition that transactions that lack economic substance other than tax avoidance should be disregarded. See FSA 200143004 (July 5, 2001) (restatement of government’s economic substance argument in situation involving a family corporation). Cf. Estate of Lockett v. Comm’r, 103 TCM (CCH) 1671 (2012) (no discounts where all interests in partnership on dissolution of partnership held by decedent).

eral tax purposes. The Service was similarly unsuccessful in attacking FLPs and FLLCs on other grounds.

In some cases, however, the Service was successful in looking through the partnership “device” and valuing the inside assets. For example, if the FLP or FLLC owns only one asset or a few assets of the same type, there is authority for valuing the ownership interests as if they were partial interests in each of the entity’s inside assets. But where the entity itself alters the nature of the decedent’s interest in the inside assets, it is not enough simply to aggregate the values of a fixed percentage of each asset. In most cases, of course, the FLP or FLLC arrangement does in fact substantively alter the nature of the owner’s interest in the inside assets.

In recent years, the Service has applied Section 2036(a)(1) to disregard the FLP and FLLC entity and thereby disallow discounts in situations where...

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241 The Service has unsuccessfully argued that Section 2703 requires disregard of the FLP or FLLC entity. The Service views the entire FLP or FLLC structure as a “restriction” on the inside assets of the FLP or FLLC that it asserts should not affect valuation under Section 2703. This argument misinterprets Section 2703 by reading the word “property” as a reference to the entity’s inside assets. Church v. United States, 2000-1 USTC (CCH) 60,369 (WD Tex. 2000), aff’d without op., 268 F3d 1063 (5th Cir. 2001); Estate of Strangi v. Comm’r, 115 TC 478 (2000), rev’d sub nom. (on another issue) Gulig v. Comm’r, 293 F3d 279 (5th Cir. 2002). See ¶ 19.04[2], text accompanying notes 20–26. In the future, the Service may attack various provisions in the FLP or FLLC agreement or under state law as “restrictions” under Section 2703. See Holman v. Comm’r, 601 F3d 763 (8th Cir. 2010) (restrictions on transferability disregarded under Section 2703); FSA 200143004 (July 5, 2001) (a full litany of the government’s current arguments against FLPs or FLLCs in the context of an S corporation).

A further unsuccessful attack on such entities has occurred using Section 2704(b) to argue that the entities are subject to “applicable restrictions” that reduce the amount of the marketability discounts. Kerr v. Comm’r, 113 TC 449 (1999); Knight v. Comm’r, 115 TC 506 (2000); Harper v. Comm’r, 79 TCM (CCH) 2232 (2000); Estate of Jones v. Comm’r, 116 TC 121 (2001). See ¶ 19.05[3][b], text accompanying note 59.

Finally, the Service has argued a “gift on formation” as a result of the reduced valuation resulting from discounts. But the courts, with some judges dissenting, have failed to embrace this argument. Estate of Strangi v. Comm’r, 115 TC 478 (2000), rev’d sub nom. (on another issue) Gulig v. Comm’r, 293 F3d 279 (5th Cir. 2002); Estate of Jones v. Comm’r, 116 TC 121 (2001). This argument is discussed at ¶ 10.01[2][b], text accompanying notes 24–26, and ¶ 10.02[2][c][v].

242 See, e.g., Estate of Lehmann v. Comm’r, 74 TCM (CCH) 415 (1997) (limited partnership’s asset was a leasehold interest in parcel of real estate).

the owners, through their actions, have essentially disregarded the FLP or FLLC entity. Numerous courts have applied Section 2036 in such circumstances, both refusing to apply the Section 2036(a) exception of “a bona fide sale for adequate and full consideration in money or money’s worth” and finding an implied agreement by the decedent with the entity to retain the right to the income from or enjoyment of the property under Section 2036(a)(1). Generally, the courts have applied Section 2036(a)(1) in situations where the decedent commingled the entity’s income with the decedent’s income, where the decedent retained insufficient assets outside the entity for the decedent’s support, where the decedent transferred the decedent’s residence to the entity and continued to reside there with inadequate payment of rent, where the decedent failed to abide by the entity agreement and formalities, where the entity made disproportionate distributions to the decedent, or where the decedent’s personal obligations could be satisfied by the entity. The cases

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244 In addition to the direct attacks of the Service on the use of FLPs and FLLCs, Circular 230 (issued by the Department of Treasury prescribing standards governing those of who practice before the Service) may provide a mechanism of indirect attack on the use of FLPs and FLLCs when used to obtain improper valuation discounts and no legitimate business purpose exists for the creation of the entity. 31 CFR §§ 10.50–10.53 (2011). Through its imposition of disciplinary measures (31 CFR §§ 10.0–10.93 (2011)), Circular 230 may make tax practitioners more cautious in advising the use of FLLPs and FLLCs to advance marketability and minority discounts.

245 IRC § 2036(a). See ¶ 4.08[1][a].

246 Reg. § 20.2036-1(a). See ¶ 4.08[4][c][ii].


248 Estate of Korby v. Comm’r, 471 F3d 848 (8th Cir. 2006); Estate of Thompson v. Comm’r, 382 F3d 367 (3d Cir. 2004); Strangi v. Comm’r, 417 F3d 468 (5th Cir. 2005). Cf. Estate of Jorgensen v. Comm’r, 97 TCM (CCH) 1328 (2009), aff’d, 431 Fed. Appx. 544 (9th Cir. 2011) (insufficient assets retained to make planned gifts and pay taxes).


250 Estate of Bigelow v. Comm’r, 503 F3d 955 (9th Cir. 2007); Estate of Harper v. Comm’r, 83 TCM (CCH) 1641 (2002); Estate of Hillgren v. Comm’r, 87 TCM (CCH) 1008 (2004); Estate of Gore v. Comm’r, 93 TCM (CCH) 1436 (2007).

251 Estate of Korby v. Comm’r, 471 F3d 848 (8th Cir. 2006); Estate of Abraham v. Comm’r, 408 F3d 26 (1st Cir. 2005), cert. denied, 547 US 1178 (2006); Estate of Rosen v. Comm’r, 91 TCM (CCH) 1220 (2006); Estate of Liljestrand v. Comm’r, 102 TCM (CCH) 440 (2011).

are analyzed elsewhere, but there are also numerous recent cases in which Section 2036(a)(1) was not applied. Originally, those cases appeared to be ones where the assets, at least in part, involved an active trade or business. However, more recently more sophisticated taxpayers have avoided the Section 2036(a)(1) trap by avoiding the pitfalls that triggered the section. Thus, recent cases have allowed discounts even though the assets of the FLP or FLLC involved only marketable securities or other nonbusiness assets.

[5] Temporal Property Interests

Although valuing fractional interests in property involves application of minority and fractional interest discounts that vary from case to case, the valuation of temporal property interests (like a term of years or a remainder) involves application of actuarial rules and tables. Furthermore, if the decedent’s interest is measured with reference to the life of another person (such as a life estate pur autre vie), mortality tables will also come into play. Consider a relatively simple example: Suppose that an irrevocable trust will pay income to A for A’s life, with the remainder to be paid to B or B’s estate. If B dies before A, the personal representative must determine the value of B’s remainder interest that is included in B’s gross estate under Section 2033. Stated differently, the amount included in B’s gross estate is the present value of B’s right to receive the trust assets outright upon A’s death.

Section 7520 and the regulations thereunder provide that the fair market value of annuities, interests for life or a term of years, and remainder or rever-
sionary interests are calculated by means of a Section 7520 actuarial factor. This unisex factor is derived by using the applicable Section 7520 interest rate and, if the interest is measured with reference to a life, a mortality component.\textsuperscript{259}

The Section 7520 interest rate is equal to 120 percent of the applicable federal midterm rate in effect under Section 1274(d)(1) for the month in which the valuation date falls.\textsuperscript{260} Gender-neutral tables for interest rates between 0.2 percent and 20.0 percent provide the actuarial factor to be used in calculating the present value of the property interest to be valued under Section 7520.\textsuperscript{261} The regulations contain the tables to be used for estate tax purposes.\textsuperscript{262} The precise method for using the tables to calculate the present value of ordinary

\textsuperscript{259} IRC § 7520; Reg. §§ 20.7520-1(a)(1), 20.7520-1(b), 20.7520-1(c). See also Reg. § 20.2031-7(d)(1) for actuarial valuations after April 30, 2009. Section 7520(c)(3) requires the tables to be actuarially updated at least every ten years. The most recent tables reflect valuation on or after July 1, 2009. See IRS Publications 1457 and 1458 (Rev. May 2009) for examples using the mortality component tables and rates between 0.2 percent and 20 percent.

Single unisex tables have replaced tables previously used in separately measuring male and female life expectancies. See Reg. § 20.2031-7(d)(6). The prior gender-based mortality tables were held to be unconstitutional. Manufacturers Hanover Trust Co. v. United States, 775 F2d 459 (2d Cir. 1985), cert. denied, 475 US 1045 (1986).

\textsuperscript{260} IRC § 7520(a)(2). See Reg. § 20.7520-1(b)(1). The valuation date is the date of the transfer. Reg. § 20.7520-1(b)(1)(ii). The Section 7520 interest rate is determined and published monthly in the Internal Revenue Bulletin. Reg. § 20.7520-1(b)(1)(i). For estate tax purposes, this is the date of death or the Section 2032 alternate valuation date, if it is elected.

Special rules are provided for charitable transfers. See IRC § 7520(a) (flush language); Reg. § 20.7520-2; ¶¶ 5.05[5][a], note 208, 5.05[5][b], note 265, 5.03[5][c], text accompanying note 290, 5.05[6][b], text accompanying notes 327, 328.

\textsuperscript{261} IRC § 7520(a)(2) (parenthetical). The same tables are used for federal gift tax purposes. Reg. § 25.2512-5(a).

Many standard actuarial factors are not included in the tables under Regulations Section 20.2031-7(d)(6), but can be found in IRS Publications 1457 and 1458 (Rev. May 2009). Reg. § 20.2031-7(d)(4). For example, Regulations Section 20.2031-7(d)(6) does not contain tables with actuarial factors for life or term income interests, but those tables can be found in IRS Publication 1457. Alternatively, Regulations Section 20.2031-7(d)(2)(iii) demonstrates how the factors can be determined mathematically using the tables in Regulations Section 20.2031-7(d)(6). If a special factor is required in order to value an interest, the Service will furnish the factor upon a request for a ruling. Reg. §§ 20.7520-1(c), 20.2031-7(d)(4).
remainder and reversionary interests, ordinary term-of-years and life interests, and annuities is also set out in the regulations.263

Because Section 7520 values property interests by means of a projected rate of return and actuarial factors, there will be a discrepancy between the actual value of the interest and its value computed under Section 7520. The justification for the Section 7520 method of valuation is that it provides a system for uniform valuation. In some circumstances, however, the nature of the property interest is such that use of Section 7520 produces a value that is clearly distorted, so the Section 7520 valuation method is inapplicable in some of these instances.264 Section 7520 will not apply (nor will a special Section 7520 factor be required) if the property interest is subject to any contingency, power, or other restriction that is provided for in the governing instrument or that is caused by other circumstances that in either case, changes the nature of the interest.265 For example, Section 7520 will not apply for the purpose of valuing an income interest in unproductive property when the beneficiary does not have the legal right to compel investment in productive property.266 The Section 7520 mortality component is also inapplicable if the decedent and the

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263 See Reg. §§ 20.2031-7(d)(2)(ii), 20.2031-7(d)(2)(iii), 20.2031-7(d)(2)(iv), respectively. For the present value of remainder interests in pooled income funds, charitable remainder annuity trusts, charitable remainder unitrusts, and the present value of life or term interests in charitable remainder unitrusts that are not calculated under the tables in Regulations Section 20.2031-7(d)(6), see ¶ 5.05[5][a][ii], 5.05[5][b][ii], 5.05[5][c][ii], 5.05[6][b]. The determination of the present value of an annuity or unitrust payable until the earlier of the lapse of a specific number of years or the death of an individual is made in accordance with Regulations Section 25.2512-5(d)(2)(iv). See Reg. § 20.2031-7(d)(2)(v).


265 Reg. §§ 20.7520-3(b)(1)(ii), 20.7520-3(b)(2).

Where the Section 7520 tables produce an unrealistic or unreasonable approach to valuation, the courts will not employ the tables. An interesting controversy has arisen with respect to the valuation of lottery winnings where there are frequently restrictions on transferability. Some courts have refused to use the Section 7520 tables in such circumstances. Estate of Gribauskas v. Comm’r, 342 F3d 85 (2d Cir. 2003); Estate of Shackleford v. United States, 262 F3d 1068 (9th Cir 2001). Other courts have employed the Section 7520 tables, concluding that their valuation is not unrealistic or unreasonable. Estate of Cook v. Comm’r, 349 F3d 850 (5th Cir. 2003); Negron v. United States, 553 F3d 1013 (6th Cir. 2009); Estate of Donovan v. United States, 95 AFTR2d 2005-2131 (D. Mass. 2005); Davis v. United States, 241 F. Supp. 2d 192 (DNH 2007). Cf. Estate of Davenport v. Comm’r, 92 TCM (CCH) 324 (2006) (annuities paid under a settlement contract valued using the Section 7520 tables); Anthony v. United States, 520 F3d 374 (5th Cir. 2008) (following Cook using the Section 7520 tables for valuing nontransferable private annuities received in a structured settlement agreement). See Hayes & Krzanowski, “When IRS Actuarial Tables Don’t Apply in Valuing Interests,” 32 Est. Plan. 21 (Feb 2005); Gerzog, “Donovan and Davis: Two More Lottery Cases,” 110 Tax Notes 543 (Jan. 30, 2006). See also ¶ 4.11[4][a], text accompanying notes 43–44.

individual whose life is the measuring life, die as a result of a common accident or occurrence.267

When the value of an interest is measured by a life or lives, rather than by a fixed period, the physical condition of the measuring life will be taken into account in some cases. The Section 7520 mortality component is disregarded if the measuring life is “terminally ill” at the time of the decedent’s death.268 A person is considered to be terminally ill if: (1) the individual is “known to have an incurable illness or other deteriorating physical condition,” and (2) “there is at least a 50 percent probability” that the measuring life will die within one year of the decedent’s death.269 In those circumstances, the measuring life’s actual physical condition is considered in valuing the relevant interest. But if the measuring life actually survives for at least eighteen months, the measuring life is presumed not to have been terminally ill at the time of the decedent’s death, and the normal mortality tables will come into play, unless the contrary is established by “clear and convincing evidence.”270

[6] Statutes Related to Valuation

[a] Section 1014

Under Section 1014, the valuation of property under the estate tax generally establishes its basis under the income tax.271 As a general rule, property

267 Reg. §§ 20.7520-3(b)(3)(iii), 20.7520-3(b)(4), Ex. 2.

268 See Reg. §§ 20.7520-3(b)(3), 20.7520-3(b)(4), Ex. 1. Even before these regulations became effective for decedents dying after December 31, 1995, the courts and the Service had concluded that the actuarial tables were inappropriate where the death of the measuring life was imminent because of some incurable disease. In such cases, calculations were made with reference to the actual expected duration of the measuring life. See O’Reilly v. Comm’r, 973 F2d 1403 (8th Cir. 1992); Continental Ill. Nat’l Bank & Trust Co. v. United States, 504 F2d 586 (11th Cir. 1974); Jennings v. Comm’r, 10 TC 323 (1948); Rev. Rul. 80-80, 1980-1 CB 194; Priv. Ltr. Rul. 9504004 (Jan. 27, 1995). See also Estate of McLendon v. Comm’r, 66 TCM 946 (1993), rev’d on other grounds, 135 F3d 1017 (5th Cir. 1998). All of these precedents are now superseded by the regulations under Section 7520. See Rev. Rul. 96-3, 1996-1 CB 348.

269 Reg. §§ 20.7520-3(b)(3)(i), 20.7520-3(b)(4), Ex. 1. But see ¶ 3.05[3][b], text accompanying notes 34, 35, explaining that the terminally ill valuation rules do not apply for purposes of determining the value of a life interest received by a transferee that qualifies for a Section 2013 credit if there has been a final determination of the federal estate tax liability of the transferor estate requiring valuation of the life interest. See also Reg. § 20.7520-3(b)(3)(ii).

270 Reg. § 20.7520-3(b)(3)(i).

271 Section 1015 establishes the income tax basis of gifted property, which is generally a carryover basis. See ¶ 9.02[4]. If a decedent died in the year 2010 and the decedent’s estate elected out of the application of the estate tax (see ¶ 8.10[2]), the property
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¶ 4.02[6][a]

included in a decedent’s gross estate is assigned an income tax basis equal to its fair market value on the date of the decedent’s death. The effect of this rule is to give property that appreciated in value during the decedent’s life a “stepped-up” basis without any income tax costs. Thus, although appreciated property is fully potentially subject to the estate tax, the appreciation itself generally escapes the income tax. Of course, a stepped-down basis results without a deductible income tax base if property declined in value during the decedent’s ownership.

There are several statutory exceptions to the general Section 1014 fair market value on the date of the decedents’ death basis rule. Property that is valued on the alternate valuation date under Section 2032 (rather than the date of decedent’s death) is assigned a basis equal to its fair market value on the alternate valuation date. Real property that is valued at its actual use value rather than its fair market value under Section 2032A is assigned a basis equal to its actual use value on either the date of the decedent’s death or the alternate valuation date. Property that constitutes a right to receive an item of income in respect of the decedent under Section 691 is denied any step-up in basis. If an exclusion from the gross estate under Section 2031(c) acquired from the decedent is assigned a modified carryover basis under Section 1022. See ¶ 8.10[3].

272 See IRC § 1014(b); Chapter 4.
273 Reg. § 20.2031-1(b).
274 IRC § 1014(a)(1).
Cf. Section 1014(b)(6), which also gives a surviving spouse’s one-half share of community property a fair market value basis, if at least one half of the whole of the community interest in such property was included in the decedent spouse’s gross estate.
275 But see IRC § 2010; ¶ 3.02.
277 IRC § 1014(a)(1).
278 See ¶ 4.03.
279 IRC § 1014(a)(2).
280 See ¶ 4.04. Either the date of death or the alternate valuation date may be used in conjunction with Section 2032A.
282 See ¶ 4.05[4].
283 IRC § 1014(c).
applies to property, that property is assigned a carryover basis equal to the basis it had in the hands of the decedent prior to death.

In addition, Section 1014(e) was enacted to prevent a potentially abusive possibility under the stepped-up basis rule. If a person (donor) who owned appreciated property gave it to an elderly or ill person who was expected to die in the near future and then, at the death of the elderly or ill person, the property passed back to the donor, the property would receive a fair market value basis. Under Section 1014(e), if appreciated property is acquired by gift by the decedent within the one-year period ending on the decedent’s death and if the property (or property acquired with the proceeds of its sale by the decedent’s estate or grantor trust) passes from the decedent to the donor or to the donor’s spouse, the donor’s basis or the spouse’s basis in the property is the adjusted basis of the property in the hands of the decedent immediately before the decedent’s death.

[b] Understatement Penalty and Reasonable Cause: Sections 6662 and 6664

Apart from the proper computation of tax, valuation is also important from a more practical perspective. If that asset is undervalued on the federal estate or gift tax return, an underpayment of tax will necessarily result. If the underpayment is attributable to a “substantial estate or gift tax valuation understatement,” the estate or donor will owe, in addition to the underpayment amount, a penalty equal to 20 percent of the underpayment amount. The penalty does not apply unless the underpayment amount for the estate tax return or for the gift tax return for the year exceeds $5,000. A substantial understatement occurs any time the value of property included in the gross estate

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284 See infra ¶ 4.02[7].
285 IRC § 1014(a)(4). See ¶ 4.02[7][e][iii].
286 IRC § 1014(e)(2)(A).
287 IRC § 1014(e)(2)(B).
288 IRC § 1014(e)(1). Cf. IRC § 1015.
289 IRC § 6662(b)(5).
290 IRC § 6662(a). If there is no tax due, for example, because of the unlimited marital deductions or charitable deduction, no penalty is imposed because there is no underpayment. In addition to the penalty imposed on the estate or donor, penalties may also be imposed on the tax return preparer and/or on the appraiser in connection with an understatement of taxpayer liability. See infra ¶ 4.02[6][c].
291 IRC § 6662(g)(2).
(or the value of property transferred by gift for federal gift tax purposes) is 65 percent or less of the finally determined value.\textsuperscript{292} Thus, if the personal representative or donor states the value of an asset at $130,000, but the actual value of the asset is determined to be $200,000 or more, the substantial understatement penalty applies.

If the value of property included in the gross estate (or reported on the federal gift tax return) is 40 percent or less of the value finally determined, the penalty amount increases to 40 percent of the underpayment amount.\textsuperscript{293} In the above example, the more drastic penalty would apply if the actual value of the asset is determined to be $325,000 or more.

Section 6664(c) offers a safe harbor from the substantial understatement penalty. If the personal representative can prove that there was reasonable cause for the understatement and that the personal representative acted in good faith with respect to any portion of the valuation, the substantial understatement penalty will not apply to that portion.\textsuperscript{294} Reliance on a professional appraisal will not, by itself, warrant relief from the penalty.\textsuperscript{295} Consideration must also be given to the information supplied to the appraiser, the methodology used in the appraisal, the circumstances under which the appraisal was obtained, and the relationship, if any, of the appraiser to the parties in interest.\textsuperscript{296} The Tax Court has held that a taxpayer who relied on the advice of a professional is not subject to the Section 6662 penalty if the following three-prong test is met: (1) the adviser was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer provided necessary and accurate information to the adviser; and (3) the taxpayer actually relied in good faith on the adviser’s judgment.\textsuperscript{297}

\textsuperscript{292} IRC § 6662(g)(1). For returns filed prior to August 17, 2006, the percentage was 50 percent or less of the finally determined value. See Pension Protection Act of 2006, Pub. L. No. 109-280, § 1219(c)(1), 120 Stat. 780, 1085 (2006).

\textsuperscript{293} IRC §§ 6662(h)(1), 6662(h)(2)(C). For returns filed prior to August 17, 2006, the percentage was 25 percent or less of the finally determined value. See Pension Protection Act of 2006, Pub. L. No. 109-280, § 1219(c)(1), 120 Stat. 780, 1085 (2006).

\textsuperscript{294} IRC § 6664(c). See Estate of Rector v. Comm’r, 94 TCM (CCH) 567 (2007) (Section 6664(c) inapplicable); Estate of Giustina v. Comm’r, 101 TCM (CCH) 1676 (2011) (same).

\textsuperscript{295} Reg. § 1.6664-4(b)(1).

\textsuperscript{296} Reg. § 1.6664-4(b)(1).

[c] Understatement of Taxpayer Liability by Return Preparer: Section 6694

Section 6694 imposes penalties on tax return preparers. The provision potentially applies where there is an understatement of valuation, but it applies more broadly where there is any understatement of liability. The provision was substantially amended in both 2007 and 2008. As originally enacted, Section 6694 was applicable only to income tax return preparers, but the 2007 legislation broadened the scope of the provision so that it applies to all “tax return preparers,” including preparers of estate, gift, and generation-skipping transfer tax returns.

In general, a tax return preparer is subject to a penalty if any part of an understatement of liability is due to an unreasonable position and the return preparer knew (or reasonably should have known) of the position. If a position is not disclosed, it is unreasonable unless there is or was “substantial au-
authority” for the position.\textsuperscript{305} If the position was adequately disclosed,\textsuperscript{306} it is unreasonable unless there is a reasonable basis for the position.\textsuperscript{307} The penalty for the unreasonable position violation is the greater of $1,000 or 50 percent of the preparer’s income from the preparation of the return.\textsuperscript{308} However, no penalty is imposed if there is reasonable cause for the understatement and the tax preparer acted in good faith.\textsuperscript{309}

If any part of the understatement is due to preparer conduct that is a willful attempt to understate liability or a reckless or intentional disregard of rules or regulations,\textsuperscript{310} a potentially stiffer penalty of the greater of $5,000 or 50 percent of the preparer’s income from preparation of the return or claim is im-

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\item \textsuperscript{305} IRC § 6694(a)(2)(A). Notice 2009-5, 2009-1 CB 309, adopts the current regulatory rules of Regulations Section 1.6662-4(d) in defining substantial authority. In deciding if there is substantial authority for the tax treatment of an item, the weight of the authorities supporting the position must be substantial in relation to the weight of authorities supporting a contrary position. Reg. § 1.6662-4(d)(3)(i). In doing this balancing, factors such as identity of facts and persuasiveness of reasoning are considered. Reg. § 1.6662-4(d)(3)(ii). Authority that may be considered in determining whether there is substantial authority for a position include the Internal Revenue Code (the Code), the regulations (including proposed and temporary regulations), revenue rulings (public and private) and procedures, court cases, legislative history, and other pronouncements by the Service. Notably, conclusions reached in treatises, legal periodicals, and legal opinions are expressly not considered authority. Reg. § 1.6662-4(d)(3)(iii). The jurisdiction of court cases in relation to the taxpayer’s residence generally is disregarded except that there is substantial authority for the tax treatment of an item if the treatment is supported by controlling authority of a U.S. court of appeals to which the taxpayer has a right of appeal. Reg. § 1.6662-4(d)(3)(iv)(B). Substantial authority for the tax treatment of an item in a return exists if there was such authority at the time the return was filed or on the last day of the taxable year to which the return relates. Reg. § 1.6662-4(d)(3)(iv)(C).
\item \textsuperscript{306} IRC § 6694(a)(2)(B). Reasonable basis has the same meaning as in Regulations Section 1.6662-3(b)(3). Reg. § 1.6694-2(d)(2). The regulations describe “reasonable basis” as “a relatively high standard of tax reporting, that is, significantly higher than not frivolous or patently improper.” Reg. § 1.6662-3(b)(3). To satisfy the reasonable basis standard, the position has to be more than “merely arguable” or a “colorable claim.” Reg. § 1.6662-3(b)(3). In determining whether the tax return preparer has a reasonable basis for a position, the preparer may rely in good faith without verification upon information furnished by the taxpayer and advice furnished by another adviser, another tax return preparer or other party, as provided in Regulations Sections 1.6664-1(e) and 1.6694-2(e)(5). Reg. § 1.6694-2(d)(2).
\item \textsuperscript{307} IRC § 6694(a)(1). The regulations provide detailed rules for determining a preparer’s income from the preparation of the return or the claim for refund. Reg. § 1.6694-1(f).
\item \textsuperscript{308} IRC § 6694(a)(3). The regulations provide a number of factors that the Service will consider in determining if the preparer acted with reasonable cause and in good faith, including the nature, frequency, and materiality of the error or errors, the tax return preparer’s normal office practice, reliance on the advice of others, and reliance on generally accepted administrative or industry practice. Reg. § 1.6694-2(e).
\item \textsuperscript{309} IRC § 6694(b)(2). See Reg. §§ 1.6694-3(b), 1.6694-3(c), 1.6694-3(d).
\end{enumerate}
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posed. The amount of this penalty is reduced by the amount of any penalty paid under the rule for understatements owing to an unreasonable position.

In addition to the penalties on tax return preparers, Section 6695A may be used to impose a penalty on the appraiser who prepares an appraisal that results in a substantial or gross valuation misstatement if the appraiser knew or reasonably should have known that the appraisal would be used in connection with a return or refund claim.

[d] Section 7491

In the context of valuation disputes, Section 7491 purports to shift the burden of proof to the Service if the taxpayer submits "credible evidence" in support of the taxpayer's valuation. In reality, the burden shift is illusory. In most cases, the only "credible evidence" of valuation that will effectively shift the burden to the Service will be an expert appraisal. In effect, the taxpayer must meet the traditional burden of proof to shift the burden to the Service.

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311 IRC § 6694(b)(1). See Reg. § 1.6694-1(f).
312 IRC § 6694(b)(3).
314 An appraiser may be subject to penalties under Sections 6694 and 6695A as both a signing and nonsigning preparer if the appraisal is a substantial portion of the return or claim for refund and the applicable standards of care are not met. The Service will not stack penalties under Sections 6694 and 6695A with respect to the same conduct. TD 9436, Supplementary Information: Appraisers, 2009-1 CB 268, 275 (Jan. 21, 2009). See Bogdanski, "For Appraisers, New Tax Qualification Rules and Special Penalty," 34 Est. Plan. 16 (June 2007).
315 IRC § 7491(a). See, e.g., Kohler v. Comm’r, 92 TCM (CCH) 48 (2006); Estate of Van v. Comm’r, 101 TCM (CCH) 1077 (2011). The burden is shifted only if (1) the taxpayer kept records that meet the substantiation requirements of the Code; (2) the taxpayer cooperated with requests from the Service for information and exhausted any available administrative remedies within the Service; and (3) the taxpayer is an individual or an estate, or, if the taxpayer is a trust, corporation, or partnership, its net worth does not exceed $7 million. IRC § 7491(b). See Chiang, “Shifting the Burden of Proof to the IRS in Tax Court,” 83 Prac. Tax Strategies 340 (Dec. 2009).
316 The legislative history to Section 7491 defines “credible evidence” as “the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted (without regard to the judicial presumption of IRS correctness).” S. Rep. No. 174, 105th Cong., 2d Sess. 1, 45 (1998), reprinted in 1998-3 CB 537, 581.
Additionally, the taxpayer must agree to several conditions for the burden shift to be effective.\footnote{\textsc{IRC} § 7491(a)(2).}

[e] \textbf{Section 7517}

Section 7517 is designed to reduce friction between taxpayers and the Service over estate, gift, or generation-skipping transfer tax valuation issues. If the Service challenges the value of an item stated on the estate tax return, the personal representative can require that within forty-five days of a request, the Service furnish the personal representative with a statement\footnote{\textsc{IRC} § 7517(a). See Reg. § 301.7517-1.} that includes\footnote{\textsc{IRC} § 7517(b). But see Estate of Abruzzo v. United States, 21 Cl. Ct. 351 (1990) (estate cannot delay discovery of its valuation reports until Service disclosed its report).} (1) the basis for the Service’s conflicting valuation; (2) any computations used by the Service in arriving at the item’s value; and (3) a copy of any expert appraisal performed for the Service.

This information is always helpful to a personal representative in deciding whether to contest the valuation issue, even though neither the value disclosed nor the valuation method used to determine the value disclosed is binding on the Service.\footnote{\textsc{IRC} § 7517(c).}

[7] \textbf{Exclusion of the Value of Land Subject to a Qualified Conservation Easement}

[a] Introduction

Section 2031(c) allows an executor to elect to exclude a portion of the value of “land subject to a qualified conservation easement”\footnote{\textsc{IRC} §§ 2031(c)(1), 2031(c)(8)(A). See infra ¶ 4.02[7][b].} from a decedent’s gross estate.\footnote{Section 2031(c) is discussed in Lindstrom & Small, “New Estate Tax Relief for Land Under Conservation Easement,” 78 Tax Notes 1171 (Mar. 2, 1998); Deason, “Section 2031(c): Post-Mortem Estate Planning,” 11 Back Forty—Newsletter of Land Conservation L. 1 (Winter 2006).} Section 2031(c) is unique in that it is the only provision that contains an exclusion from the gross estate. The exclusion is allowed where land included in the gross estate is subject to a qualified conservation easement. The exclusion is available even though an income tax deduction is allowed under Section 170 or an estate tax deduction is allowed under Section
2055 for the value of the qualified conservation easement. However, when either deduction is allowed, the amount of the exclusion may be reduced. The qualified conservation easement may be granted by the decedent, a member of the decedent’s family, the decedent’s executor or a trustee if the land is held in trust. Section 2031(c) may be elected to provide an exclusion to multiple estates as “land subject to the qualified conservation easement” is subsequently included in the gross estates of more than one family member. The exclusion is subject to a ceiling limitation of $500,000.

[b] Land Subject to a Qualified Conservation Easement

The exclusion applies only to “land subject to a qualified conservation easement.” As defined, that term imposes requirements related to the location and the ownership of the land. The qualified conservation easement must be created by an applicable individual either before, at, or after the death of the decedent.

[i] Land to which the provision applies. Location. The land whose value is to be partially excluded from the decedent’s gross estate must be located in the United States or in a possession of the United States. As originally enacted and for the years 1998 through 2000, a more stringent location requirement applied. The rule expanding the scope of Section 2031(c) was

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324 See infra ¶ 4.02[7][b], text accompanying notes 361–365.
325 IRC § 2031(c)(1)(A). See infra ¶ 4.02[7][d][i], especially note 376.
326 See infra ¶ 4.02[7][b], text accompanying notes 361–365.
327 See infra ¶¶ 4.02[7][b], 4.02[7][c], text accompanying notes 369, 370.
328 IRC § 2031(c)(3). See infra ¶ 4.02[7][d][iii]. The maximum estate tax savings resulting from an election of Section 2031(c) is $200,000 (40 percent (the maximum tax rate) times $500,000 (the maximum ceiling)). The maximum savings varied in prior years depending upon the tax rates and the ceiling limitation. See IRC §§ 2011(c), 2031(c)(3).
329 IRC §§ 2031(c)(1), 2031(c)(8)(A).
330 IRC § 2031(c)(8)(A)(i).
331 IRC § 2031(c)(8)(A)(ii).
332 IRC § 2031(c)(8)(A)(iii).
333 IRC §§ 2031(c)(8)(A)(iii), 2031(c)(8)(C).
334 IRC §§ 2031(c)(8)(A)(iii), 2031(c)(8)(C), 2031(c)(6). See ¶ 4.02[7][b], text accompanying notes 361–365.
335 Cf. IRC §§ 2208, 2209; ¶ 8.09.
337 Under Section 2031(c)(8)(A)(i) prior to amendment in the Economic Growth and Tax Relief Reconciliation Act of 2001, the land had to meet one of three alternative location requirements on the date of the decedent’s death. Economic Growth and Tax Relief
enacted to allow more land to qualify in an effort to preserve environmentally significant land.338

Ownership. The land must have been owned by the decedent or a member of the decedent’s family at all times during the three-year period ending on the date of the decedent’s death.339 The term “member of the decedent’s family” is broadly defined to include the decedent’s ancestors, spouse, and lineal descendants as well as the lineal descendants of the decedent’s parents and spouse and the spouses of all such lineal descendants.340 If the land that is subject to a qualified conservation easement is held in a partnership, corporation or trust, Section 2031(c) is applicable to the interest in the entity only if at

Reconciliation Act of 2001, Pub. L. No. 107-16, § 551(a), 115 Stat. 38, 86 (2001), reprinted in 2001-3 CB 9, 58. It had to be located in or within (1) twenty-five miles of a metropolitan area (see repealed IRC § 2031(c)(8)(A)(i)(II)); the term “metropolitan area” is defined by the Office of Management and Budget; see Office of Management and Budget, Bulletin No. 96-08 (1996)); (2) twenty-five miles of a national park or wilderness area that is part of the National Wilderness Preservation System (see repealed IRC § 2031(c)(8)(A)(i)(II)); the National Wilderness Preservation System was established by the Wilderness Act. Wilderness Act, Pub. L. No. 88-577, § 2, 78 Stat. 890 (1964); land located within twenty-five miles of a national park or wilderness area, however, did not qualify for the exclusion if the Secretary determined that the land was not under significant development pressure. IRC § 2031(c)(8)(A)(i)(II)); or (3) ten miles of an Urban National Forest (see repealed IRC § 2031(c)(8)(A)(i)(III)); the Forest Service designates what constitutes an Urban National Forest. Id.).

338 HR Rep. No. 37, 107th Cong., 1st Sess. 33 (2001). In addition, the prior rules were technical and it was unclear how distances were to be measured.

339 IRC § 2031(c)(8)(A)(ii).

340 IRC § 2031(c)(8)(D). See IRC § 2032A(e)(2); ¶ 4.04[3][b][vii]. A legally adopted child of an individual is considered a child of the individual by blood. IRC § 2032A(e)(2).
least 30 percent of the entity is owned directly or indirectly\footnote{Indirect ownership rules under repealed Section 2057(e)(3) are employed to determine ownership for purposes of Section 2031(c)(10). IRC § 2031(c)(10). Ownership is determined under repealed Section 2057(e)(3)(A). IRC § 2031(c)(10). Thus, the 30 percent test should be applied to both combined voting power \textit{and} total value with respect to a corporation (see repealed IRC § 2057(e)(3)(A)(i)) and 30 percent of the capital interests with respect to a partnership (see repealed IRC § 2057(e)(3)(A)(ii)).} by the decedent.\footnote{Indirect ownership rules under repealed Section 2057(e)(3) are employed to determine ownership for purposes of Section 2031(c)(10). IRC § 2031(c)(10). Ownership is determined under repealed Section 2057(e)(3)(A). IRC § 2031(c)(10). Thus, the 30 percent test should be applied to both combined voting power \textit{and} total value with respect to a corporation (see repealed IRC § 2057(e)(3)(A)(i)) and 30 percent of the capital interests with respect to a partnership (see repealed IRC § 2057(e)(3)(A)(ii)).}

\[\text{[ii] Qualified conservation easement.}\]

\textit{Definition.} The land qualifying for the Section 2031(c) exclusion must be subject to a “qualified conservation easement,”\footnote{IRC §§ 2031(c)(1)(A), 2031(c)(8)(B).} which is defined as a restriction limiting the use of the land for “conservation purposes”\footnote{IRC §§ 2031(c)(1)(A), 2031(c)(8)(B).} given in

\begin{itemize}
  \item \footnote{Indirect ownership rules under repealed Section 2057(e)(3) are employed to determine ownership for purposes of Section 2031(c)(10). IRC § 2031(c)(10). Ownership is determined under repealed Section 2057(e)(3)(A). IRC § 2031(c)(10). Thus, the 30 percent test should be applied to both combined voting power \textit{and} total value with respect to a corporation (see repealed IRC § 2057(e)(3)(A)(i)) and 30 percent of the capital interests with respect to a partnership (see repealed IRC § 2057(e)(3)(A)(ii)).} by the decedent.
  \item \footnote{Indirect ownership rules under repealed Section 2057(e)(3) are employed to determine ownership for purposes of Section 2031(c)(10). IRC § 2031(c)(10). Ownership is determined under repealed Section 2057(e)(3)(A). IRC § 2031(c)(10). Thus, the 30 percent test should be applied to both combined voting power \textit{and} total value with respect to a corporation (see repealed IRC § 2057(e)(3)(A)(i)) and 30 percent of the capital interests with respect to a partnership (see repealed IRC § 2057(e)(3)(A)(ii)).} Qualified conservation easement.
\end{itemize}
perpetuity\textsuperscript{345} to a qualified organization\textsuperscript{346} The restriction on use must include a prohibition on use of a qualified real property interest\textsuperscript{347} in the land for commercial recreational activity other than a use that is de minimis.\textsuperscript{348} Conservation purposes include the preservation of land areas for outdoor recreation by, or for the education of, the general public\textsuperscript{349}, the protection of a relatively natural habitat of fish, wildlife, plants or similar ecosystem\textsuperscript{350}, and the preservation of open space (including farmland and forests) where the preservation is either for the scenic enjoyment of the public or pursuant to a clearly delineated governmental conservation policy and where the preservation will yield a significant public benefit.\textsuperscript{351} However, no exclusion is allowed for an easement for the preservation of a historically important land area or a certified historic structure.\textsuperscript{352}

\textit{Qualified Grantors.} The qualified conservation easement must be conveyed by an individual\textsuperscript{353} who is either the decedent,\textsuperscript{354} a member of the decedent’s family,\textsuperscript{355} the executor of the decedent’s estate,\textsuperscript{356} or the trustee of a

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\item \textsuperscript{345} IRC \textsection{} 170(h)(2)(C).
\item \textsuperscript{346} IRC \textsection{} 2031(c)(8)(B). The term “qualified organization” is defined in Section 170(h)(3). See \textsection{} 5.05[7][c] note 347.
\item \textsuperscript{347} A qualified real property interest may be the entire interest in the land (other than a qualified mineral interest), a remainder interest, or a restriction (granted in perpetuity) on the use of the real property. IRC \textsection{} 170(h)(2).
\item \textsuperscript{348} IRC \textsection{} 2031(c)(8)(B). See HR Conf. Rep. No. 220, 105th Cong., 1st Sess. 403 (1997), reprinted in 1997-4 CB (Vol. 2) 1457, 1873. De minimis commercial recreational activity consistent with the conservation purpose, such as the granting of hunting or fishing licenses, will not prevent the land from qualifying for the Section 2031(c) exclusion. HR Conf. Rep. No. 220, 105th Cong., 1st Sess. 403 (1997), reprinted in 1997-4 CB (Vol. 2) 1457, 1873. The Secretary of the Treasury will provide guidance to indicate the scope of the de minimis exception. Id.
\item \textsuperscript{349} IRC \textsection{} 170(h)(4)(A)(i).
\item \textsuperscript{350} IRC \textsection{} 170(h)(4)(A)(ii).
\item \textsuperscript{351} IRC \textsection{} 170(h)(4)(A)(iii). See IRC \textsection{} 170(h)(1)(C), 2031(c)(8)(B). The conservation policy may be that of the federal, state, or local government.
\item \textsuperscript{352} IRC \textsection{} 2031(c)(8)(B), 170(h)(4)(A)(iv). The exclusion is not available for historic structures because the legislation was not intended to exclude structures, just land. The fact that the exclusion is not available for historically important land areas is in all likelihood merely a mistake. See Lindstrom & Small, “New Estate Tax Relief for Land Under Conservation Easement,” 78 Tax Notes 1171, 1174 (Mar. 2, 1998).
\item \textsuperscript{353} IRC \textsection{} 2031(c)(8)(A)(iii). Cf. supra note 342.
\item \textsuperscript{354} IRC \textsection{} 2031(c)(8)(C)(i).
\item \textsuperscript{355} IRC \textsection{} 2031(c)(8)(C)(ii). A “member of the decedent’s family” means any member of the family as defined in Section 2032A(e)(2). IRC \textsection{} 2031(c)(8)(D). See supra text accompanying note 340.
\item \textsuperscript{356} IRC \textsection{} 2031(c)(8)(C)(iii). Although a qualified conservation easement is to be made by an “individual,” a corporate fiduciary serving as executor of the decedent’s estate should be a qualified grantor. See IRC \textsection{} 2031(c)(8)(A)(iii), 2031(c)(8)(C).
\end{itemize}
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trust the corpus of which includes the land subject to the easement. A corporate trustee, although not an individual, should be permitted to convey a qualified conservation easement. See supra note 356.

For example, if a decedent’s land passes to a nonfamily member and that individual conveys a qualified conservation easement prior to the filing of the decedent’s estate tax return, the decedent’s gross estate does not qualify for a Section 2031(c) exclusion.

IRC § 2031(c)(8)(A)(iii). The election is discussed infra ¶ 4.02[7][c].

IRC §§ 2031(c)(8)(A)(iii), 2031(c)(9). See infra ¶ 4.02[7][c], text accompanying note 368.

See supra text accompanying notes 353–360.

This would result in an income or estate tax deduction to the family member and an inclusion in the decedent’s gross estate of the value of the land reduced by the value of the easement and further reduced by the amount of the Section 2031(c) exclusion.

This would result in an income tax deduction for the decedent during the decedent’s lifetime, an inclusion in the decedent’s gross estate of the value of the land reduced by the value of the easement and further reduced by the amount of the Section 2031(c) exclusion.

This would result in both an exclusion under Section 2031(c) and an estate tax deduction under Section 2055(a) for the decedent’s gross estate, but no Section 170 income tax deduction on the creation of the easement. See Priv. Ltr. Rul. 200143011 (July 25, 2001) (portion of property included in decedent’s gross estate qualified for both Section 2031(c) and an estate tax deduction under Section 2055(a)) for the decedent’s gross estate, but no Section 170 income tax deduction on the creation of the easement.
4. Created by a family member after the land is distributed from the estate prior to the timely filing of the decedent’s estate tax return (with a Section 170 deduction to the distributee).365

[c] The Election

Section 2031(c) applies only if an election is made by the decedent’s executor366 on the decedent’s estate tax return.367 The election must be made on or before the due date (including extensions) of the filing of the return, and once made, the election is irrevocable.368

More than one exclusion election may be made with respect to land subject to a qualified conservation easement. For example, if such land passes from the decedent to the decedent’s surviving spouse369 or some other family member, when that family member dies a Section 2031(c) exclusion may again be elected if the requirements of Section 2031(c) are otherwise met.370

[d] The Amount of the Exclusion

The amount of the Section 2031(c) exclusion is determined by first adjusting the value of the land that is subject to the qualified conservation easement and then multiplying the adjusted land value by an applicable percentage.371 However, the amount that may be excluded is also subject to a ceiling limitation.372

[i] The value of the land. In computing the amount of the exclusion, the determination of the value of the land begins with a determination of its value for federal estate tax purposes.373 If the easement has been placed on the land prior to the date of the decedent’s death, the value of the land is reduced for

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365 Cf. IRC § 2031(c)(9). This would result in a Section 2031(c) exclusion to the decedent’s gross estate and a Section 170 deduction to the distributee, but no Section 2055(a) deduction to the decedent’s estate. See infra ¶ 4.02[7][c], note 376.

366 IRC § 2031(c)(1). See ¶ 8.02. The term would include the trustee of a living trust in the absence of any other executor of the estate. See ¶ 8.02, text accompanying note 12.

367 IRC § 2031(c)(6).

368 IRC § 2031(c)(6).

369 Cf. infra ¶ 4.02[7][e], text accompanying notes 425–429.

370 The statute does not preclude multiple use of the exclusion with respect to a qualified conservation easement.

371 IRC § 2031(c)(1)(A).

372 IRC § 2031(c)(1)(B). See infra ¶ 4.02[7][d][iii].

373 See IRC §§ 2031, 2032, 2032A. See infra ¶ 4.02[7][e][ii].
gross estate inclusion purposes by the value of the qualified conservation easement at the date of the decedent’s death.\textsuperscript{374} If the qualified conservation easement is placed on the land at or subsequent to the death of the decedent, then the value of the land included within the gross estate is not reduced by the value of the qualified conservation easement; instead, the date-of-death value of the land without regard to the easement is determined, and then that value is reduced by the amount of any Section 2055 deduction allowed to the estate for the qualified conservation easement.\textsuperscript{375} Thus, the possibility of both a gross estate exclusion and an estate tax charitable deduction for the value of the qualified conservation easement is foreclosed.\textsuperscript{376} For example, if a decedent owned land worth $100,000 subject to no acquisition indebtedness and no retained development rights, and the land was subject to a qualified conservation easement worth $30,000 for which the amount of the gross estate was reduced (if the easement was created prior to decedent’s death) or for which a $30,000 Section 2055 deduction was taken by the estate, only the $70,000 net value would be multiplied by the applicable fraction in computing the exclusion.\textsuperscript{377}

\textsuperscript{374} See IRC §§ 2031, 2032, 2032A. Although the value of a qualified conservation easement is not included in the transfer tax base whether the transfer is inter vivos or testamentary, an inter vivos transfer has the added advantage of generating an income tax deduction. IRC § 170.

\textsuperscript{375} IRC § 2031(c)(1)(A). See ¶ 5.05[7][c]. The Section 2055 deduction is limited to the fair market value of the qualified conservation easement. IRC §§ 2055(a), 2055(f). Thus, the net value used in determining the amount of the Section 2031(c) exclusion is the same whether the qualified conservation easement is conveyed before the decedent’s death or is conveyed by the estate after the decedent’s death. Cf. infra note 376.

\textsuperscript{376} If an income tax deduction is allowed to a family member for the creation of a qualified conservation easement by that family member after the decedent’s death and prior to the timely filing of the decedent’s federal estate tax return (see supra ¶ 4.02[7][b], text accompanying note 365), the value of the land should not be reduced by amount of the Section 170 deduction in computing the Section 2031(c)(1)(A) amount, because no Section 2055 deduction is allowed to the estate and hence no taxable estate reduction occurs for the value of the easement.

The statute does not preclude the possibility of both an income tax deduction and an estate tax exclusion for the full value of the property. Section 2031(c)(9), which states that “no income tax deduction is allowed to the estate or the qualified heirs with respect to such postmortem conservation easements [with respect to which a Section 2055(f) deduction is allowed].” (Emphasis added.) S. Rep. No. 174, 105th Cong., 2d Sess. 161 (1998), reprinted in 1998-3 CB 537, 697.

\textsuperscript{377} This interpretation of the Section 2031(c)(1)(A) computation eliminates the overlap of the deduction and the exclusion and is supported by the legislative history. HR Conf. Rep. No. 220, 105th Cong., 1st Sess. 402 (1997), reprinted in 1997-4 CB (Vol. 2) 1457, 1872. The legislative history provides that the “exclusion amount is calculated
The value of the land used in the determination of the exclusion is subject to two further reductions that effectively prevent the allowance of an exclusion to the extent that the property is “debt-financed”\(^{378}\) or to the extent that the qualified grantor has retained any “development rights”\(^{379}\) in the property.\(^{380}\)

**Debt-Financed Property.** The value of the land is reduced to the extent that the property is “debt-financed property.”\(^{381}\) Thus, generally only the decedent’s equity interest in the property qualifies for an exclusion under Section 2031(c). This reduction makes sense because, to the extent the property is debt-financed, the property is not included in the decedent’s taxable estate even in the absence of Section 2031(c).\(^ {382}\) “Debt-financed property” is defined as property upon which there is acquisition indebtedness at the date of the decedent’s death.\(^ {383}\) “Acquisition indebtedness” is defined to include indebtedness incurred in the acquisition of the property,\(^ {384}\) incurred prior to acquisition of the property that would not have been incurred but for such acquisition,\(^ {385}\) or incurred after the acquisition of the property if it would not have been incurred but for the acquisition and such indebtedness was reasonably foreseeable at the time the property was acquired.

To apply the applicable percentage to the value of the land without accounting for the easement and then reduce the resulting figure by the amount of the Section 2055 deduction would result in a large disparity between the effect of an inter vivos and a testamentary transfer of a qualified conservation easement in the determination of the Section 2031(c) exclusion. For example, if Decedent conveyed just before death a qualified conservation easement worth $30,000 and the value of the land subject to the easement was $70,000 at Decedent’s death, taking into account the easement, $28,000 could be excluded from Decedent’s gross estate under Section 2031(c). Alternatively, assume that Decedent devised an easement worth $30,000 on land valued at $100,000 at death and a $30,000 Section 2055 deduction was allowed. If the 40 percent applicable percentage is applied to the value of the land, $100,000, and the result, $40,000, is then reduced by the Section 2055 deduction allowed, $30,000, only $10,000 of the value of the land would qualify for exclusion under Section 2031(c). However if the value of the land, $100,000, is reduced by the Section 2055 deduction, $30,000, before the 40 percent applicable percentage is applied, the Section 2031(c) exclusion amount is $28,000, an exclusion equaling the same amount excluded where the easement was conveyed before death. See also supra text accompanying note 376.

\(^{378}\) IRC § 2031(c)(4).
\(^{379}\) IRC § 2031(c)(5)(D).
\(^{380}\) IRC § 2031(c)(5)(A).
\(^{381}\) IRC § 2031(c)(4)(A).
\(^{382}\) See IRC § 2053(a)(4); ¶ 5.03[5].
\(^{383}\) IRC § 2031(c)(4)(B)(i). One should question why this reduction is limited to acquisition indebtedness. It would seem that it should apply to any indebtedness on the property.
\(^{384}\) IRC § 2031(c)(4)(B)(ii)(I).
\(^{385}\) IRC § 2031(c)(4)(B)(ii)(II).
time of the acquisition. The term also includes any extension, renewal, or refinancing of such acquisition indebtedness.

*Retained Development Rights.* The value of the property is also reduced by the value of any development rights retained in the land by the qualified grantor in the conveyance of a qualified conservation easement. A development right is a right to use the land for any commercial purpose that is not subordinate to and directly supportive of the use of the land as a farm for farming purposes.

However, there is no reduction for the value of retained development rights to the extent that all persons who have an interest in the land (possessory or not) at the time of the agreement execute an agreement to extinguish permanently some or all of such development rights and such agreement is made prior to the date for filing the decedent’s estate tax return. Thus, if the parties agree to extinguish some or all of such rights, the exclusion may be increased and the estate tax reduced. Any failure to implement the relinquishment agreement within two years of the date of the decedent’s death (or on or before the date of sale of the land, if earlier) generally results in the imposition of additional estate tax taking such retained development rights into consideration in computing the amount of the exclusion. The method to be employed

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386 IRC § 2031(c)(4)(B)(ii)(III). See also IRC § 514(b).
387 IRC § 2031(c)(4)(B)(ii)(IV).
388 IRC § 2031(c)(5)(A).
389 IRC § 2031(c)(5)(D). The term “farming purposes” is defined in Section 2032A(e)(5). See ¶ 4.04[3][b][iii].
390 IRC § 2031(c)(5)(B). Priv. Ltr. Rul. 200014013 (Dec. 22, 1999) (valid extinction of retained development rights). The agreement must be filed with the estate tax return. IRC § 2031(c)(5)(B). The Instructions for Form 706 list six items that must be included in the agreement and must be signed by all of the parties to the agreement. Instructions for Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, Schedule U, line 7, at 47 (Rev. August 2012). Such extinguished development rights are also disregarded when determining the Section 2031(c)(2) applicable percentage. See infra text accompanying note 396.
391 IRC § 2031(c)(5)(B). But see infra text accompanying note 403 demonstrating that the exclusion instead may be decreased.
392 IRC § 2031(c)(5)(C). The additional tax will be due within six months of such triggering date. Id. But see infra text accompanying note 403.

An agreement of this type may be used to defer payment of any additional estate tax related to the retained development rights until six months after the earlier of the date two years after the decedent’s death or the date of the sale of the land.
to determine the amount of estate tax attributable to such retained development rights is to be specified by the Secretary.393

[ii] The applicable percentage. The applicable percentage is generally 40 percent.394 However, the percentage is reduced (not below zero) by two percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement at the time of the contribution is less than 30 percent of the value of the land at such time.395 The easement is disregarded in valuing the land for purposes of determining the denominator used in calculating the percentage reduction; however, in computing the denominator, the value of the land is reduced by the value of any development rights retained.396 If the value of the qualified conservation easement is equal to 15 percent of the value of the land (both values determined at the time of the contribution and disregarding the qualified conservation easement) and if there are no retained development rights, the applicable percentage is reduced to 10 percent.397 If, at the time of the contribution, the value of the easement is equal to only 10 percent of the value of the land (disregarding the qualified conservation easement) and if there are no retained development rights, the ap-

393 IRC § 2031(c)(7), last sentence. The Secretary is also directed to prescribe the forms to be used. Id.
394 IRC § 2031(c)(2). The Instructions for Form 706 provide that if the easement was granted for consideration, the value of the easement is reduced by any consideration received. If the date of death value of the easement is different from the value at the time the consideration was received, the reduction is for the portion of the consideration received. The Instructions for Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, Schedule U, line 10, at 48 (Rev. August 2012).
395 IRC § 2031(c)(2). See IRC § 2031(c)(8)(B). Cf. supra ¶ 4.02[7][b], text accompanying notes 361–365.
396 IRC § 2031(c)(2). See supra text accompanying notes 390–392. This reduction in the denominator may work to a taxpayer’s advantage, because a reduction in the denominator (of the value of the retained development rights) increases the percentage of the value of the qualified conservation easement to the adjusted value of the land and may increase the Section 2031(c)(2) applicable percentage. This result seems inappropriate and is probably based on the thinking that since such rights may not be excluded under Section 2031(c) (see supra text accompanying notes 388–392), they should result in a reduction of the amount used in computing the applicable percentage. However, this reduction may actually result in an increase of the exclusion. See infra text accompanying note 403.
397 Because 15 percent is 15 percentage points below 30 percent, the 40 percent applicable percentage is reduced by 30 percentage points (two percentage points for each of those 15 percentage points), to 10 percent.
plicable percentage is zero and no exclusion is allowed under Section 2031(c).

[iii] **The exclusion limitation.** The value of land qualifying for the exclusion is subject to an “exclusion limitation” that imposes a ceiling on the maximum amount that can be excluded from the gross estate under Section 2031(c). Since 2002, the exclusion limitation has been $500,000.

(iv) **Examples.** Some examples might be helpful in demonstrating the computation of the amount of the Section 2031(c) exclusion. Suppose in the current year a decedent owned land that was worth $100,000 both at the date of the decedent’s death and the time of the contribution. The land was not subject to acquisition indebtedness or retained development rights, but it was subject to a qualified conservation easement worth $30,000 (created either during the decedent’s life or by the decedent’s executor). The amount of the Section 2031(c) exclusion would be $28,000, which amount is the product of the net value of the land at the decedent’s death, $70,000, multiplied by a 40 percent applicable percentage. Because the ratio of the value of the easement to the value of the land (not reduced by the easement) at the time of the contribution is exactly 30 percent, no reduction of the applicable percentage occurs. If the land was worth $100,000 at the time of the contribution, but $150,000 at the date of the decedent’s death, and the easement was worth $30,000 at both the date of the creation of the easement and of the decedent’s death, the amount of the exclusion would be $48,000, the net estate tax value of the property, $120,000, multiplied by the 40 percent applicable percentage. If the land was worth $2 million and the easement was worth $600,000 both at the date of the decedent’s death and at the time of the contribution, the exclusion potential would be $560,000, but it would be limited by the exclusion limitation to $500,000. If the easement on the $2 million property was valued at only $400,000, then the potential exclusion would be $320,000, the $1,600,000 net

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398 Because 10 percent is 20 percentage points below 30 percent, the 40 percent applicable percentage is reduced by 40 percentage points to zero, 2 percentage points for each of those 20 percentage points.

399 See IRC § 2031(c)(1)(A).

400 IRC § 2031(c)(1)(B).

401 IRC § 2031(c)(1). The exclusion was phased in between 1998 and 2002 as follows:

<table>
<thead>
<tr>
<th>Year of Decedent’s Death</th>
<th>Exclusion Limitation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>$100,000</td>
</tr>
<tr>
<td>1999</td>
<td>$200,000</td>
</tr>
<tr>
<td>2000</td>
<td>$300,000</td>
</tr>
<tr>
<td>2001</td>
<td>$400,000</td>
</tr>
<tr>
<td>2002 and thereafter</td>
<td>$500,000</td>
</tr>
</tbody>
</table>

Section 2031
value of the land multiplied by a 20 percent applicable percentage.\footnote{402} If, however, the decedent had retained development rights on the property worth $400,000, the amount of the potential exclusion would be increased to $360,000, $1,200,000 (the net value of the land reduced by the development rights) multiplied by a 30 percent applicable percentage.\footnote{403}

[e] The Interrelationship of Section 2031(c) and Other Estate Tax Sections and Other Taxes

[i] Introduction. The resolution of many of the issues that arise with respect to the interrelationship of Section 2031(c) with other estate tax sections and to other taxes depends on the underlying nature of the Section 2031(c) exclusion. In all probability, the underlying nature of Section 2031(c) is an exclusion of specific land from the decedent’s gross estate.\footnote{404} However, it can also be argued that Section 2031(c) provides an exclusion of a dollar amount (but not specific land) from the gross estate\footnote{405} or even a combination of the two, an exclusion of specific land if Section 2031(c)(1)(A) applies or of a dollar amount if Section 2031(c)(1)(B) applies.\footnote{406} In considering the three alternatives, the third seems inappropriate in that different decedents’ estates would

\footnote{402} The percentage of the value of the easement to the land (not reduced by the easement) would be 20 percent ($400,000/$2 million), and the applicable percentage would be 20 percent, 40 percent reduced by 20 percent (two times 10 percent).

\footnote{403} The applicable percentage is 30 percent, because the $400,000 value of the easement over $1,600,000 (the $2 million value of the land not reduced by the easement but reduced by the $400,000 retained development rights) is 25 percent. As a result, the applicable percentage is 30 percent, 40 percent less 10 percent (two times 5 percent). Thus, in some circumstances, a retention of development rights results in an increase in the amount of the exclusion. See supra note 396.

\footnote{404} As a result of the income tax basis rules of Section 1014(a)(4) (see infra text accompanying notes 441–452), it is likely that Section 2031(c)(1)(A) excludes a portion of the value of the land subject to the qualified conservation easement from the gross estate, and a specific asset is therefore excluded. Section 2031(c)(1)(B) can be interpreted as simply imposing a dollar ceiling on the amount of the exclusion of such assets.

When read in conjunction with Section 2033, Section 2031(c) also would seem to provide for such an asset exclusion. Section 2033 provides that “[t]he value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.” IRC § 2033. Section 2031(c) then provides that “there shall be excluded from the gross estate…the value of land subject to a qualified conservation easement.” IRC § 2031(c)(1).

\footnote{405} It can be argued that Section 2031(c)(1)(B) excludes a dollar amount, $100,000 to $500,000 depending on the year of death, and that Section 2031(c)(1)(A) limits the dollar amount to the value of the land included in the gross estate.

\footnote{406} It can be argued that when Section 2031(c)(1)(A) determines the exclusion, there is a specific exclusion of land and that when Section 2031(c)(1)(B) applies, it excludes a dollar amount but not specific land.
be treated inconsistently, with more stringent rules applied to a decedent with land with a smaller value.\footnote{In general, if the value of a decedent’s land is small, then Section 2031(c)(1)(A) applies with more stringent rules limiting what would be an asset specific exclusion. If the land value is larger, Section 2031(c)(1)(B) applies a dollar amount exclusion with more lenient rules. It hardly seems that Congress would want to be more stringent on land with a smaller value than a larger one. As a result, this alternative will be disregarded in the discussion below.} The legislative history fails to deal with the issue of the nature of the exclusion.\footnote{See S. Rep. No. 33, 105th Cong., 1st Sess. 45 (1997), reprinted in 1997-4 CB (Vol. 2) 1067, 1125; HR Conf. Rep. No. 220, 105th Cong., 1st Sess. 403 (1997), reprinted in 1997-4 CB (Vol. 2) 1457, 1873.} And, to date, the Treasury has not taken a position offering guidance with respect to the interrelationship of Section 2031(c) with other estate tax provisions and other taxes.

[ii] Interrelationships with other estate tax provisions.

The Interrelationship With Section 2032A. An election to use the Section 2031(c) exclusion does not preclude an election to value the property under Section 2032A.\footnote{IRC § 2031(c)(8). See ¶ 4.04[7][b][i].} Furthermore, if a qualified heir grants a qualified conservation easement over the property, the grant is not a disposition that triggers the recapture tax under Section 2032A(c).\footnote{IRC § 2032A(b)(1)(A), 2032A(b)(1)(B).} However, beyond those conclusions, the interrelationship of Sections 2031(c) and 2032A is often unclear. Most of the interrelationship problems between the two sections involve the issue of the extent to which one section is taken into consideration in satisfying the qualification requirements under the other section. A chicken-and-egg-type Section 2031(c)–Section 2032A interrelationship problem occurs when real property that is potentially eligible for a Section 2032A reduction in value is also potentially eligible for a Section 2031(c) exclusion, and an executor elects the application of both sections. It is unclear which section is applied first. The statutes do not explicitly state the impact of a Section 2032A reduction in value on the requirements to qualify for the Section 2031(c) exclusion. Simil-\footnote{See IRC §§ 2031(c)(1)(A), 2031(c)(2). See supra ¶ 4.02[7][d].}arly, the impact of a Section 2031(c) exclusion on the qualification requirements for Section 2032A valuation is not specifically addressed.\footnote{IRC §§ 2032A(b)(1)(A), 2032A(b)(1)(B).} The question is best resolved by assuming that the other section is applicable in determining qualification under each section, that is, measuring the amount of
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the Section 2031(c) exclusion by using Section 2032A valuation and testing Section 2032A qualification by applying the Section 2031(c) exclusion.

The effect of a Section 2032A election on satisfying the requirements of Section 2031(c) is first considered. Recall that the value of the land is significant in determining the amount of the Section 2031(c) exclusion.413 If the land subject to the qualified conservation easement is valued under Section 2032A,414 any such special Section 2032A valuation should be used in measuring the amount of the Section 2031(c) exclusion.

The impact that an exclusion under Section 2031(c) has on the qualification for Section 2032A must be similarly analyzed. Section 2032A(b)(1) imposes two tests that an estate must satisfy in order to qualify for Section 2032A treatment. Under the first test, the adjusted value of the real and personal property being used on the decedent’s date of death for a qualified use by the decedent or a member of the decedent’s family, which property meets certain duration of ownership and material participation tests and was acquired from or passed from the decedent to a qualified heir of the decedent must equal or exceed 50 percent of the adjusted value of the gross estate.415 Under the second test, the adjusted value of only real property that meets similar requirements, must equal or exceed 25 percent of the adjusted gross estate.416 Under both of the percentage tests, the denominator of the fraction is based on the value of the gross estate determined without regard to Section 2032A.417 The numerator of both tests is based on the value of property included in the gross estate determined without regard to Section 2032A.418 None of these definitions specifically provides for the exclusion under Section 2031(c).419 Because the denominator of both fractions is a function of the gross estate, the Section 2031(c) exclusion (regardless of its nature) should reduce the denominator of both fractions. The effect of Section 2031(c) on the numerator of both fractions depends on a number of factors. If the land subject to the easement is not a part of the special valuation property, Section 2031(c) has no effect on the numerators. If the land is a part of the special-use valuation property, then the nature of the Section 2031(c) exclusion becomes relevant.420 If, as is likely, the nature of the Section 2031(c) exclusion is effectively a reduction for estate

413 See supra ¶ 4.02[7][d], text accompanying note 373.
414 The land may be valued at fair market value under Section 2031 or Section 2032 if the land is separate from the real property valued under Section 2032A.
415 IRC § 2032A(b)(1)(A). See ¶ 4.04[3][b].
416 IRC § 2032A(b)(1)(B). See ¶ 4.04[3][c].
417 IRC § 2032A(b)(3)(A).
419 Note that Section 2032A was in existence before Section 2031(c) was conceived.
420 See supra ¶ 4.02[7][e][i].
tax purposes in the value of the specific land, then the exclusion would reduce the numerators of both of the fractions. Alternatively, if the nature of the Section 2031(c) exclusion is related to a dollar amount and not a specific asset, then the numerators of neither fraction would be reduced by the Section 2031(c) exclusion.

The Interrelationship With Section 2056. The question of the underlying nature of the Section 2031(c) exclusion is again significant in determining the interrelationship of Section 2031(c) with Section 2056. If, as is likely, the Section 2031(c) exclusion is an asset-specific exclusion, then any excluded land passing to a surviving spouse would not qualify for the marital deduction, because it would be a nondeductible interest. Thus, although the Section 2031(c) exclusion might be applicable to the same land if it is included in both a decedent spouse’s and a surviving spouse’s gross estates, the decedent spouse likely will not be allowed a marital deduction to the extent of the Section 2031(c) exclusion to the decedent spouse’s gross estate. On the other hand, if the Section 2031(c) exclusion is a general exclusion of a specified dollar amount, then the land subject to a qualified conservation easement passing to a surviving spouse would be a deductible interest for purposes of the marital deduction.

Use of the Section 2031(c) exclusion is significant in estate planning. The exclusion effectively increases the amount that can bypass federal estate tax.

The Interrelationship With Section 6166. Section 6166 was enacted after Congress identified potential liquidity problems for decedents owning closely held businesses. The land subject to a qualified conservation easement may be a part of such a closely held business. To qualify for deferral of estate tax

421 See supra text accompanying note 404.
422 This would make qualification for Section 2032A more difficult because subtracting the same amount from the numerator and the denominator of a fraction will always reduce the fraction to where the numerator is smaller than the denominator.
423 See supra text accompanying note 405.
424 This result would make it easier to satisfy the Section 2032A tests because a reduction in a denominator of a fraction without any reduction in its numerator will always increase the amount of the fraction.
425 See supra text accompanying note 404.
426 IRC § 2056(a) (last clause). Reg. § 20.2056(a)-2(b)(1).
427 See supra ¶ 4.02[7][c], text accompanying notes 369, 370.
428 See supra text accompanying note 405.
429 IRC § 2056(a) (last clause). Reg. § 20.2056(a)-2(b)(1).
430 The share bypassing federal estate taxation should be increased above the normal formula (based generally on the Section 2010 credit) by the Section 2031(c) exclusion amount.
431 See ¶ 2.02[3][c].
attributable to the closely held business interest, the interest\textsuperscript{432} must be “included in determining the gross estate of a decedent,”\textsuperscript{433} and it must exceed 35 percent of the adjusted gross estate\textsuperscript{434} of the decedent.\textsuperscript{435} There would be property other than the land involved in such a closely held business that would be in includible in the gross estate; therefore the exclusion of a portion of the value of land under Section 2031(c) should not preclude qualification for the Section 6166 deferral.\textsuperscript{436} In addition, in computing the denominator of the 35 percent test under Section 6166,\textsuperscript{437} regardless of the underlying nature of Section 2031(c), the Section 2031(c) exclusion should be taken into account in determining the “adjusted gross estate.” If the portion of the land subject to the Section 2031(c) exclusion is not a part of the value of the closely held business, the end result would be no reduction in the numerator, but a reduction in the denominator, thereby making the 35 percent test easier to satisfy.\textsuperscript{438} If the portion of the land subject to the Section 2031(c) exclusion is a part of the value of the closely held business interest for purpose of Section 6166, then the issue is whether the excluded portion reduces the numerator of the 35 percent test. If, as is likely, the nature of the Section 2031(c) exclusion is effectively a reduction for estate tax purposes in the value of the specific land,\textsuperscript{439} then the excluded portion will reduce the numerator of the fraction (as well as the denominator) in applying the 35 percent test. Alternatively, if the nature of the Section 2031(c) exclusion is related to a dollar amount and not a specific asset,\textsuperscript{440} then the excluded portion would not reduce the numerator of the 35 percent test.

[iii] Interrelationship to the income tax.

\textit{Income Tax Basis.} Property excluded from the decedent’s gross estate under Section 2031(c) takes a carryover basis from the decedent.\textsuperscript{441} Recall that Section 2031(c) can apply in four situations.\textsuperscript{442} In the first two situations,
where either the qualified conservation easement was created by a family member with the land subsequently held by the decedent at death or the easement was created inter vivos by the decedent, the income tax basis is the same amount. In both situations, if property worth $100,000 with a $50,000 basis is subject to a $30,000 easement, the $70,000 net value of the land potentially included in the gross estate would have a $35,000 adjusted basis prior to the decedent’s death and would qualify for a $28,000 exclusion. The included $42,000 portion of value would take a basis of $42,000, and the excluded portion would take a basis of $14,000 ($28,000/$70,000 times $35,000), for a total basis of $56,000.

In the third situation, the easement is created at or subsequent to the decedent’s death, and the issue is whether the total basis for the land is determined and a portion is then allocated to the charitable contribution or whether the charitable contribution is made and the retained portion absorbs all of the carryover basis. Assume a decedent had purchased land at a cost of $50,000 that appreciated to a fair market value of $100,000 at the date of the decedent’s death, the easement is conveyed at or subsequent to the decedent’s death, and the decedent’s executor conveyed a qualified conservation easement worth $30,000 and properly elected to exclude $28,000 under Section 2031(c). If the total basis is determined and then allocated, the total basis of the property would be $86,000, $72,000 for the land included in the decedent’s gross estate ($100,000 less $28,000) plus $14,000 for the portion excluded under Section 2031(c) ($28,000/$100,000 of the Section 1012 basis of $50,000). The $86,000 basis would be apportioned between the qualified conservation easement and the land subject to the easement according to their relative fair market values, with the land subject to the easement having a basis of $60,200 ($70,000/$100,000 times $86,000). If the basis is allocated first and then the Section 1014(a)(4) reduction occurs, the retained value of the property would be $70,000, and that 2/3 of the value of the property would receive a step-up to $42,000 and the remainder would receive a $14,000 carryover basis, resulting in a $56,000 total basis (identical to the basis where there was a pre-death contribution).

Finally, if a family member made a post-distribution conveyance of the easement prior to the timely filing of the decedent’s estate tax return and if the

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444 See supra ¶ 4.02[7][d][iv].
445 IRC § 1014(a)(1).
446 IRC § 1014(a)(4).
447 See supra ¶ 4.02[7][d][iv].
449 In this situation and in all three other situations one can concoct other possible results in determining the basis for the property. Therefore, regulatory guidance will be welcomed.
Section 2031(c) exclusion is $28,000,\footnote{450} the property would take a total $86,000 basis to the distributee ($72,000 plus $14,000). On the creation of the easement, that basis would be allocated between the retained and donated portions of the land.\footnote{451} The land subject to the easement would have a basis of $60,200 ($70,000/$100,000 times $86,000). If, however, the amount of the Section 2031(c) exclusion is $40,000,\footnote{452} the property would have a total basis of $80,000 ($60,000 plus $20,000) and on creation of the easement, 70 percent of that basis ($56,000) would be allocated to the retained property.

Section 303. Stock that qualifies for capital gain treatment under Section 303 must be included in the decedent’s gross estate and all such corporate stock must, in general, exceed 35 percent of the decedent’s gross estate.\footnote{453} Issues similar to those arising in determining the interrelationship of Section 2031(c) with Section 6166 and with Section 2032A arise with respect to the interrelationship of Section 2031(c) to Section 303.\footnote{454} Regardless of the nature of Section 2031(c), the measurement of the denominator of the fraction is based on “the value of the gross estate”\footnote{455} and the Section 2031(c) exclusion would reduce the denominator. If, as is likely, Section 2031(c) is an asset-specific exclusion, and if the land subject to the easement is in the corporation whose stock is being redeemed, then both the numerator and denominator of the fraction should be reduced and the 35 percent test would be more difficult to meet.\footnote{456} Alternatively, if Section 2031(c) is treated as excluding a dollar amount and not as an asset-specific exclusion,\footnote{457} or the land subject to the qualified conservation easement is not in the corporation whose stock is being tested, the stock is included in the gross estate and is also a part of the numerator of the 35 percent fraction. In these circumstances, a reduction of the denominator without any reduction of the numerator will make meeting the greater than 35 percent requirement easier to satisfy.\footnote{458}

[iv] Interrelationship to the generation-skipping transfer tax. Regardless of the underlying nature of Section 2031(c), the section should generally have no effect on consequences that occur under the generation-skipping transfer tax. Since Section 2031(c) is an estate tax provision, it does not apply to

\footnote{450}{But see supra ¶ 4.02[7][d], note 376.} \footnote{451}{See Reg. §§ 1.170A-14(h)(3)(ii), 1.170A-14(h)(4), Ex. 9.} \footnote{452}{No reduction of the value of the land should occur in computing the exclusion, with the result that the exclusion would be 40 percent of $100,000, or $40,000. See supra ¶ 4.02[7][d], note 376.} \footnote{453}{IRC §§ 303(a), 303(b)(2)(A).} \footnote{454}{See supra text accompanying notes 409–424, 431–440.} \footnote{455}{IRC § 303(b)(2)(A).} \footnote{456}{See supra text accompanying notes 404, 421, 422.} \footnote{457}{See supra text accompanying note 405.} \footnote{458}{See supra text accompanying note 424.}
any inter vivos transfers made by a transferor. But even if a testamentary transfer is made by a transferor, the fact that an exclusion has been allowed by Section 2031(c) does not preclude applicability of the generation-skipping transfer tax. The definitions of a “taxable termination” and a “taxable distribution” are met even if the property was originally specifically excluded from a transferor’s gross estate. One of the requirements for a direct skip is that there is “a transfer subject to a tax imposed by Chapter 11.”

Even if the underlying nature of Section 2031(c) is that specific land is excluded from taxation under Chapter 11 by Section 2031(c), such land is still “subject to” Chapter 11 taxation. The same “subject to tax imposed by Chapter 11” rationale applies to make the decedent the transferor of such property for purposes of the generation-skipping transfer tax.

[f] Effective Date

Section 2031(c) applies to the estates of decedents dying after December 31, 1997.

459 This testamentary transfer would include either direct transfers that could constitute direct skips or transfers to trusts that might potentially result in taxable terminations or taxable distributions.

460 Since Section 2031(c) is not a valuation section, it has no effect on valuation of any property subject to a generation-skipping transfer. See IRC § 2624.

461 IRC § 2612(a)(1).

462 IRC § 2612(b).

463 IRC § 2612(c)(1).

464 If Section 2031(c) simply excludes a dollar amount (see supra text accompanying note 405), the “subject to” issue is not raised and Section 2031(c) has no generation-skipping transfer tax consequences.

465 In effect the property was subject to such taxation but excluded by election from it. See the discussion of the relationship of Section 2503(e) (transfer not subject to taxation) and Section 2503(b) (transfer subject to but excluded from taxation) at ¶ 13.02[4][b], text accompanying notes 259–264.

It might be argued that the language of Regulations Section 26.2652-1(a)(2) (“a transfer is subject to Federal estate tax if the value of the property is includible in decedent’s gross estate as determined under Section 2031”) provides that property excluded under Section 2031(c) is not “subject to” Chapter 11. However, this regulation was promulgated prior to the enactment of the Section 2031(c) exclusion, and it would be inconsistent with the treatment of exclusions under the gift tax, which are treated as “subject to” the gift tax, under the first sentence of Regulations Section 26.2652-1(a)(2).

466 IRC § 2652(a)(1)(A). See ¶ 17.02[1][b], text accompanying note 21.

¶ 4.03 SECTION 2032. ALTERNATE VALUATION DATE

[1] Introduction

Section 2032 provides an optional date for valuing property required to be included in the gross estate. In general, the executor may elect the date six months after the decedent’s death, instead of the date of death. The provision permitting valuation of the estate as of a date after the date of death was enacted in 1935, which affords a clue to its purpose. At the time of the 1929 stock market crash and the attending general recession, which marked the beginning of the Depression, some persons died wealthy but, before administration of the estate could be completed, the value of their estates had shrunk to a figure less than the amount of estate tax based on the value of the estates at death. This extreme situation reflects the type of difficulty arising out of a strict date-of-death valuation rule; Section 2032 affords some tax relief from such difficulties.

The significance of the tax relief provided by this provision was reinforced by the bear stock markets in 2008 and 2011.

The Section 2032 election is made by proper notation on the estate tax return and generally cannot be withdrawn once made. The election is made on the last estate tax return filed by the executor on or before the due date (including extensions of time to file actually granted) or, if a timely estate tax return is not filed, the first estate tax return filed after the due date, provided it is filed no later than one year after the due date (including granted extensions).

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1 The six-month rule applies to estates of decedents dying in 1971 and later years. In the case of earlier death, the principal alternate date is one year after death. Where there is no date in the sixth month following the decedent’s death that corresponds numerically to the date of death, the basic alternate valuation date is the last day of the sixth month. Rev. Rul. 74-260, 1974-1 CB 275.

2 The time interval between a decedent’s date of death and the basic alternate valuation date has been shortened from one year to six months, a necessary corollary to shortening the time for filing estate tax returns from fifteen months to nine months. See IRC § 6075, discussed at ¶ 2.02[1][c], text accompanying note 13. As a result, there is less chance for sharp valuation changes. See S. Rep. No. 1444, 91st Cong., 2d Sess. 5 (1970), reprinted in 1971-1 CB 574, 576.

3 IRC § 2032(d)(1). Although the election is generally irrevocable, it may be revoked on a subsequent return on or before the due date of the return (including extensions actually granted). Reg. § 20.2032-1(b)(1).

4 The basic statutory period for filing an estate tax return is “within 9 months after the date of the decedent’s death.” IRC § 6075. An extension, generally limited to six months, may be granted. IRC § 6081. See ¶ 2.02[1][c]. The six-month extension is automatic if certain requirements are met. Reg. § 20.6081-1(b). See ¶ 2.02[1][c], text accompanying note 15.
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sions). If the estate tax return is filed within either of the time periods, an extension of time to make the Section 2032 election may be granted. If, based on the estate tax return as filed, the estate would not qualify for the use of Section 2032 because of the Section 2032(c) requirements, a protective election to use Section 2032 is effective if it is subsequently determined that the requirements are met.

If the alternate valuation date is elected, the election applies to all the property included in the gross estate; the statute does not permit the alternate date to be used selectively with regard only to part of the estate. Moreover, when any estate tax provision makes reference to the value of property at the time of the decedent’s death, the provision must be read as value as of the alternate date if the benefits of Section 2032 are elected. Section 2032(b) so specifies.

Election of the alternate valuation date not only affects the estate tax but also establishes the date-of-death value basis of property for the income tax.

Back in the good (bad?) old days when individual income tax rates were as

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9 Reg. § 20.2032-1(b)(3). See Reg. §§ 301.9100-1, 301.9100-3. The Section 2032(d)(2) prohibition does not prevent the election in this situation because the estate tax return is filed within the prescribed one-year period. See TD 9172, Supplementary Information, 2005-1 CB 468; Priv. Ltr. Rul. 200438014 (May 25, 2004) (extension of time to elect alternate valuation granted after timely return filed and receipt of closing letter under Regulations Sections 301.9100-1 and 301.9100-3 one year after due date of estate tax return); Priv. Ltr. Ruls. 200740009 (May 10, 2007), 2010229002 (Dec. 15, 2009), 201103003 (Sept. 15, 2010), 201122009 (Feb. 24, 2011), 201144011 (July 25, 2011), 201151003 (June 3, 2011), 201216013 (Jan. 5, 2012).

10 See infra text accompanying notes 17, 18.


12 IRC § 1014(a)(2). See e.g., Estate of Bary v. Comm’r, 368 F2d 844 (2d Cir. 1966).
high as 70 percent or 50 percent rather than roughly 40 percent on ordinary income (and the generally 15–20 percent rate on net capital gain),\(^{12}\) it was sometimes advantageous to elect Section 2032 when the value of property in the gross estate was higher on the alternate valuation date than on the date of death, if the tax rates on the estate were less than the potential income tax rates applicable to gain on a subsequent sale of the property.\(^ {13}\) With the current similarity in the estate\(^ {14}\) and income tax rates,\(^ {15}\) the incentive to elect a higher alternate valuation date may be attributed to the applicable exemption amount and the marital deduction.\(^ {16}\) However, Congress enacted Section 2032(c)\(^ {17}\) to ensure that Section 2032 is used only to provide estate tax relief and not to avoid income taxes. That subsection allows a Section 2032 election only where the election will result in both a decrease in the value of the decedent’s gross estate and a decrease (after allowable credits) in the sum of the decedent’s estate tax and the tax on generation-skipping transfers with respect to property included in the decedent’s gross estate.\(^ {18}\)

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12 IRC §§ 1(a), 1(b), 1(c), 1(d), 1(e), 1(h), 1(i)(2), 1222(11). Cf. IRC § 1(g). These rates disregard the additional 3.8 percent Section 1411 net investment income tax.

13 Prior to the enactment of Section 2032(c), if an estate was not required to pay any estate tax or was taxed at a lower estate tax rate, an executor would want to elect a higher alternate date valuation so as to increase the income tax basis of property. Prior to the enactment of Section 2032(c), the Treasury had conceded that the Code allowed the election of Section 2032 in a lower date-of-death value situation. Reg. § 20.2032-1(b)(1). See Rev. Rul. 55-333, 1955-1 CB 449. However, the Treasury refused to recognize such use of the alternate valuation date in a situation where the value of the gross estate was so small that no return was required to be filed. Reg. § 20.2032-1(b)(1). See Rev. Rul. 56-60, 1956-1 CB 443. Cf. IRC § 6018.

14 See ¶ 2.01[1][c].

15 See supra note 12.

16 There is also little incentive to use a higher valuation date with respect to property taxed under the generation-skipping transfer tax that is imposed at the effective estate tax rate. See IRC §§ 2641, 2642(b)(2)(A).

17 Section 2032(c) was originally enacted as part of the Deficit Reduction Act of 1984. Pub. L. No. 98-369, § 1023, 98 Stat. 495, 1030 (1984), reprinted in 1984-3 CB 1, 538. Section 2032(c)(2) was amended in 1986 to include the tax on generation-skipping transfers as well as the estate tax. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1432(c)(1), 100 Stat. 2085, 2730 (1986), reprinted in 1986-3 CB (Vol. 1) 1, 647. See supra note 16; ¶ 14.05[2][a], text accompanying note 17.

18 IRC § 2032(c). The determination of whether there has been a decrease in the sum of the estate and generation-skipping transfer tax liability is made only with reference to the estate tax and generation-skipping transfer tax payable by reason of the decedent’s death, excluding from consideration any tax to be paid on future generation-skipping transfers. Reg. § 20.2032-1(b)(1). See TD 9172, Supplementary Information, 2005-1 CB 468. The possibility of the imposition of additional estate tax under Section 2032A(c) is also excluded from this consideration.
[2] Identification of Gross Estate

As previously indicated, when the alternate provision is elected, the usual date for valuation of the estate is six months after death. It is very important to understand that this section does not require or permit a redetermination of what property is to be included in the gross estate; the identification of interests subject to tax is made as of the date of death and is generally unaffected by subsequent events, regardless of whether the alternate date or the date of death is used for valuation purposes. The alternate date provision merely permits the election of a different time for valuation reflecting changes in economic or market conditions, casualty and theft losses (not compensated by insurance or deducted under Section 2054), and other similar consequences. The adoption of a time for valuation different from the time used for identification creates some problems that need discussion.

The gross estate may be thought of as consisting of two elements: the actual estate and the artificial estate. The provisions of Section 2032 apply alike to property interests owned by the decedent and to interests the ownership of which is merely imputed to the decedent. For purposes of simplicity, however, the impact of Section 2032 is discussed here largely with respect to property actually owned at death. It has probably always been clear that a disposition of estate assets after death would not remove the assets from the gross estate, even if Section 2032 is elected and the disposition occurs before the alternate date.

Some related problems present greater difficulty. Should property that was not a part of the gross estate at death but that came into the estate during the six months after death be included in the valuation of the gross estate if the alternate provision is elected? For example, what about an ordinary cash dividend, payable to stockholders of record as of a date after death, received during the six-month period? Such a dividend is not a part of the gross estate

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20 Section 2033 (and Section 2034) taxes property to the extent of the decedent’s actual interest in the property at death.

21 Sections 2035 through 2042 and Section 2044 tax other property interests without regard to the decedent’s date-of-death ownership, which interests are nevertheless considered properly within the reach of the death duty.

22 See the comments infra ¶ 4.03[3] on exceptions to usual valuation date.
because it cannot be identified at death as property owned by the decedent,\(^{23}\) and its value is not to be included even if the alternate date is elected.\(^{24}\)

[a] Bond Interest and Rent

The same principle generally applies to bond interest that accrues between the date of death and the alternative date, to an increase in the redemption price of a nontransferable government savings bond during that period,\(^{25}\) and to rent on property owned by the decedent that accrues during the six-month period.\(^{26}\) Nevertheless, the Treasury maintains that an advance payment of bond interest or rent during the six-month period, which constitutes payment for a period subsequent to the alternate valuation date, may be identified as realistically a part of the gross estate at death and included in the alternate valuation along with the diminished value of the principal assets.\(^{27}\) This principle is unassailable. Such prepaid interest or rent represents an immediate cash realization of a part of the value of the very property owned at death, and therefore must be viewed as “included” property, to use the term of the regulations.\(^{28}\)

[b] Corporate Stock

Some transactions involving corporate stock raise much more difficult problems under the alternate valuation date provision. For example, a decedent might own shares of cumulative preferred stock on which there were substantial dividend arrearages at the time of the decedent’s death. If such arrearages are discharged by dividends declared and paid during the alternate valuation

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\(^{23}\) Reg. § 20.2033-1(b). See infra ¶ 4.03[2][c]. But see Reg. § 20.2031-2(i), properly indicating a different result if at death the stock is selling “ex-dividend” even though the record date has not been passed.

\(^{24}\) Maass v. Higgins, 312 US 443 (1941); Reg. § 20.2032-1(d)(4). See Bartram v. United States, 1975-1 USTC ¶ 13,041 (D. Conn. 1974) (capital gain dividend declared and paid after death not included under the Maass rationale); Rev. Rul. 76-234, 1976-1 CB 271 (the Service agrees, if the amount of such dividends is not substantial in relation to the value of the underlying stock). But see Estate of Fleming v. Comm’r, 33 TCM (CCH) 1414 (1974) (improperly concluding that the value of stock included the amount of the dividend declared after the date of death and payable to shareholders of record after the alternate valuation date).

\(^{25}\) The increase is in substance an interest payment to be excluded from valuation. Reg. § 20.2032-1(d)(3).

\(^{26}\) Reg. § 20.2032-1(d)(2). Interest and rent accrued at death are of course included. Estate of Sloane v. Comm’r, 3 TCM (CCH) 555 (1944). See ¶ 4.05[4].

\(^{27}\) Reg. §§ 20.2032-1(d)(1), 20.2032-1(d)(2).

\(^{28}\) Reg. § 20.2032-1(d)(1). Within this provision, a payment of principal on a bond or note or mortgage is logically treated the same as an advance payment of interest and is included. Rev. Rul. 58-576, 1958-2 CB 625, 626, Situation 5.
period, are they “included” or “excluded” property? Passed preferred dividends are not analogous to accrued interest, since no debtor-creditor relationship arises between the shareholder and the corporation until the dividend is declared. On this ground, such dividends have been held to represent post-death income not includible when received during the alternate period if declared after death.29 The decision seems too technical. In such circumstances, the right to the dividends when and if paid is an element in the value of the stock at the date of death and an absent element on the later date if the dividends have been paid in the meantime. Logically, the value of the hoped for payment should be included, whichever date is selected; an all-or-nothing approach seems to tax either too much or too little. The difficulty well illustrates the problem arising out of the split identification and valuation dates.

Other corporate transactions can raise comparable difficulties, but not all do. During the boom stock market of the mid- to late 1990s, many appreciated stocks split. On December 31, 1999, for example, wireless communication provider Qualcomm split its stock four for one. It is a safe assumption that some of its many shareholders died just before the split. If such a shareholder’s personal representative elected the alternate valuation date, the personal representative held on the later date 4,000 shares of Qualcomm instead of the 1,000 shares owned at death by the decedent, and the personal representative was issued a new 3,000-share certificate at the time of the split. The old 1,000-share certificate may have been worth more at death compared to the value on the alternate date as a result of the split and market fluctuations. Could the decedent use the lower valuation figure, ignoring the new certificate? Clearly not. Both certificates simply represent the same interest in Qualcomm as the one certificate did prior to the split, and both are “included” property.

[c] Stock Dividends

Stock dividends (and, indeed, even extraordinary cash distributions), however, are something else again. If the Sun Oil Corp. declares and distributes a 12.5 percent stock dividend during the critical valuation period, which indeed had occurred in the case of Estate of Schlosser v. Commissioner30 in 1953, is the dividend stock “included” property? The determinative question can easily be asked: Does it represent a part of the very property interest owned by the decedent at death or is it, in effect, new property first owned by the estate? The answer comes hard. The Third Circuit included the dividend shares in the gross estate, largely on the basis of an income tax case holding that a common stock dividend paid on common is not income within the meaning of the Six-

teenth Amendment. The result in Schlosser gets some support from the underlying fact that at the time of the decedent’s death, the corporation’s surplus was sufficient to cover both the stock dividend and cash dividends paid the same year. Thus, even if the corporate veil were pierced, the dividend could be said to represent an interest in corporate assets that the decedent owned when he died. While the Third Circuit rejected this refinement, preferring to rest its decision on a broader ground, the source of a stock dividend may be important. The Treasury and other courts have taken the position that post-death stock dividends escape tax if “they are out of earnings of the corporation after the date of the decedent’s death.” This basically acceptable principle is flawed, however, by the absence of any guide in the determination of what the dividend is paid “out of.” The need for legislative specification has long been recognized.

[d] Other Types of Property

The income-versus-property problem under Section 2032 may arise with respect to other types of property. For instance, appreciation in the value of cattle during the alternate valuation period, even though it may represent new


32 No assertion was made that the cash dividends should be included, and, even if this may be open to philosophical question, it seems settled that “ordinary dividends,” whether paid in cash or stock, are not to be included. Maass v. Higgins, 312 US 443 (1941); Reg. § 20.2032-1(d)(4). However, retained earnings of a corporation that are not declared as dividends are included. TAM 200343002 (June 11, 2003). Cf. Bartram v. United States, 1975-1 USTC ¶ 13,041 (D. Conn. 1974). The regulations do not include within the scope of “ordinary dividends” either (1) a cash dividend, distributed by a corporation in which the decedent held a substantial interest, which consisted of “all” (or presumably a substantial part of) the earnings and profits accumulated at the date of the decedent’s death, or (2) a distribution in partial liquidation of the decedent’s interest without a surrender of stock, except to the extent paid out of earnings and profits earned after the decedent’s death. Reg. § 20.2032-1(d)(4).

33 Reg. § 20.2032-1(d)(4).

34 Cf. Tuck v. United States, 282 F2d 405 (9th Cir. 1960); English v. United States, 270 F2d 876 (7th Cir. 1959); Estate of McGehee v. Comm’r, 260 F2d 818 (5th Cir. 1958); Rev. Rul. 80-142, 1980-1 CB 197.

35 Compare Estate of McGehee v. Comm’r, 260 F2d 818 (5th Cir. 1958), where the corporate history answered the question in favor of post-death earnings, and in an analogous Section 2035(a) setting, the dividend stock was excluded, with Tuck v. United States, 282 F2d 405 (9th Cir. 1960), where the taxpayer failed to prove that a stock dividend was out of post-transfer earnings, yielding an adverse decision under Section 2040. Cf. IRC § 316(a), which is not applicable to the estate tax but for income tax purposes adopts a last-in, first-out (LIFO) approach to the distributions of corporate earnings.

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meat, is considered property included in the estate.\footnote{Rev. Rul. 58-436, 1958-2 CB 366. In addition, the ruling holds that feed given to the cattle is included in the estate at its value on the date of its use, which is a disposition, but that its value is deductible under Section 2053 as an administration expense. Thus, the feed, which is converted into meat, is really not taxed twice.} Oil and gas royalties collected during the alternate valuation period have been held includible in the gross estate when the alternate valuation date is elected.\footnote{Estate of Holl v. Comm’r, 967 F2d 1437 (10th Cir. 1992); Johnston v. United States, 779 F2d 1123 (5th Cir.), cert. denied sub nom. Payne v. United States, 477 US 904 (1986). A discount is allowed to reflect properly only the value of the reserves in place. Rev. Rul. 71-317, 1971-2 CB 328. In Estate of Holl v. Comm’r, 54 F3d 648 (10th Cir. 1995), the Tenth Circuit reversed the Tax Court’s valuation of reserves in place on the alternate valuation date and the decedent’s date of death must be determined by apportioning services, pro rata, to quantities produced during the interim period and valuing the reserves as of the date of severance. See Selby, “Determining Estate Tax Value of Mineral Interests Under the Section 2032 Alternate Valuation Date; Estate of Holl v. Commissioner,” 46 Tax Law. 865 (1993); Wacker, “The In-Place Value of Oil and Gas Reserves Extracted During the Alternate Valuation Period of IRC 2032(a)(1),” 4 Oil & Gas Tax Q. 731 (1994).} Similar problems arise with respect to the valuation of life insurance. When the decedent owns a policy on the life of another, its increase in value during the six-month period is not included in the decedent’s estate to the extent that it is attributable to premium payments or interest earned.\footnote{Rev. Rul. 55-379, 1955-1 CB 449.} However, if the insured under the policy dies during the period, the proceeds are fully included in the decedent’s gross estate, because an event has merely increased the value of the policy to face value.\footnote{Rev. Rul. 63-52, 1963-1 CB 173.}

[3] Exceptions to Usual Alternate Date

The alternate valuation date is not invariably the date six months after death. In Section 2032(a), the applicable date is expressed in the form of three alternatives. It is more generally thought of, however, as the date six months after death, subject to two exceptions, one relating to property disposed of within the six months after death and the other to property whose value changes as a result of the mere passage of time.

[a] Property Disposed Of

Section 2032(a)(1) requires that “property distributed, sold, exchanged, or otherwise disposed of” during the six-month period is to be valued as of the
date of the transaction.\footnote{This rule does not apply to events that occur subsequent to death but are deemed by the Code to occur at death. See IRC § 2031(c); Prop. Reg. §§ 20.2032-1(c)(4), 20.2032-1(c)(5), Ex. 13(ii); ¶ 4.02[7].} Thus, in the case of property sold by the estate within the six-month period, the alternate date is the date of sale, not the date six months after death. In the case of a “sale,” the reason for this exception to the usual alternate date is easy to understand; conversion of an asset to cash closes any further concern about market fluctuations.\footnote{The sale price will not necessarily establish the property’s alternate valuation if the sale is not at arm’s length or if the decedent was not “locked into” the sales price. Estate of Critchfield v. Comm’r, 32 TC 844 (1959). See ¶¶ 4.02[2][c], 19.04.} A distribution to beneficiaries has the same effect, as far as the estate is concerned, and at least it enables the beneficiaries to convert the asset to cash if they choose to do so.\footnote{Regulations Section 20.2032-1(c)(2) broadly defines what constitutes a distribution. See Prop. Reg. §§ 20.2032-1(c)(1)(i)(E), 20.2032-1(c)(5), Ex. 13(i). However, property is not distributed if it passes directly at death as a result of a beneficiary designation or other contractual obligation or by operation of law. Prop. Reg. § 20.2032-1(c)(2). See Prop. Reg. § 20.2032-1(c)(5), Ex. 9 (operation of law), Ex. 12 (beneficiary designation). But see Prop. Reg. § 20.2032-1(c)(5), Ex. 10. In addition, actual distributions are not distributions within Section 2032 if the property may still be used by the executor to satisfy claims and expenses of the estate. Rev. Rul. 78-378, 1978-2 CB 229. The ruling is a reversal of an earlier position of the Commissioner, who successfully agreed to the contrary in Estate of Prell v. Comm’r, 48 TC 67 (1967). Other distributions include a collection of contingent attorney fees, Rev. Rul. 54-444, 1954-2 CB 300, and a division of a trust where the trust was terminated, Rev. Rul. 73-97, 1973-1 CB 404; but see Rev. Rul. 78-431, 1978-2 CB 230, and Rev. Rul. 57-495, 1957-2 CB 616 (no distribution because no termination). See also Reg. § 20.2032-1(e), Ex. 1 (illustrating both a distribution and the principles discussed supra ¶ 4.03[2]). Issues can also arise as to the timing of a distribution. See Hertsche v. United States, 244 F. Supp. 347 (1965), aff’d per curiam, 366 F2d 93 (9th Cir. 1966) (a final order directing distribution, which preceded actual distribution, constituted a Section 2032 distribution); Estate of Sawade v. Comm’r, 86-2 USTC ¶ 13,672 (8th Cir. 1986) (under state law a distribution of stock to beneficiaries occurred only when the shares were transferred on the corporate books); Rev. Rul. 54-444, 1954-2 CB 300 (distribution occurred on the date assets were delivered in a corporate liquidation), Cf. Stoutz v. United States, 324 F. Supp. 197 (ED La. 1970), aff’d per curiam, 439 F2d 1197 (5th Cir. 1971); Reardon v. United States, 429 F. Supp. 540 (WD La. 1977), aff’d per curiam, 565 F2d 381 (5th Cir. 1978); Land v. United States, 429 F. Supp. 545 (WD La. 1977), aff’d per curiam, 565 F2d 355 (5th Cir. 1978) (entry of judgment of possession was a distribution under Louisiana law).} An “exchange”\footnote{See Estate of Aldrich v. Comm’r, 46 TCM (CCH) 1295 (1983) (amount received in settlement of a contingent fee case constituted an “exchange” to the decedent attorney’s estate).} can occur even though the transaction qualifies for nonrecognition under the income tax.\footnote{Prop. Reg. §§ 20.2032-1(c)(1)(i)(F)–20.2032-1(c)(1)(i)(I). See Prop. Reg. § 20.2032-1(c)(5), Ex. 1. But see infra text accompanying note 50.}
But it is important to understand that these words and the words “otherwise disposed of,” according to the Treasury, comprehend “all possible ways by which property ceases to form a part of the gross estate.”

This language involves a very broad range of transactions. For example, cash on hand at death, which is used to pay funeral or other expenses of, or charges against, the estate during the six-month period is property “disposed of” within the meaning of the section. If only a portion of the property is distributed, sold, exchanged, or otherwise disposed of, there are rules to determine the extent to which the transaction date or dates apply and the extent to which the alternate valuation date applies.

The broad range of transactions encompassed in the statutory language is subject to two exceptions. Under the first exception, if an interest in a corporation, partnership, or other entity included in the decedent’s gross estate is exchanged for one or more different interests in the same entity or in an acquiring or resulting entity or entities and if the exchanged interests are essentially equal in value (with no more than a 5 percent differentiation in value) to the value of the exchanged interest, the transaction is not treated as an “exchange” and the acquired property is valued on the alternate valuation date.

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47 Proposed Regulations Section 20.2032-1(c)(1)(i) provides a nonexclusive list of such transactions that includes, for example: the use of cash on hand to invest in property (Prop. Reg. § 20.2032-1(c)(1)(i)(B)); the exercise of stock options (Prop. Reg. §§ 20.2032-1(c)(1)(i)(C), 20.2032-1(c)(5), Ex. 2); a change in the ownership structure or interests in, or in the assets of, a corporation, partnership, or other entity such that the included property after the change does not represent the property included at the decedent’s date of death (Prop. Reg. §§ 20.2032-1(c)(1)(i)(I), 20.2032-1(c)(5), Exs. 3, 4, 6(ii)); and a surrender of an equity ownership in a partial or complete liquidation (Prop. Reg. § 20.2032-1(c)(1)(i)(D)).

48 Prop. Reg. § 20.2032-1(c)(1)(i)(A). This is entirely in keeping with the purposes of this relief provision. Of course, the estate may get a deduction for such expenses and charges, but their payment does not operate to reduce the gross estate, and it is appropriate to take the cash into account as it passes out of the probate estate.

49 Prop. Reg. § 20.2032-1(c)(1)(iv). See Prop. Reg. § 20.2032-1(c)(5), Ex. 7 (all property distributed in separate distributions prior to the alternate valuation date), Ex. 8 (some property distributed prior to six months date and some held on alternate valuation date). Even though a minority interest is distributed or is valued on the six months date, no discounts are allowed in determining the valuation. See Prop. Reg. § 20.2032-1(c)(5), Ex. 8 (last sentence); ¶ 4.02[4]. But see Kohler v. Comm’r, 92 TCM (CCH) 48 (2006), nonacq. 2008-1 CB xv (restrictions imposed on stock pursuant to post-death reorganization allowed a valuation discount).

Under the second exception, a distribution from a business entity, bank account, or a retirement trust (entity) does not disqualify the entity from alternate date valuation if the fair market value of the entity immediately prior to the distribution equals the sum of the fair market value of the distributed property on the date of the distribution and the fair market value of the entity immediately after the distribution.51

The disposition, which fixes the alternate valuation date, can be made by one other than the executor.52 For example, if a person owned a joint tenancy with a right of survivorship interest in property fully funded by the decedent, the value of which is fully included in the decedent’s gross estate because the property was funded by the decedent, and the surviving joint tenant disposes of the property by sale or otherwise during the six months after the decedent’s death, the date of the disposition of the property becomes the alternate date.53 There is an interesting hiatus here, however. If one who receives a lifetime transfer taxable under Section 2035(a) sells the property before the decedent’s death, the very property transferred is still to be valued for estate tax purposes.54 If the alternate valuation date is elected, is the property to be valued as of the date of disposition in this case as well? Apparently not. The date six months after death will control55 because the property was not disposed of “after the decedent’s death” so as to invoke the exception to the usual rule.56 Anomalous? It seems so. Indeed, if alternate valuation is elected, the value on the date of disposition seems just as relevant if disposition occurs the day before the decedent’s death as it does when it occurs the day after.

[b] Value Affected by Time Lapse

Section 2032(a)(3) supplies a special rule for dealing with property whose value is affected by a mere lapse of time. A patent, which of course has a limited life span and may diminish in value as time passes for that reason alone,

51 Prop. Reg. § 20.2032-1(c)(1)(iii)(A). The distributed property is valued on the distribution date and the entity is valued on the alternate valuation date. See Prop. Reg. § 20.2032-1(c)(5), Exs. 6(i), 11. If the equality requirement is not met, both properties are valued on the distribution date. Prop. Reg. § 20.2032-1(c)(5), Ex. 6 (ii).

See also a rule to determine the portion of a trust includible, by reason of a retained interest, in the decedent’s gross estate under Section 2036. Prop. Reg. §§ 20.2032-1(c)(1)(iii)(B), 20.2032-1(e), Ex. 2.

52 Prop. Reg. § 20.2032-1(c)(3).


54 Rev. Rul. 72-282, 1972-1 CB 306. See ¶ 4.07[2][c].

55 IRC § 2032(a)(2).

56 IRC §§ 2032(a)(1), 2032(a)(2).
is one example of such property. To use the date six months after death to value a patent would give effect to normal shrinkage in value unrelated to market conditions, which is not the aim of Section 2032. The statute requires such property to be valued as of the date of death (expressly ruling out the later date), but with adjustment for differences in value not attributable to a mere lapse of time. Suppose the patent is sold three months after death. Are both the “disposition” rule and the “lapse of time” rule applicable? They are, and the regulations illustrate the method of applying them.

The Tax Court has properly held that a decrease in the value of an annuity occasioned by the death of the annuitant after the decedent’s death does not reflect a difference in value due to mere lapse of time. Such a property interest, if included in the gross estate, must be valued as of the date of death because its value is affected by mere lapse of time; but the adjustment in value that the statute permits may take into account the annuitant’s death within the six-month period. In the case referred to, the effect was to reduce the value of the annuity from approximately $120,000 to approximately $5,000. Similarly, an increase in annuity payments owing to a cost-of-living adjustment does not reflect a difference in value due to mere lapse of time and must be considered in valuing the annuity at the alternate date.

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58 The proposed regulations provide the following illustration: If a patent owned by the decedent had ten years to run at death and was sold by the estate six months after death, the patent’s value under Section 2032 is its value at the time of sale divided by 0.95. Prop. Reg. § 20.2032-1(f)(2)(ii). This may appear at odds with the statute, but in fact it makes the adjustment for passage of time and all other factors by using the date of sale, and then restores shrinkage due to mere lapse of time by recognizing that the patent was worth only 95 percent of its date-of-death value at the time of sale because one twentieth, or 5 percent, of its remaining life had lapsed by that time. To update the regulation’s example, assume the patent was sold only three months after the decedents’ death. Under Section 2032, its value would be 97.5 percent of its value at the time of sale reflecting the expiration of one fortieth, or 2.5 percent, of its useful life.

59 Estate of Hance v. Comm’r, 18 TC 499 (1952), acq. 1953-1 CB 4. See also Estate of Hull v. Comm’r, 38 TC 512 (1962), acq. 1964-2 CB 6, rev’d on another issue, 325 F2d 367 (3d Cir. 1964) (compromise of a claim held by the decedent that occurred during the alternate valuation period was relevant in valuing the claim because the compromise did not reflect a difference in value owing to mere lapse of time).

60 See IRC § 2039; ¶ 4.11.

61 Estate of Welliver v. Comm’r, 8 TC 165 (1947).

62 This result should be compared with the alternate valuation date special rule concerning the marital deduction, which is discussed infra ¶ 4.03[4][b].

[4] Effect of Election on Deductions

Section 2032(b) provides special rules that apply in determining estate tax deductions if the alternate valuation date is elected.

[a] General Impact on Deductions

Any deduction otherwise allowed in determining the taxable estate is disallowed if the item in question is in effect taken into account by the election of the alternate date. If an asset of the estate is destroyed by fire or other casualty during the six months following death, and the loss is not compensated for by insurance or in some other manner, Section 2054 allows a deduction for such loss in computing the taxable estate.\[64\] However, if the alternate date is used, the loss will be reflected in the value at which the asset is included in the gross estate. In these circumstances, the usual loss deduction under Section 2054 is sensibly disallowed. If, for example, by reason of the election of the alternate valuation date, an asset wholly destroyed shortly after death is included in the gross estate at a zero valuation, obviously no casualty loss deduction should be allowed with respect to the asset.\[65\] The same principle applies if the loss is something less than a total loss.\[66\]

[b] Relation to Charitable and Marital Deductions

Another special rule, expressed in Sections 2032(b)(1) and 2032(b)(2), is that if the alternate valuation date is elected, the valuation of property for the purpose of determining the charitable deduction and the marital deduction under Sections 2055 and 2056, respectively, must be made on the basis of the

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\[64\] See ¶ 5.04.

\[65\] Reg. § 20.2032-1(g). In addition, the estate would not be allowed a Section 165(c) income tax casualty loss deduction for the property because, by being valued as of the alternate valuation date, the Section 1014 basis for the property would be zero and Section 165(b) would disallow any income tax deduction. With regard to the income tax, Section 642(g) disallows any income tax deduction for the decedent’s estate for casualty losses allowable in determining the taxable estate, unless the estate tax deduction is waived and not claimed. But Section 642(g) does not expressly foreclose the income tax deduction merely because a casualty loss is given estate tax effect by election of the alternate date. No such rule was seriously needed because Section 1014 date-of-death (or alternate date) basis provisions effectively restrict the potential income tax deduction.

\[66\] If the property were not totally destroyed, there would be an income tax basis for the property and arguably an income tax deduction for the loss. See Reg. § 1.165-7(b)(1), especially Reg. § 1.165-7(b)(1)(ii). An alternative argument is that the income tax basis already reflects the loss and no further loss is justified. This problem and the problem raised supra note 65 do not arise if the loss occurs after the alternate valuation date. Cf. IRC § 642(g).
value of the property at the date of death. However, adjustment is made for any difference in value as of the alternate date that is not due to the mere lapse of time or to the occurrence or nonoccurrence of some contingency. As a practical matter, if shares of stock specifically bequeathed to charity are worth $10,000 at death, but only $8,000 as of the date six months after death, and if the alternate valuation date is elected, $8,000 is the amount includible in the gross estate and also the amount deductible in determining the taxable estate, provided, of course, the stock is not disposed of in the interim. The date-of-death value is used as the starting point, even though the alternate date is elected, but a full adjustment would be made in these circumstances to reflect the smaller value as of the later date. If there is a disposition within the six months after death, such as an actual transfer to the charity, the date of disposition becomes the date to be used in determining the adjustment in the date-of-death value.

No adjustment is to be made for changes in value that result from the mere lapse of time or the occurrence or nonoccurrence of a contingency. For example, if the decedent devised a residence worth $40,000 at the decedent’s death to a child for the child’s life, with a remainder to a qualified charity, the death of the child during the six months following the decedent’s death would be the occurrence of a contingency that would affect the value of the interest passing to the charity. The present interest of the charity at the later date would be more valuable than the future interest dependent upon the child’s death. However, the date-of-death value of the charity’s interest would fix the amount of the charitable deduction without adjustment for the increase in the value of the charity’s interest that resulted from the child’s death. On the other hand, if the residence itself decreased in value during the six months, that decrease would require an adjustment in the valuation of the charitable remainder and a corresponding reduction in the charitable deduction if the alternate date is used.

In this light, the special rule on valuation for purposes of the charitable deduction seems to yield a sound result. The decedent’s philanthropy, which

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67 See IRC §§ 2106(a)(2), 2106(a)(3) as to estates of nonresident aliens, which are discussed at ¶¶ 6.06[2], 6.06[3].

68 If the decedent provides that an amount equal to a percentage of the decedent’s gross estate is to pass under Section 2055 or Section 2056, and if Section 2032 is elected, then the amount of the gross estate is determined as of the alternate valuation date. Cf. Rev. Rul. 70-527, 1970-2 CB 193.

69 The remainder interest discussed here qualifies for a charitable deduction. But see IRC § 2055(e), discussed at ¶¶ 5.05[4]–5.05[8], which sometimes disallows deductions for such interests.
gives rise to the deduction, is measured by circumstances existing at the decedent’s death, except for market fluctuations.\textsuperscript{70}

The rule might appear to yield a less supportable result with regard to the marital deduction. In the \textit{Hance} case,\textsuperscript{71} the Tax Court properly took into account the death of a surviving annuitant, the decedent’s wife, in determining the value to be included in the decedent’s gross estate under the alternate valuation provisions, and included the annuity at a value of only $5,000, rather than $120,000. The decedent had died in 1947, and the estate tax marital deduction was not an issue. If the marital deduction applied,\textsuperscript{72} should the property be valued for that purpose without regard to the wife’s death? The statute specifically says that such a contingency shall be disregarded. On the facts in the \textit{Hance} case, it might seem that property entering into the gross estate at only $5,000 would then support a $120,000 marital deduction. However, the seeming problem under Section 2032 is taken care of by Section 2056(a), in its last clause, which limits the marital deduction to the value at which the interest passing to the surviving spouse is included in the decedent’s gross estate. Thus, in the \textit{Hance} situation, the marital deduction with respect to the annuity would be limited to $5,000, and no distortion results from the different Section 2032 rules on inclusions and deductions.

\[\textbf{4.04 SECTION 2032A. VALUATION OF CERTAIN FARM, ETC., REAL PROPERTY}\]

\[\textbf{[1] Introduction}\]

The alternate \textit{time} of valuation under Section 2032, just discussed, has long been a familiar estate tax phenomenon. This part of the chapter covers other \textit{methods} of valuation designed, when available, to afford relief to estates in which a farm or other real property utilized in a closely held business forms a substantial part of a decedent’s estate.

\textsuperscript{70} The statute does not invariably follow this principle with regard to the charitable deduction. See IRC § 2055(a), discussed in Chapter 5, which in some circumstances permits a qualified disclaimer made after death to enlarge the deduction. See IRC §§ 2046 and 2518, ¶¶ 4.18, 10.07, on qualified disclaimers.

\textsuperscript{71} Estate of Hance v. Comm’r, 18 TC 499 (1952), acq. 1953-1 CB 4.

\textsuperscript{72} See IRC §§ 2056(b)(1), 2056(b)(6), which are discussed at ¶¶ 5.06[7], 5.06[8][c]. An annuity does not necessarily run afoul of the “terminable interest” rule.
Section 2032A provides “optional methods of valuation” based on actual use for a limited amount of “qualified real property” required to be included in the gross estate. This section represents an elective statutory exception to the general rule that the value of an item includible in the gross estate is its fair market value on the applicable valuation date; for familiar fair market valuation, approximate actual-use value may be substituted. Fair market value, the price a willing buyer would pay a willing seller, takes account of the highest and best use to which the real property could be put, rather than the actual use of the property. Section 2032A is the product of a congressional determination that potential use valuation is inappropriate for certain real property, particularly that used before and after death as a farm for farming purposes or in other closely held business activities. This section is designed to encourage or facilitate continued use of real property for farming and other small business purposes and to curtail forced sales of this type of property to pay estate tax. The valuation relief afforded by this section is not unlimited; the reduction in the value of the gross estate may not exceed $750,000, adjusted

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2 IRC § 2032A(a)(2).

3 IRC § 2032A(b).

4 Reg. § 20.2031-1(b). Either the date of death or the alternate valuation date may be used in conjunction with a Section 2032A election. Rev. Rul. 83-31, 1983-1 CB 225. If alternate valuation is elected, it must also be used to determine if the Section 2032A requirements are met. Rev. Rul. 88-89, 1988-2 CB 333. A taxpayer may make a protective election to use Section 2032 in the absence of qualifying for Section 2032A. Estate of Mapes v. Comm’r, 99 TC 511, 527 (1992).


6 IRC § 2032A(e)(4). See infra ¶ 4.04[3][b][iii].

7 IRC § 2032A(e)(5). See infra ¶ 4.04[3][b][iii].

8 See infra ¶ 4.04[3][b][iv]. See also IRC §§ 2032A(g) and 6166(b)(1) for the determination of whether a business other than a sole proprietorship is closely held, discussed infra ¶ 4.04[3][b][v]. ¶ 2.02[3][c], text accompanying notes 69–82.


10 IRC § 2032A(a)(2). See infra ¶ 4.04[5], note 171, involving the measurement of the ceiling when discounts are taken.

Section 2032A, in effect, provides a conditional exemption. Viewed in this manner, the section runs counter to stated policy reasons for the enactment of the unified credit (IRC §§ 2010, 2505) to replace the specific exemptions (IRC §§ 2052, 2521), now re-
for inflation for the estates of decedents dying in a year after 1998.\footnote{11} Nor is the tax benefit derived from use of this section unconditional; tax avoided may be recaptured in whole or in part if the qualifying real property is disposed of or converted to a nonqualifying use.\footnote{12} Gaining the benefits provided by Section 2032A requires an election by the executor,\footnote{13} accompanied by a specified agreement.\footnote{14}

Much of the momentum for legislative action to repeal the estate tax\footnote{15} was generated by the appealing argument that there was a “need for tax relief for all decedents’ estates, decedents’ heirs, and businesses, including small businesses, family-owned businesses, and farming businesses…to provide…relief…from the unduly burdensome…taxes.”\footnote{16} This is not to say that such interests are not already provided special relief under the transfer tax structure. Section 6166 permits a deferral of payment of taxes on certain

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\begin{tabular}{lll}
Year of & Section 2032A valuation & Authority \\
decedent’s death & relief limitation & \\
2001 & 800,000 & Rev. Proc. 2001-13, 2001-1 CB 337, 341 \\
2003 & 840,000 & Rev. Proc. 2002-70, 2002-2 CB 845, 849 \\
2009 & 1,000,000 & Rev. Proc. 2008-66, 2008-2 CB 1107, 1113 \\
2010 & 1,000,000 & Rev. Proc. 2009-50, 2009-2 CB 845, 849 \\
2011 & 1,020,000 & Rev. Proc. 2010-40, 2010-2 CB 663, 849 \\
2012 & 1,040,000 & Rev. Proc. 2011-52, 2012-1 CB 701, 707 \\
2013 & 1,070,000 & Rev. Proc. 2012-41, 2012-2 CB 539, 541 \\
\end{tabular}

\footnote{12} IRC § 2032A(c). The recapture provisions of Section 2032A may cause a “lock-in” effect.

\footnote{13} IRC §§ 2032A(a)(1)(B), 2032A(d)(1). See infra ¶ 4.04[6].

\footnote{14} IRC §§ 2032A(a)(1)(B), 2032A(d)(2). See infra ¶ 4.04[6].

\footnote{15} IRC § 2210(a). See ¶ 8.10[1]. But see also ¶ 8.10[5].

closely held businesses. Section 2032A is also a relief provision that provides a reduction in valuation generally to the extent that the actual use valuation of property used by small businesses or in farming is less than the highest and best use valuation of such property. Regrettably, there is no uniform set of requirements that apply to both relief provisions and, even worse, the provisions are each very complicated with potentially complex and sometimes uncertain interrelationships. Thus, Congress, while lamenting the impact of the estate tax on small business, has itself contributed to the problem for small businesses by enacting relief provisions that are exceedingly complex, not properly coordinated, and, in an attempt to be targeted at only specific situations, probably too restrictive.

The details of this very intricate piece of legislation will be analyzed in the following paragraphs.

[2] Qualification for Special-Use Valuation in General

Elective special-use valuation is available for a limited amount of real property if both the decedent’s estate and the real property itself satisfy separate eligibility prerequisites.

A decedent’s estate qualifies for use of Section 2032A if the following three conditions are satisfied: (1) The estate must be that of a citizen or resident of the United States; (2) at least 50 percent of the adjusted value of the gross estate must consist of the adjusted value of real or personal property, used for a qualified use by the decedent or the decedent’s family on the date of the decedent’s death, which passes to a qualified heir; and (3) a minimum of 25 percent of the adjusted value of the gross estate must consist of the adjusted value of real property that passes to a qualified heir and that, for periods aggregating at least five years in the eight-year period immediately preceding the decedent’s death, was owned by the decedent or a member of the

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17 IRC §§ 2032A(g), 6616(b)(1); see ¶ 2.02[3][c], text accompanying notes 69–82.
19 See, e.g., ¶ 2.02[3][c][ii], discussing the qualification requirements for a Section 6166 extension.
20 IRC § 2032A(a)(1)(A).
21 IRC § 2032A(b)(1)(A). “Adjusted value” is discussed infra ¶ 4.04[3][b][i].
22 IRC § 2032A(b)(1)(A)(i). See IRC § 2032A(c)(2).
23 IRC § 2032A(b)(1)(A)(ii). See infra ¶ 4.04[3][b][ix].
decedent’s family and used for a qualified use generally involving material participation by the decedent or a member of the decedent’s family.\footnote{[24]} If the estate qualifies for Section 2032A valuation, the real property to be valued under that section must satisfy additional requirements in order to be denominated “qualified real property.” It must (1) be located in the United States\footnote{[25]}; (2) have been acquired from or have passed from the decedent to a qualified heir of the decedent\footnote{[26]}; (3) have been used on the date of the decedent’s death for a qualified use by the decedent or the decedent’s family\footnote{[27]}; (4) have been owned by the decedent or a member of the decedent’s family and used for a qualified use that required material participation by the decedent or a member of the decedent’s family generally for periods aggregating at least five years in the eight-year period immediately preceding the decedent’s death\footnote{[28]}; and (5) be designated in a written agreement signed by all persons having an interest in the property consenting to the potential imposition of a recapture tax.\footnote{[29]}

[3] Estate Qualification

[a] Citizens or Residents Only

The decedent must have been a citizen or resident of the United States at the time of death for the decedent’s estate to take advantage of Section 2032A. The usual means of acquiring status as a citizen of the United States is, of course, birth within this country. In other instances, the Immigration and Naturalization Act determines whether an individual is a citizen. Generally, a person is classified as a resident if the person lives in the United States with no definite intention of leaving.\footnote{[30]}

\footnote{[24]} IRC § 2032A(b)(1)(B). See IRC §§ 2032A(b)(1)(A)(ii), 2032A(b)(1)(C). See also IRC § 2032A(b)(4). The estate qualification requirements are discussed infra ¶ 4.04[3].

\footnote{[25]} IRC § 2032A(b)(1).

\footnote{[26]} IRC § 2032A(b)(1).

\footnote{[27]} IRC § 2032A(b)(1).

\footnote{[28]} IRC § 2032A(b)(1)(C). See also IRC § 2032A(b)(4).

\footnote{[29]} IRC §§ 2032A(b)(1)(D), 2032A(d)(2). The real property requirements are discussed infra ¶ 4.04[4].

\footnote{[30]} The questions of citizenship and residence are discussed in Chapter 6 in connection with the estate tax on nonresident noncitizens. IRC §§ 2101–2108. See ¶ 6.01[2]. See also IRC §§ 2208, 2209; ¶ 8.09.

Section 2032A
[b] The 50 Percent Test

For the decedent’s estate to qualify for special-use valuation, one half of the decedent’s estate must consist of assets devoted to a trade or business that is retained by the decedent’s family after the decedent’s death. Specifically stated, at least one half of the adjusted value of the gross estate must consist of the adjusted value of real or personal property meeting two requirements. The real or personal property must have been (1) used for a qualified use by the decedent or the decedent’s family on the date of the decedent’s death, and (2) acquired from or passed from the decedent to a qualified heir of the decedent.

[i] Adjusted value. The numerator of the fraction posited by the 50 percent test is the adjusted value of certain real and personal property. The denominator is the adjusted value of the gross estate. “Value” here means value on the applicable valuation date, determined without regard to Section 2032A, employing the usual valuation techniques to arrive at fair market value. “Adjusted value” is that value reduced by amounts allowable as deductions for unpaid mortgages and indebtedness under Section 2053(a)(4). The gross estate denominator is to be reduced by all amounts allowable under Section 2053(a)(4); and the value of each item of real or personal property in the numerator is to be reduced by amounts allowable with respect to the particular item.

These adjusted value determinations include any transfers within three years of death, even though the transferred property is excluded from the decedent’s gross estate. This prevents a decedent from qualifying the estate for Section 2032A valuation with near-death transfers of nonqualifying property. Near-death outright transfers of property not devoted to a qualified use reduce the decedent’s gross estate, thereby reducing the adjusted value of the gross estate.

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31 IRC § 2032A(b)(1)(A).
32 IRC § 2032A(b)(1)(A)(i).
33 IRC § 2032A(b)(1)(A)(ii).
35 IRC § 2032A(b)(3)(A). Generally, Section 2053(a)(4) allows a deduction for indebtedness for which the decedent’s estate is liable where payment of the indebtedness is secured by property included in the gross estate. The deduction allowable under Section 2053(a)(4), in addition to the principal sum due, includes any interest on the indebtedness accrued to the date of death. Reg. § 20.2053-7. For a discussion of IRC § 2053(a)(4), see ¶ 5.03[5].
36 IRC § 2032A(b)(3)(B).
38 See ¶ 4.07[2].
39 See IRC § 2035(a).
estate, the denominator of the fraction. Although possibly not contemplated by Congress, outright transfers within three years of death to qualified heirs of real or personal property devoted to a qualified use before and after the transfer will be included in both the numerator and the denominator of this fraction.40

[iii] Qualified use. Property has a “qualified use” if it is used as a farm for farming purposes41 or in a trade or business other than that of farming.42 There is no statutory prohibition against lumping farm and other trade or business property together for purposes of satisfying the 50 percent test.43 But the dichotomy between farm and nonfarm business may affect the method of valuing the property under Section 2032A.44

The question of whether the leasing of a farm constitutes a qualified use has arisen in several contexts.45 In general, if there is an element of risk to the owner, there is a qualified use. For example, if there is a percentage lease or a sharecropping arrangement, there is a qualified use46; however, generally a mere net cash rental is not a qualified use.47 Since qualified use can be made by either the decedent or a family member,48 a cash lease by the decedent to a

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40 A decedent’s near-death transfer to a qualified heir of property devoted to a qualified use should be considered acquired from or passed from the decedent. Section 2032A(e)(9)(A) defines property as acquired from or passed from a decedent if the property is so considered under Section 1014(b). Near-death transfers of property required to be included in the decedent’s gross estate by Section 2035 are considered acquired from the decedent under Section 1014(b)(9). See Reg. §§ 1.1014-2(b)(2), 1.1014-2(b)(3); Priv. Ltr. Rul. 8514032 (Jan. 8, 1985). Pretend inclusion under Section 2035(a) for purposes of Section 2032A results in pretend acquisition from the decedent under Section 1014(b).

41 IRC § 2032A(b)(2)(A).

42 IRC § 2032A(b)(2)(B).


44 See discussion of IRC §§ 2032A(e)(7), 2032A(e)(8) infra ¶ 4.04[5].

45 See infra ¶¶ 4.04[3][c], note 141, 4.04[7][b], text accompanying notes 283–288.

46 Schuneman v. United States, 783 F2d 694 (7th Cir. 1986) (leasing a farm property for a percentage of the farm’s production constituted a qualified use). See infra text accompanying note 68; cf. infra ¶ 4.04[7][b], text accompanying note 285.

47 Heffley v. Comm’r, 884 F2d 279 (7th Cir. 1989) (cash rental to an unrelated party did not constitute a qualified use); Brockmann v. Comm’r, 903 F2d 518 (7th Cir. 1990) (same); Estate of Abell v. Comm’r, 83 TC 696 (1984) (same); Bruch v. United States, 86-2 USTC ¶ 13,692 (ND Ind. 1986) (same).

family member who makes a qualified use of the property will qualify the property for Section 2032A valuation.

[iii] Farm and farming. The term “farm” encompasses a very wide range of agricultural and horticultural pursuits. It is defined to include plantations, ranches, nurseries, ranges, orchards, and woodlands. Greenhouses or other similar structures used primarily to raise agricultural or horticultural commodities are classified as farms. Various types of farms specifically included within the definition are stock, dairy, poultry, fruit, and truck farms as well as fur-bearing-animal farms.

The term “farming purposes” is broadly defined in the statute. It encompasses cultivating the soil and raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, training, care, and management of animals) on a farm. Property used for farming purposes includes property used for “handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state,” if the owner, operator, or tenant regularly produces more than one half of the commodity so treated. If more than one half of the commodity so treated is produced by others, the property will be considered to be used in a trade or business other than farming, which is considered a qualified use, and will still aid in satisfying the 50 percent test. Farming purposes also include the planting, cultivating, care, or cutting of trees, or the preparation of trees for market, excluding milling. However, property devoted to the milling of trees

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50 IRC § 2032A(e)(4).
51 IRC § 2032A(e)(4).
52 IRC § 2032A(e)(4).
53 IRC § 2032A(e)(5). Participation in “Payment-in-Kind” and other related land diversion programs offered to farmers by the Department of Agriculture will not have an adverse effect on qualifying for or maintaining Section 2032A treatment for either the owner decedent or the qualified heir. Ann. 83-43, 1983-10 IRB 29 (Mar. 7, 1983); cf. TAM 9212001 (Mar. 20, 1992).
54 IRC § 2032A(e)(5)(A).
55 IRC § 2032A(e)(5)(B).
56 IRC § 2032A(e)(5)(B).
57 IRC § 2032A(e)(5)(C)(i); Estate of Holmes v. Comm’r, 62 TCM (CCH) 839 (1991) (test not met).
58 IRC § 2032A(e)(5)(C)(ii).

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should constitute property used in a trade or business other than farming, a qualified use.\(^{59}\)

**[iv] Other business use.** The term “trade or business” is not defined in Section 2032A or any other place in the Internal Revenue Code (the Code). What amounts to trade or business use within the meaning of Section 2032A(b)(2)(B) is not determined by reference to a broad concept of “business,” a case law definition for purposes of deductions under Section 162\(^{60}\) or Section 167, or provisions in the regulations under Section 513.\(^{61}\) Past struggles with the trade or business concept may be of little guidance.

The term as used in this section applies only to active businesses, not passive investment activities.\(^{62}\) Maintaining an office and regular hours for the management of income-producing property does not necessarily constitute a trade or business under Section 2032A.\(^{63}\) Mere passive rental of land constitutes a passive investment and not an active trade or business.\(^{64}\) An activity not engaged in for profit is not a trade or business.\(^{65}\)

**[v] Indirect ownership and use.** The 50 percent test may be satisfied by property in a business indirectly held in a partnership, trust, estate, or corporation. If the business is such that the decedent’s relation to it constitutes an interest in a closely held business as defined in Section 6166(b)(1), regulations

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\(^{59}\) The only difference ultimately is the restriction on choice of methods of valuation of the real property contained in Sections 2032A(e)(7) and 2032A(e)(8).

\(^{60}\) Reg. § 20.2032A-3(b).

\(^{61}\) A definition of “trade or business” is contained in Regulations Section 1.513-1(b), regarding unrelated trade or business of certain exempt organizations.

\(^{62}\) Reg. § 20.2032A-3(b).

\(^{63}\) Reg. § 20.2032A-3(b).

\(^{64}\) Estate of Trueman v. United States, 6 Cl. Ct. 380 (1984); Estate of Abell v. Comm’r, 83 TC 696 (1984); Sherrod Estate v. Comm’r, 774 F2d 1057 (11th Cir. 1985) (rental land was not qualified even though rental income from the land was used to pay taxes on contiguous active business land). But see Priv. Ltr. Rul. 8516012 (Dec. 28, 1984). Query whether rental to an unrelated third person for a percentage of profits constitutes a qualified use under Regulations Section 20.2032A-3(b).

\(^{65}\) IRC § 2032A(g). A closely held business within the meaning of Section 6166(b) includes an interest in a partnership with forty-five (fifteen prior to 2002) or fewer partners or one in which 20 percent or more of the capital interest is included in determining the gross estate of the decedent or a corporation with forty-five (fifteen prior to 2002) or fewer shareholders or one in which at least 20 percent of the voting stock is included in the decedent’s gross estate. See ¶ 2.02[3][c], text accompanying notes 69–82.

Beneficial ownership of trust property is treated as constituting an interest in a closely held business as defined in Section 6166(b)(1) if the requirements of Section 6166(b)(1)(C) would be satisfied if the property were owned by a corporation and all beneficiaries having vested interests in the trust were shareholders in the corporation. See Reg. § 20.2032A-3(d). Beneficial ownership of estate property is treated like trust prop-
are to indicate how Section 2032A is to be applied.\(^{67}\) Property owned by a decedent that is leased to a partnership, corporation, or trust may qualify for valuation under Section 2032A and the numerator of the 50 percent test if, at death, the decedent’s interest in the lessee qualifies as an interest in a closely held business as defined in Section 6166(b)(1).\(^{68}\) Real property leased to a farming corporation owned and operated by the decedent and the decedent’s child is eligible for the numerator of the 50 percent test.\(^{69}\)

The statute states that the property must be used for a qualified use by the decedent or a member of the decedent’s family on the date of the decedent’s death.\(^{70}\) The statute does not preclude including in the numerator the value of property located outside the United States but included in the decedent’s gross estate that at death is used for a qualified use by the decedent or a member of

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\(^{67}\) The Secretary had indicated that the decedent’s interest in a business “must, in addition to meeting the tests for qualification under section 2032A, qualify under the tests of section 6166(b)(1) as an interest in a closely held business on the date of the decedent’s death and for sufficient other time (combined with periods of direct ownership) to equal at least 5 years of the 8-year period preceding the death.” Reg. § 20.2032A-3(b). This statement in the regulation raises an issue whether an interest in a closely held partnership, trust, or corporation must qualify under the tests of Section 6166(b)(1) combined with periods of direct ownership for at least five years of the eight-year period preceding death to be considered in the numerator of the 50 percent test. This issue should be answered in the negative to prevent unfair discrimination against indirectly owned business property. The five-out-of-eight-year test should be applied only where that test is generally applied in Section 2032A.

\(^{68}\) Reg. § 20.2032A-3(b). This regulation section provides that to be “qualified real property,” the decedent’s interest in the partnership, trust, or corporation must qualify as an interest in a closely held business under Section 6166(b)(1) on the date of the decedent’s death and “for sufficient other time (combined with periods of direct ownership) to equal at least five years of the eight-year period preceding the death.” Cf. Minter v. United States, 19 F3d 426 (8th Cir. 1994) (the Section 6166(b)(1) test was applied to post-death leasing). The five-out-of-eight-year test should not be a prerequisite for the inclusion of the decedent’s interest in a closely held business in the numerator of the 50 percent test. The 50 percent test deals with the determination of an estate’s qualification, not whether an interest in a closely held business is qualified real property.

\(^{69}\) Reg. § 20.2032A-3(b). Unresolved and left for further consideration by the Secretary pursuant to Section 2032A(g) is the question of participation in a closely held business by a decedent and nonfamily members. It is idle to speculate on the requirements that will have to be met, under the broad grant of authority to promulgate regulations, for property devoted indirectly to a qualified use to qualify for consideration under Section 2032A.

\(^{70}\) IRC § 2032A(b)(1)(A)(i).
the decedent’s family, if the property passes to a qualified heir.\(^{71}\) The question considered here is satisfaction of the 50 percent estate eligibility test, not ultimate valuation of a particular parcel of real property under Section 2032A. There is, generally speaking, no requirement that property, real or personal, entering into the numerator be held by the decedent or a member of the decedent’s family for any length of time.\(^{72}\) The only requirement is that the property be used for a qualified use by the decedent or a member of the decedent’s family on the date of the decedent’s death.

[vi] **Nature of use.** Real property devoted to a qualified use includes roads, buildings, and other structures and improvements functionally related to the qualified use.\(^{73}\) Elements of value that are not functionally related to the qualified use are not to be taken into account. For example, the legislative history identifies mineral rights as an element of value not to be taken into account in the valuation of qualified-use property.\(^{74}\)

Residential buildings and related improvements are classified as real property used for a qualified use if the following three requirements are satisfied by such property:  
(1) The residential building and related improvements must be located on or contiguous to\(^{76}\) qualified real property\(^{77}\); (2) the real property on which the structures are located, for periods aggregating five years in the eight-year period immediately preceding the decedent’s death, must have (a) been owned by the decedent or a member of the decedent’s family, (b) been used for a qualified use by the decedent or a member of the decedent’s family, and (c) generally involved material participation by the decedent or a member

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\(^{71}\) This is so even though only real property located in the United States may ultimately qualify for valuation under Section 2032A.

\(^{72}\) The one exception to this rule is residential buildings and related improvements, which may be treated as used for a qualified use. See IRC § 2032A(e)(3), discussed infra ¶ 4.04[3][b][vi].

\(^{73}\) IRC § 2032A(e)(3). See Reg. § 2032A-3(b)(2).

\(^{74}\) HR Rep. No. 1380, 94th Cong., 2d Sess. 3, 24 (1976), reprinted in 1976-3 CB (Vol. 3) 735, 758. See also Sherrod Estate v. Comm’r, 774 F2d 1057 (11th Cir. 1985); TAM 9443003 (Oct. 28, 1994).

\(^{75}\) Residential buildings qualify under either qualified use, use as a farm for farming purposes, or use in a trade or a business other than farming, if the qualifications specified are satisfied. Compare the language of Section 2032A(e)(3) with that of Section 6166(b)(3).

\(^{76}\) The legislative history states that “residential buildings or related improvements shall be treated as being on the qualified real property if they are on real property which is contiguous with qualified real property or would be contiguous with such property except for the interposition of a road, street, railroad, stream, or similar property.” HR Rep. No. 1380, 94th Cong., 2d Sess. 3, 24 (1976), reprinted in 1976-3 CB (Vol. 3) 735, 758.

\(^{77}\) IRC § 2032A(e)(3). See Reg. § 2032A-3(b)(2).
of the decedent’s family; and (3) the residential or other structures must have been occupied on a regular basis by the owner or lessee, or employee of either, for the purpose of operating or maintaining real property used for farming or in another trade or business.

Tangible personal property devoted to a qualified use is included in the numerator of the 50 percent estate qualification test. Personal property as used in Section 2032A(b)(1)(A) may also include intangible personal property, such as goodwill, devoted to a qualified use. An important question is whether inventory held for sale or consumption in connection with a qualified use is to be treated as personal property devoted to a qualified use. Treatment of inventories as personal property devoted to a qualified use would simplify and aid estate qualification. Business capital invested in inventories represents capital committed to a qualified use. It should be noted that the personal property itself will not qualify for special-use valuation; it is merely a factor in the 50 percent estate qualification test. Similarly, working capital used in the activity is counted in the 50 percent measurement.

The value of real property used as a farm for farming purposes includes the value of trees and vines on the property. An unanswered question is whether growing crops are to be considered as property used as a farm for farming purposes. Unharvested crops on land used in a trade or business are artificially defined as property used in a trade or business for income tax purposes if certain requirements are met under Section 1231(b)(4). Exclusion of the value of growing crops from the numerator of the 50 percent estate qualification test would work to preclude estate qualification, rather than being merely a neutral factor. It seems reasonable to suggest that growing crops ought to be treated as property used for qualified use. A further question whether a growing crop on real property may ever be valued as real property devoted to a qualified use has been answered affirmatively in at least one instance. Trees growing on qualified woodland are not treated as a crop and

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78 IRC § 2032A(e)(3). See IRC § 2032A(b)(1)(C). See also IRC §§ 2032A(b)(4), 2032A(b)(5).
79 IRC § 2032A(e)(3). As a practitioner becomes submerged in the intricacies of Section 2032A, one may begin to wonder whether the game is worth the candle.
81 But see Watson v. Comm’r, 345 US 544 (1953).
82 IRC § 2032A(e)(13).
may be valued as real property devoted to a qualified use. Generally, however, growing crops are not treated as qualified real property.

[vii] **Member of the family.** Real and personal property entering the numerator of the 50 percent test must be used for a qualified use by the decedent or a member of the decedent’s family. The decedent’s family includes only the decedent’s ancestors, spouse, and lineal descendants as well as the lineal descendants of the decedent’s parents and spouse and the spouses of all those lineal descendants. Legally adopted children are treated as children by blood.

[viii] **Acquired from the decedent.** The 50 percent test speaks of property “acquired from or passed from the decedent,” not a new phrase to those familiar with Section 1014(b) concerning income tax basis. Property is considered to be acquired from or passed from the decedent for purposes of Section 2032A if it would be so treated under Section 1014(b). Property acquired by inheritance, bequest, devise, or as a result of a qualified disclaimer, as well as property transferred inter vivos but included in the gross estate by reason of death, form of ownership, or through the exercise or nonexercise of a power of appointment, is considered property acquired from the decedent. Property acquired from the decedent includes property acquired from the decedent’s estate as well as from a trust to the extent that the trust assets are included in

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83 See infra ¶ 4.04[3][c].
85 IRC § 2032A(b)(1)(A)(i).
86 While the legislative history indicates that the ancestral chain does not extend any further than the decedent’s parents, HR Conf. Rep. No. 215, 97th Cong., 1st Sess. 253 (1981), reprinted in 1981-2 CB 481, 510, the statutory language employed is not so limited.
87 IRC § 2032A(e)(2).
88 IRC § 2032A(e)(9)(A).
89 Rev. Rul. 82-140, 1982-2 CB 208. See ¶ 10.07.
90 Whether real property is qualified is determined at the time of the decedent’s death, and a transfer preceding death might disqualify the property.
An interesting question will arise if property transferred inter vivos to a qualified heir, but required to be included in the decedent’s gross estate, is transferred by that qualified heir to a family member prior to the decedent’s death. If gross estate property devoted to a qualified use upon the date of the decedent’s death was, before death, transferred to another qualified heir by the decedent’s donee (who was also a qualified heir), the question whether the property was acquired by the second qualified heir from the decedent arises. Strictly speaking, the second qualified heir did not acquire the property from the decedent. However, after death, a qualified heir may dispose of an interest in qualified real property to any member of the qualified heir’s family who thereafter is treated as the qualified heir. IRC § 2032A(e)(1).
91 IRC § 2032A(e)(9)(B).
the decedent’s gross estate. Property acquired from the decedent’s estate includes property purchased from the estate, whether under an option granted by the decedent or upon a sale by the personal representative, as well as property acquired in satisfaction of a right to a pecuniary bequest.

Property may be acquired or passed from the decedent outright or in trust. The regulations provide that if qualified property passes in successive interests (e.g., life estates and remainder interests), an election under Section 2032A is available only with respect to property (or a portion of property) in which qualified heirs receive all such successive interests. For example, the Service would contend that if a decedent established a trust with income to a child for life, remainder to other family members, and the child also was granted a nongeneral power of appointment, the remainder interest would not be treated as passing to a qualified heir if the child could exercise the power in favor of a nonfamily member, thereby divesting the other family members of their interests.

The courts have not always agreed with the Service and have held the Treasury regulation invalid where a trust has a remote contingent charitable beneficiary and where grandchildren holding life estates after life estates in their parents hold special powers to appoint to nonqualified heirs, or in a combination of such situations. The holdings are in keeping with the pol-

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92 IRC § 2032A(c)(9)(C).
95 See Reg. § 20.2032A-8(a)(2). The possibility of divestment in favor of a nonfamily member may be eliminated by a qualified disclaimer of the nongeneral power of appointment. Rev. Rul. 82-140, 1982-2 CB 208. See infra ¶ 4.04[7][a], note 263.
96 Estate of Davis v. Comm’r, 86 TC 1180 (1986); Estate of Pliske v. Comm’r, 51 TCM (CCH) 1543 (1986).
97 Estate of Clinard v. Comm’r, 86 TC 1180 (1986); Estate of Smoot v. Comm’r, 892 F2d 597 (7th Cir. 1989).
98 Estate of Thompson v. Comm’r, 864 F2d 1128 (4th Cir. 1989).
icy of Section 2032A, and the regulations should be amended to allow other than qualified heirs to hold remote contingent interests in such trusts.100

[ix] **Qualified heirs.** A qualified heir is a member of the decedent’s family who acquired property from, or to whom property passed from, the decedent.101 For this purpose, the decedent’s “family” includes only ancestors, spouse, and lineal descendants, as well as the lineal descendants of parents,

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It once appeared that a qualified heir must also hold a present interest in the trust. See IRC § 2032A(g), last sentence. See also Priv. Ltr. Rul. 8532007 (Apr. 22, 1985); Priv. Ltr. Rul. 8244001 (Jan. 14, 1982). That requirement does not appear in the Code and has been eliminated in the regulations.

The present interest requirement for property to have passed from the decedent has had an interesting history. It first appeared in the Conference Committee Report accompanying the Tax Reform Act of 1976: “Trust property shall be deemed to have passed from the decedent to a qualified heir to the extent that the qualified heir has a present interest in that trust property.” HR Rep. No. 1515, 94th Cong., 2d Sess. 610 (1976), reprinted in 1976-3 CB (Vol. 3) 807, 960 (emphasis added). The regulations initially promulgated for Section 2032A mentioned the present interest requirement. Reg. §§ 20.2032A-3(b), 20.2032A-8(a)(2).

The Report of the House Committee on Ways and Means, dated July 24, 1981, on the Economic Recovery Tax Act of 1981 acknowledges the present interest requirement in Regulations Section 20.2032A-3(b), HR Rep. No. 201, 97th Cong., 1st Sess. 38, 166 n.8 (1981), reprinted in 1981-2 CB 352, 380, and discusses the purpose of a statutory amendment to the present interest rule that treats property passing to a discretionary trust as qualifying for Section 2032A valuation if all beneficiaries of the trust are qualified heirs even though no beneficiary has a present interest under Section 2503 because of the trustee’s discretion. Id. at 176, 1981-2 CB at 385. The Conference Committee Report dated August 1, 1981, merely restates the position set forth in the House Report and acknowledges that the conference agreement follows the House bill. HR Conf. Rep. No. 215, 97th Cong., 1st Sess. 252–253 (1981), reprinted in 1981-2 CB 481, 510. The 1981 statutory amendment clearly anticipating the present interest rule was the addition of the last sentence in Section 2032A(g) that was signed into law August 13, 1981.

On August 26, 1981, TD 7786, final IRS regulations on Special Use Valuation of Farms and Closely Held Business Real Estate for Federal Estate Tax Purposes, was published. The regulations after this amendment were devoid of any direct reference to the present interest rule and Section 2503. Indirect reference was present in Regulations Section 20.2032A-8(d)(2), now repealed. It appears that the present interest rule, now not directly referred to in the Code or regulations, no longer exists. If the present interest requirement for property passing as first espoused in the Conference Committee Report on the Tax Reform Act of 1976 were to remain, it ought to be put in the statute or at the very least be clearly presented in the regulations so as not to present a trap for the unwary.

101 IRC § 2032A(e)(1).
spouse, and spouses of all lineal descendants.\textsuperscript{102} Adopted children are treated as children by blood.\textsuperscript{103}

[c] The 25 Percent Test

Seeking still to determine an estate’s qualification for use of Section 2032A, the third hurdle is the 25 percent test. Twenty-five percent or more of the adjusted value of the gross estate must consist of the adjusted value of real property that was acquired from a decedent by a family member or passed from the decedent to a family member and that, generally for periods aggregating at least five years in the eight-year period ending with the decedent’s death, was owned and used for a qualified use involving material participation by the decedent or a member of the decedent’s family.\textsuperscript{104} Only real property enters the numerator of the 25 percent test, but the adjusted value of personal property is a part of the adjusted value of the gross estate, the denominator, just as it is in the 50 percent test. There is no statutory prohibition against the use of foreign real property to satisfy the 25 percent estate qualification requirement.\textsuperscript{105}

Growing crops are generally not treated as part of the real property and are thus not included in the numerator of the 25 percent test.\textsuperscript{106} The executor may, however, irrevocably elect\textsuperscript{107} to treat trees growing on qualified woodland\textsuperscript{108} as real property and add their value to the numerator of the 25 percent test.

\textsuperscript{102} A widow or widower of a lineal descendant of the decedent is a qualified heir. Rev. Rul. 81-236, 1981-2 CB 172; Priv. Ltr. Rul. 8412014 (Dec. 2, 1983). A grandniece of the decedent’s spouse is not within the term “family” and thus is not a qualified heir. Estate of Cowser v. Comm’r, 736 F2d 1168 (7th Cir. 1984). Nor is a lineal descendant of decedent’s spouse’s parents. Estate of Cone v. Comm’r, 60 TCM (CCH) 137 (1990).


\textsuperscript{104} IRC § 2032A(b)(1)(B). See Finfrock v. United States, 109 AFTR2d 1439 (DC Ill. 2012) and Miller v. United States, 88-1 USTC ¶ 13,757 (CD Ill. 1988), both holding Regulations Section 20.2032A-8(a)(2) invalid in requiring the estate to elect special-use valuation with respect to 25 percent of the adjusted value of the gross estate. The statute merely requires that such property make up 25 percent of the adjusted value of the gross estate. See IRC §§ 2032A(b)(1)(A)(ii), 2032A(b)(1)(C); see also IRC §§ 2032A(b)(4), 2032A(b)(5).

\textsuperscript{105} See supra ¶ 4.04[3][b], text accompanying note 71.

\textsuperscript{106} See supra ¶ 4.04[3][b], text accompanying note 84.

\textsuperscript{107} IRC § 2032A(e)(13)(D). This election is made on the federal estate tax return.

\textsuperscript{108} IRC § 2032A(e)(13)(B). Qualified woodland is an identifiable area of land for which records are maintained and that is used in timber operations. IRC §§ 2032A(e)(13)(B), 2032A(e)(13)(C).

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The term “adjusted value,” whether modifying real property or the gross estate, has the same meaning here as in the 50 percent test.\textsuperscript{109} Similarly, the requirement that real property entering into the computation of the numerator of the 25 percent test must have been acquired or passed from the decedent to a member of the decedent’s family presents concepts previously considered.\textsuperscript{110} In general, at least one fourth of the estate must consist of real property passing from the decedent to the decedent’s family members.\textsuperscript{111}

[i] Ownership and use requirements. Real property that enters into the numerator of the 25 percent test must have been owned and used as a farm for farming purposes, or in a trade or business other than farming, by the decedent or a family member generally for periods aggregating at least five years in the eight-year period ending on the decedent’s death.\textsuperscript{112} The ownership and devotion to a qualified use need not have been continuous; ownership and devotion to qualified use by any combination of the decedent, members of the decedent’s family, and qualified closely held businesses\textsuperscript{113} must merely aggregate five years in the critical eight-year period. However, only periods during which both the required ownership and the required use coincide may be aggregated. Moreover, the real property need not have been used for a qualified use on the date of the decedent’s death, as is required of property entering into the numerator of the 50 percent test. However, qualifying improvements must have

\textsuperscript{109} “Adjusted value” is discussed supra ¶ 4.04[3][b][i]. Allocation problems will undoubtedly arise in determining the adjusted value of real property when a single indebtedness is secured by a group of assets. The indebtedness should be apportioned to the various assets securing payment on a pro rata basis using the fair market value of each asset.

\textsuperscript{110} See supra ¶¶ 4.04[3][b][vii], 4.04[3][b][viii].

\textsuperscript{111} Real property used as a farm and real property in another trade or business may be combined to satisfy the 25 percent test. Rev. Rul. 85-168, 1985-2 CB 197.

\textsuperscript{112} The liberalization of the period during which material participation is required (IRC § 2032A(b)(1)(C)(ii)), by a retired or disabled decedent (IRC § 2032A(b)(4)(A)), does not apply to the time period required for ownership and use of the real property by the decedent or a member of the decedent’s family (IRC § 2032A(b)(1)(C)(i)), which is incorporated into the 25 percent test of Section 2032A(b)(1)(B).

\textsuperscript{113} Property transferred to a corporation or partnership is considered continuously owned to the extent of the decedent’s equity interest if the transfer met the requirements of Section 351 or Section 721 and if the decedent’s interest in this business qualifies under Section 6166(b)(1) as an interest in a closely held business. See supra ¶ 4.04[3][b], note 66. Property transferred to a trust is considered continuously owned if, treating all the beneficiaries having vested interests in the trust as shareholders of a corporation, the requirements of Section 6166(b)(1)(C) would be met. Any period during which the decedent’s interest in the corporation, partnership, or trust does not meet the requirements of Section 6166(b)(1) is not counted toward satisfying the five-out-of-eight-years ownership requirement. Reg. § 20.2032A-3(d).
been made at least five years prior to the date of the decedent’s death to satisfy the five-year ownership requirement.\textsuperscript{114}

Generally, periods of ownership and qualified use of real property acquired in a like-kind exchange under Section 1031 or after an involuntary conversion under Section 1033 may be tacked on to periods of ownership and qualified use of the real property exchanged or converted.\textsuperscript{115} Tacking is available if the use of the replacement property\textsuperscript{116} and the replaced property\textsuperscript{117} is the same,\textsuperscript{118} and then only to the extent that the fair market value of the replacement property, on the date of acquisition, does not exceed the fair market value of the replaced property on the date of disposition.\textsuperscript{119}

[ii] \textbf{Material participation.} The real property entering into the computation of the numerator must have been devoted for five years to a qualified use involving material participation by the decedent or a member of the decedent’s family.\textsuperscript{120} Contemporaneous material participation by the decedent and one or more family members during any year will not satisfy more than one year of the five-year requirement.\textsuperscript{121} Brief absence from the farm or other business during periods requiring material participation will be disregarded in ascertaining the five aggregate years if preceded by and followed by substantial periods of uninterrupted material participation.\textsuperscript{122} Generally, the periods of material participation aggregating five years must be in the eight-year period ending with the date of the decedent’s death.\textsuperscript{123} However, if this requirement cannot be met with respect to the decedent, the eight-year period ends on the earlier

\textsuperscript{114}Possibly, real property devoted to a variety of qualified uses for periods no one of which aggregates five years will be considered in the composition of the numerator of the 25 percent test. For example, if a decedent owned a parcel of real property for the entire eight-year period preceding death, and for four years the land was devoted to use as a farm for farming purposes and for the four years thereafter the land was used as a golf course—a trade or business other than farming—it can be argued that the land, if otherwise qualifying, satisfies the five-year requirement. Neither the statute nor the legislative history indicates that the real property is required to have a single use for the required five-year period.

\textsuperscript{115}IRC § 2032A(e)(14).

\textsuperscript{116}IRC § 2032A(e)(14)(C)(i).

\textsuperscript{117}IRC § 2032A(e)(14)(C)(ii).

\textsuperscript{118}IRC § 2032A(e)(14)(C).

\textsuperscript{119}IRC § 2032A(e)(14)(B).

\textsuperscript{120}Activities of a member of the decedent’s family are considered only if the requisite relationship existed at the time the activities occurred. Reg. § 20.2032A-3(c)(1). The material participation requirement cannot be satisfied with a marriage after the fact. A marriage of convenience would have to last at least five years.

\textsuperscript{121}Reg. § 20.2032A-3(c)(2).

\textsuperscript{122}Regulations Section 20.2032A-3(c)(2) suggests a brief period of absence as 30 days or less and a substantial period of material participation as 120 days or more.

\textsuperscript{123}IRC § 2032A(b)(1)(C).
of the date of disability or the date that old-age Social Security benefits commenced if the disability or benefits were continuous until the decedent’s death.\[124\] A disability is a physical or mental impairment preventing material participation by the decedent.\[125\]

The decedent or a member of the decedent’s family is not required to have carried on the business, just to have materially participated.\[126\] The required material participation is to be determined in a manner similar to that used in Section 1402(a)(1), relating to net earnings from self-employment.\[127\] Active management by a surviving spouse may be treated as material participation.\[128\]

Section 1402(a)(1) deals essentially with the determination of material participation in the production of agricultural or horticultural commodities. However, for purposes of Section 2032A, these same rules are to be applied to determine material participation by the decedent or a member of the decedent’s family in a trade or business other than farming. Generally, under Section 1402(a)(1), which Congress uses by analogy, material participation results where there is actual participation in the production or the management of pro-

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\[124\] IRC § 2032A(b)(4)(A). This provision was designed to alleviate inequities resulting from the requirement that the decedent or a member of the decedent’s family must materially participate in the farm or other business for periods aggregating five years of the eight years immediately preceding the decedent’s death. If the decedent was receiving Social Security benefits and materially participated in the farm, any income derived from the farm was treated as earned income for Social Security purposes, resulting in the potential for reduced Social Security benefits. The interaction of these two rules forced some people to choose between receiving Social Security benefits and obtaining special-use valuation for their estates.

While this provision itself would go far to rectify the inequity, Congress at the same time modified the qualified-use provision. In order to constitute “qualified real property,” the real property must, on the date of the decedent’s death, have been used for a qualified use by the decedent or a member of the decedent’s family. IRC § 2032A(b)(1); Bruch v. United States, 86-2 USTC ¶ 13,692 (ND Ind. 1986). There is no exception to this requirement, even if the decedent is retired or disabled on the date of death. Therefore, the question becomes whether it is ever possible to have the requisite use at the date of death without having at the same time material participation.

\[125\] IRC § 2032A(b)(4)(B).


\[127\] IRC § 2032A(e)(6). The material participation test is similar but not identical to the material participation test under income tax Section 469. See S. Rep. No. 313, 99th Cong., 2d Sess. 732 (1986), reprinted in 1986-3 CB (Vol. 3) 1, 732. Cf. TAM 9428002 (July 15, 1994) (treatment of an activity as a passive activity under Section 469 is a significant factor in determining material participation under Section 2032A).


\[128\] IRC § 2032A(b)(5). This subsection is discussed infra text accompanying note 144.
duction of agricultural or horticultural commodities, or a combination of both, that is material with respect to either or both combined.

“Production” refers to the physical work performed and the expenses incurred in producing an agricultural or horticultural commodity or goods or services in a trade or business other than farming. Production of farm commodities includes such activities as the actual work of planting, cultivating, and harvesting of crops and the furnishing of machinery, implements, seed, and livestock. An individual is treated as materially participating in the production if the individual engages to a material degree in the physical work related to production of the commodity produced or the goods and services rendered. Furnishing machinery, equipment, and livestock or paying expenses is not in and of itself sufficient to constitute material participation, but such activities combined with some physical labor, even only to a nonmaterial degree, may constitute material participation when the undertaking to furnish capital is substantial in relation to the total amount of capital required for the production of the commodity or the goods and services in a business. Although no single factor is determinative, doing physical work and participating in management decisions are the principal factors to be considered.

“Management of production” refers to deciding the what, how, when, and where of the productive output of a trade or business. The services rendered must be engaged in to a material degree to result in material participation. To qualify, the activity generally must involve not only planning but continued activity throughout production, such as inspection of the production activities and ongoing, periodic consultation in the production process.

Direct involvement in the operation of a directly owned farm or other business on substantially a full-time basis by the decedent or the decedent’s family constitutes material participation. Activities of agents or employees who are not family members do not count in the determination of whether there has been the requisite material participation. Direct participation that is less than full-time but sufficient to fully manage the farm or other business

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129 IRC § 1402(a)(1).
130 Reg. § 1.1402(a)-4.
131 Reg. § 1.1402(a)-4(b)(3)(ii).
132 See Reg. § 20.2032A-3(e)(2). Compare Mangels v. United States, 828 F2d 1324 (8th Cir. 1987) (material participation); Estate of Sherrod v. Comm’r, 82 TC 523 (1984), reversed on other grounds, 774 F2d 1057 (11th Cir. 1985), cert. denied, 479 US 814 (1986) (material participation); Estate of Heffly v. Comm’r, 884 F2d 279 (7th Cir. 1989) (no material participation); Brockman v. Comm’r, 903 F2d 518 (7th Cir. 1990) (no material participation).
133 Reg. § 1.1402(a)-4(b)(3)(iii).
134 See Reg. § 20.2032A-3(e)(2).
135 Regulations Section 20.2032A-3(e)(1) indicates that thirty-five hours or more a week will be considered substantially full time.
also constitutes material participation.\textsuperscript{136} A person performing all functions necessary to the operation of a directly owned farm requiring only seasonal activity participates materially, even though there is little activity other than in the producing season.

If the decedent or a member of the decedent’s family is self-employed, the material participation test is met if earnings generated by the farm or other business are earned income for self-employment tax purposes. If no self-employment taxes have been paid, material participation is presumed not to have occurred.\textsuperscript{137} If it is established that material participation did occur but no self-employment tax was paid, the self-employment tax due plus penalties and interest must be paid in order to qualify for Section 2032A valuation.\textsuperscript{138}

If the property is directly owned but used by a nonfamily member, trust, or other business entity, less than full-time involvement must be pursuant to an arrangement, oral or written, capable of proof, providing for material participation and specifying the services to be performed.\textsuperscript{139} This requirement also applies to property indirectly owned, even if there is full-time involvement.\textsuperscript{140} For example, if the property to be valued pursuant to Section 2032A is owned by a trust, the requisite arrangement providing for material participation may result from appointment as trustee, an employer-employee relationship, a management contract, or the trust instrument expressly granting management rights.\textsuperscript{141}

[iii] Active management. Active management will satisfy the requirement of material participation in one particular instance. If a surviving spouse acquires from the decedent real property that would have been eligible for special-use valuation\textsuperscript{142} and such real property is then included in the estate of the

\textsuperscript{136} Reg. § 20.2032A-3(e)(1).

\textsuperscript{137} Reg. § 20.2032A-3(e)(1). Payment of self-employment tax does not, however, establish material participation.

\textsuperscript{138} Reg. § 20.2032A-3(e)(1). See Rev. Rul. 83-32, 1983-1 CB 226, so holding but also holding that there is an exception where assessment is barred by the statute of limitations.

\textsuperscript{139} Reg. §§ 20.2032A-3(e)(1), 20.2032A-3(g), Ex. 1.

\textsuperscript{140} Reg. §§ 20.2032A-3(f)(1), 20.2032A-3(g), Ex. 5.

\textsuperscript{141} Reg. § 20.2032A-3(f)(1).

\textsuperscript{142} Special-use valuation need not have been elected by the first decedent’s estate, but the real property must have been eligible for special-use valuation had the election been made and the agreement filed. IRC § 2032A(b)(5)(B).
surviving spouse, active management of the farm or other business by the sur-

Active management is the making of management decisions of a business other than the daily operating decisions. Active management occurs is a factual determination, but it is not dependent upon the surviving spouse’s payment of self-employment tax under Section 1401. Farming activities that may constitute active management include “inspecting growing crops, reviewing and approving annual crop plans in advance of planting, making a substan-

tial number of the management decisions of the business operation, and approving expenditures for other than nominal operating expenses in advance of the time the amounts are expended.” Management decisions include “what crops to plant or how many cattle to raise, what fields to leave fallow, where and when to market crops and other business products, how to finance business operations, and what capital expenditures the trade or business should make.”

143 Whereas the material participation requirement may be satisfied by either the de-
cedent or a member of the decedent’s family, active management will be treated as material participation only if the surviving spouse personally undertakes the active management. That is, active management by a member of the surviving spouse’s family will not be deemed material participation. See IRC §§ 2032A(b)(1)(C)(ii), 2032A(b)(5)(A).

A net cash lease by the surviving spouse or a lineal descendant of a decedent to a member of the spouse’s or descendant’s family will not result in a recapture of the deecedent’s Section 2032A tax saving. See IRC § 2032A(c)(7)(E); infra ¶ 4.04[7][b], text accompanying notes 287, 288. Seemingly, in such a situation, the family member will satisfy both the qualified use and material participation tests to qualify the surviving spouse’s or the lineal descendant’s estate for a Section 2032A election. See IRC §§ 2032A(b)(1)(A)(i), 2032A(b)(1)(C)(i).

144 IRC § 2032A(b)(5)(A). If the first decedent was retired or disabled on the date of the decedent’s death, both Sections 2032A(b)(4) and 2032A(b)(5) may be applied. This, in effect, tolls the time period during which the first decedent was receiving Social Security benefits. The surviving spouse is given the benefit of satisfying the five-out-of-eight-year required material participation rule by combining the spouse’s years of active management after the first decedent’s death with the first decedent’s years of material participation before becoming retired or disabled. IRC § 2032A(b)(5)(C).

145 IRC § 2032A(e)(12).


Section 2032A
[d] Estates Involving Community Property

Estates of decedents owning qualified real property as community property are to be treated on a parity with those involving separate property. Community property is to be taken into account under the provisions of Section 2032A in a manner that provides a result consistent with that obtained had the qualified real property not been held as community property.¹⁴⁹ The entire value of the community-qualified real property, not just the decedent’s one-half interest, may be considered in determining whether the percentage qualification requirements imposed on the estate are satisfied. Without this rule, estates of decedents owning community-qualified real property would be at a disadvantage.¹⁵⁰

[4] Real Property Qualification

If an estate qualifies, real property in the gross estate must satisfy six requirements to be classified as “qualified real property” subject to special valuation under Section 2032A. First, the property must be located in the United States.¹⁵¹ Property located in a possession of the United States does not qualify.¹⁵² Second, the property must be devoted to use as a farm for farming purposes¹⁵³ or to use in a trade or business other than farming¹⁵⁴ on the date of the decedent’s death by the decedent or the decedent’s family.¹⁵⁵ Third, the

¹⁵⁰ Assume an estate with an adjusted value of $800,000 contains property devoted to a qualified use with an adjusted value of $400,000 and no community property. The 50 percent estate qualification test is met. Alternatively, if the property devoted to the qualified use is community property, without the special rule the adjusted value of the gross estate would be only $600,000 and the adjusted value of property devoted to a qualified use would be only $200,000. The 50 percent test would not be satisfied, because the adjusted value of property devoted to a qualified use would represent only 33 percent of the adjusted value of the gross estate. Note that only the interest of the surviving spouse in community qualified real property is taken into account. An estate in which the nonqualifying property is community property and the qualifying real property is the separate property of the decedent has a greater likelihood of satisfying both the 25 percent and the 50 percent estate qualification tests because of a reduced denominator.
¹⁵¹ IRC § 2032Ab(1). This includes property in one of the states or in the District of Columbia. See IRC § 7701(a)(9).
¹⁵² See IRC §§ 2032Ab(1), 7701(a)(9).
¹⁵³ The term “farm” is discussed supra ¶ 4.04[3][b], text accompanying notes 50–52.
¹⁵⁴ The term “farming purposes” is discussed supra ¶ 4.04[3][b], text accompanying notes 53–59.
¹⁵⁵ See supra ¶ 4.04[3][b][iv].
¹⁵⁶ IRC § 2032A(b)(1). Qualified real property includes residential buildings and other structures and real property improvements occupied or used on a regular basis by
property must have been acquired from or passed from the decedent\textsuperscript{157} to a qualified heir\textsuperscript{158} of the decedent.\textsuperscript{159} Fourth, the property\textsuperscript{160} must have been owned directly or indirectly and used for a qualified use\textsuperscript{161} by the decedent or a member of the decedent’s family\textsuperscript{162} for periods aggregating five years in the eight-year period immediately preceding the decedent’s death.\textsuperscript{163} Fifth, the decedent or a member of the decedent’s family must have materially participated\textsuperscript{164} in the operation of the farm or other business generally for periods aggregating five years in the eight-year period immediately preceding the date of the decedent’s death.\textsuperscript{165} Sixth, the property must be designated in the agreement required to be filed by the executor.\textsuperscript{166} Only real property satisfying these six requirements is classified as “qualified real property.”

[5] Valuation Methods

Two statutory methods are prescribed for valuing “qualified real property”: a formula method and a multiple-factor method.\textsuperscript{167} Both methods seek a value for qualified real property approximating its actual-use valuation. The formula method may be employed only in the valuation of qualified real property used as a farm for farming purposes,\textsuperscript{168} not in the valuation of qualified real property devoted to use in a trade or business other than farming. The multiple-factor method is required in the latter instance. The multiple-factor method may, however, be employed to value real property used for farming, as an elective alternative\textsuperscript{169} to formula method valuation. When applicable and ap-
propriate, these methods of valuation may be used to value qualified real property required to be included in the decedent’s gross estate by virtue of outright ownership or of the decedent’s interest in a partnership, trust, or corporation as long as the decedent’s interest is an interest in a closely held business.\footnote{170} The regulations are to prescribe how, under Section 2032A, to value qualified real property held in a partnership, trust, or corporation in which the decedent has an interest.\footnote{171}

If real property held by a corporation in which the decedent owned all outstanding shares is valued under Section 2032A, the value of the qualified real property so determined would be used in attempting to establish a value for the shares of stock required to be included in the decedent’s gross estate.

Even though real property is valued at its actual-use value for gross estate inclusion purposes, any claims against the estate, including mortgages on such property, are deducted under Section 2053 at the full value of such claims.\footnote{172} However, because Section 2032A establishes the value of the property “for purposes of this chapter,” the actual-use valuation should be used in determining the amount of the marital deduction\footnote{173} and the amount of a Section 2054 loss deduction.\footnote{174}

\footnote{170} An “interest in a closely held business,” as that term is defined in Section 6166(b)(1), is discussed supra \¶ 4.04[3][b], note 66.

\footnote{171} IRC § 2032A(g). No minority or marketability discounts (see \¶¶ 4.02[4][c], 4.02[4][d]) are taken into account in determining special use valuation. Estate of Maddox v. Comm’r, 93 TC 228 (1989) (no minority discount). However, minority and marketability discounts are allowed in measuring the fair market value of an interest for purposes of imposing the maximum Section 2032A(a)(2) reduction in value under Section 2032A (see supra \¶ 4.04[1], text accompanying note 10). Estate of Hoover v. Comm’r, 69 F3d 1044 (10th Cir. 1995), acq. 1998-2 CB xix. Cf. Priv. Ltr. Rul. 200448006 (July 19, 2004) (same principles for generation-skipping transfer (GST) tax purposes).

\footnote{172} Rev. Rul. 83-81, 1983-1 CB 230. In the case of a nonrecourse liability on such property, only the Section 2032A value of the property reduced by the principal amount of the nonrecourse liability should be included within the gross estate. See Reg. § 20.2053-7; \¶ 5.03[5].

\footnote{173} Priv. Ltr. Rul. 8422011 (Feb. 8, 1984). Nevertheless, in private rulings the Service has ruled that where a formula clause establishes the maximum amount of the marital deduction (a pecuniary formula marital bequest) and provides that property shall be valued at its fair market value at the date of distribution to satisfy the formula, then such property may be valued at its fair market value to determine the amount of the marital deduction. Priv. Ltr. Ruls. 8314001 (Sept. 22, 1982), 8314005 (Dec. 14, 1982). If these letter rulings represent Service policy, this presents some estate tax-saving possibilities. See Kolb, “Special Use Valuation and the Marital Deduction,” 6 J. Agric. Tax’n & L. 624 (1985). However, it also presents some income tax problems. Cf. Kenan v. Comm’r, 114 F2d 217 (2d Cir. 1940).

\footnote{174} See \¶ 5.04[1]. Note that such property will not qualify for a charitable deduction under Section 2055 because a charity is not a qualified heir.
[a] Formula Farm Valuation

The general rule for valuing qualified real property devoted to farming involves a capitalization of hypothetical earnings. The average annual gross cash rental of comparable land, less the average annual state and local real estate taxes for the comparable land,\(^{175}\) is divided by the average annual effective interest rate for all new Farm Credit Bank loans.\(^{176}\) If there is no comparable land from which average annual gross cash rental can be derived, the same formula may be applied using the average annual net share rental of comparable land.\(^{177}\) The annual figures in the five calendar years ending just prior to the year of death are to be used in the computation of each annual average.\(^{178}\) Each annual average of the five required years need not be derived from the same tract of comparable farm land.\(^{179}\) This formula may not be used if (1) there is no comparable farmland in the locality from which the average annual gross cash or net share rental may be determined,\(^{180}\) or (2) the executor elects to use the multiple-factor method to determine the value of the farm for farming purposes.\(^{181}\)

[i] Gross cash rental. The statutory formula requires an actual annual gross cash rental figure for comparable land when available.\(^{182}\) Annual gross cash rental is the total amount of cash rents received in the calendar year, undiminished by any expenses.\(^{183}\) Cash rental contingent upon production does not include

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\(^{175}\) IRC § 2032A(e)(7)(A)(i). Whether properties are comparable is a factual determination. Regulations Section 20.2032A-4(d) lists some factors that are to be considered in determining comparability.

\(^{176}\) IRC § 2032A(e)(7)(A)(ii). See infra text accompanying note 201.

\(^{177}\) IRC § 2032A(e)(7)(B)(i).

\(^{178}\) IRC § 2032A(e)(7)(A) (last sentence).

\(^{179}\) Reg. § 20.2032A-4(b)(2)(iv).

\(^{180}\) IRC § 2032A(e)(7)(C)(i); TAM 9328004 (Mar. 31, 1995). There may be controversy over whether there is any rented comparable land used for farming in the locality of the qualified farm property.

\(^{181}\) IRC § 2032A(e)(7)(C)(ii).

\(^{182}\) Area averages of rentals compiled by the U.S. Department of Agriculture or other statements regarding rental value may not be used; actual cash rental is required. Reg. § 20.2032A-4(b)(2)(iii). See Estate of Thompson v. Comm’r, 76 TCM (CCH) 426 (1998) (requirement not met).

\(^{183}\) Reg. § 20.2032A-4(b)(1); Estate of Klosterman v. Comm’r, 99 TC 313 (1992) (payment to irrigation district for water could not be deducted). Where comparable farmland is the subject matter of a net lease, the specified expenses of the landlord paid by the tenant constitute constructive cash rent and should be included in the gross cash rental. Improvements placed on the leasehold by the lessee may constitute additional rent for income tax purposes. Reg. § 1.61-8(c). But see IRC § 109. If there are such improvements, is that figure to be included in the gross cash rental in the formula as constructive cash rent? The alternative is that comparable rented land improved by the lessee, which im-
not qualify for use in this formula. The rent must be equivalent to that received in an arm’s-length transaction between unrelated private individuals leasing for profit not involving actual or contemplated material participation by the lessor or the lessor’s family. If cash rentals received for the use of comparable real property include the use of farm equipment, a portion of the rent may be attributed to the use of personal property and thereby excluded from consideration in the valuation formula, but only if the lease specifies that a reasonable amount of total rent is attributable to the use of the personal property.

[ii] Net share rental. It is not uncommon to rent farmland for a specified share of the crop rather than a specified amount of cash. If the personal representative cannot identify actual tracts of comparable farmland rented solely for cash in the same locality as the decedent’s farmland, the dollar value of the average annual net share rental may be substituted for the average annual gross cash rental in the formula. Net share rental is the value of the crop or other product received by the lessor, less the cash operating expenses of growing the produce, other than real property taxes paid by the lessor under the lease. The produce may be received actually or constructively by the lessor. If the lessor receives a set share of the proceeds upon sale of the crop by the tenant rather than a share of the produce, the arrangement is to be treated the same as

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184 Prior to the enactment of Section 2032A(e)(7)(B) providing for the use of net share rentals in formula valuation for estates of decedents dying after December 31, 1981, the Treasury vacillated on the question whether farmland rented on a crop share basis qualified as comparable land from which the average annual gross cash rental could be determined. Proposed Regulations Section 20.2032A-4(b) initially permitted crop share rentals to be converted to a cash equivalent to be used in some cases as a substitute for cash rental in the formula but, by later amendment, prohibited it. The exclusion of crop share rentals from the definition of “cash rentals” is contained in final Regulations Section 20.2032A-4(b)(2)(iii).


a net share rental.\textsuperscript{189} If the crops and other products received by the lessor are sold in an arm’s-length transaction within five months\textsuperscript{190} of the date of receipt, actual or constructive, the gross amount received is the value of the produce in the determination of the net share rental. Alternatively, if the produce received by the lessor is not disposed of in the prescribed time and manner, the produce is to be valued using the weighted average price of the produce of the closest national or regional commodities market on the date of actual or constructive receipt.\textsuperscript{191}

[iii] **Comparable land.** The comparable land must actually be rented for farming purposes; an offer to rent for a price is not sufficient.\textsuperscript{192} Formula farm valuation requires a computation of the average annual gross cash or net share rental, less real estate taxes for the five calendar years ending before the calendar year of the decedent’s death. The same tract of comparable land need not be rented throughout the full five-year period. All that is necessary is that an actual tract of farmland meeting the requirements of this section be identified for each year.\textsuperscript{193}

The comparable real property must be situated in the same locality as the decedent’s farmland.\textsuperscript{194} There is no fixed rule to determine what constitutes the same locality, but neither mileage nor political divisions alone are the standards. “Same locality” is to be judged according to generally accepted real property valuation rules.\textsuperscript{195}

A difficult question is the determination of comparability. Comparability of land is a factual question requiring consideration of a number of factors, no one of which is determinative.\textsuperscript{196} The factors to be considered include the size, topography, condition, and soil capacity of the land, the similarity in the quantity and quality of the agricultural and horticultural commodities that are or


\hspace{1cm} 190 This period actually is to be no longer than the period established by the U.S. Department of Agriculture for its price support program. HR Rep. No. 201, 97th Cong., 1st Sess. 38, 172 (1981), reprinted in 1981-2 CB 352, 383.


\hspace{1cm} 192 Reg. § 20.2032A-4(b)(2)(iii).

\hspace{1cm} 193 Reg. § 20.2032A-4(b)(2)(iv).


Note that the formula may not be used to value a farm “where it is established that there is no comparable land.” IRC § 2032A(e)(7)(C)(i). This “exception” places the burden to establish comparability on the taxpayer.

Section 2032A
may be produced, and the improvements made to the land. Undoubtedly, this determination will be a source of controversy and litigation. Land producing agricultural and horticultural commodities similar in kind and quantity to that produced on the farm to be valued pursuant to the formula should be classified as comparable. When a farm to be specially valued under the formula method has a variety of improvements, uses, and land characteristics, the property must be segmented and comparable land identified for each different segment. For example, when the executor elects under Section 2032A(e)(13) to treat trees growing on qualified woodlands as real property rather than as a crop, the trees may be valued under the formula method if there is comparable timberland from which the average annual cash or net share rental may be ascertained. Although the size of the particular parcel may dictate a different rental rate and render the land not comparable, in the situation where the size does not affect the rate per acre, the comparable land’s gross rental will be converted to a per-acre rate in the application of the formula.

[iv] **Real estate taxes.** The average annual state and local real estate taxes to be subtracted from average annual gross cash or net share rental in formula valuation are the taxes that are assessed by a state or local government on the comparable real property and that are allowable as income tax deductions under Section 164.

[v] **The divisor.** After determining an adjusted rental income figure (average rent, minus taxes), that figure is divided by the average annual effective interest rate for the same period on all new Farm Credit Bank loans. The average annual effective interest rate for new Farm Credit Bank loans is defined

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197 Regulations Section 20.2032A-4(d) lists ten factors that may be considered in determining comparability.

198 Reg. § 20.2032A-4(d). Section 2032A(e)(7)(A)(i) states that the value of a “farm for farming purposes” is to be determined with the formula. The formula uses the gross cash or net share rental from comparable “land used for farming.” Comparable land used for farming is not the same as a comparable farm. Qualified real property devoted to use as a farm for farming purposes may include residential buildings. IRC § 2032A(e)(3). Is comparable land without residential buildings to be treated as comparable to a farm with residential buildings that are classified as qualified real property? The improvements located on the farm could be a factor used to deny comparability. Alternatively, both parcels may have residential structures, but the residential buildings on the farm to be valued may not qualify as qualified real property devoted to use as a farm for farming purposes. See IRC § 2032A(e)(3). The point is that in establishing comparability, the real property qualifying for special formula valuation must be actually comparable with the rented land. Segment-by-segment valuation will most likely be the rule rather than the exception. See Reg. § 20.2032A-4(d); Estate of Rogers v. Comm’r, 79 TCM (CCH) 1891 (2000) (timberland comparable, pastureland not comparable).

199 Reg. § 20.2032A-4(c).

200 IRC § 2032A(c)(7)(A)(ii). The Farm Credit Banks have replaced the Federal Land Banks.
in the regulations as the average billing rate adjusted for the required purchase of land bank stock charged on new agricultural loans in the farm credit district in which the real property to be valued is located.\(^{201}\) The statute requires use of the average annual effective interest rate for “all new Federal Land Bank loans.” It is entirely unlikely that the average annual effective interest rate for new Farm Credit Bank loans in any one farm credit district, which varied in 2012 from 5.15 percent to 6.19 percent, will equal the rate for all new Farm Credit Bank loans. It would appear that the estate could properly use either the statutory or the administrative (regulations) figure.

Interest rate increases have a reverse effect on Section 2032A valuation. For example, if the rental figure to be used is $10,000, a 10 percent rate will yield a value of $100,000. Rates of 12 percent or 8 percent would reflect values of $83,333 and $125,000, respectively. The apparent and logical thesis is that farmland has a greater use value when it can be acquired and operated at a lower cost for borrowed money. This situation leads to the sliding rates at which income figures are to be capitalized.

[vi] **Objectives of formula valuation.** Formula valuation is designed to eliminate from consideration in the valuation of farmland nonfarm uses and speculative inflation of farm real estate values. The mechanical formula accomplishes this desired result. The legislative history indicates that formula method valuation of farmland will provide greater certainty in farm valuation, reducing subjectivity and controversy. Certainty of valuation results under the formula, however, only after some familiar subjective determinations regarding the value of farm real property have been completed. Conventional fair market value of the real property devoted to farm use must be determined to ascertain initial qualification for formula valuation.\(^{202}\) That fair market value determina-

\(^{201}\) Reg. § 20.2032A-4(e). The average annual effective interest rates on new Farm Credit System bank loans to be used in computing the special use value of farm real property for which an election is made under Section 2032A for recent years may be found in the following revenue rulings.

<table>
<thead>
<tr>
<th>Calendar year of decedent’s death</th>
<th>Revenue ruling listing annual effective interest rates on new farm credit bank loans</th>
</tr>
</thead>
</table>

The 2012 rates range from a low of 5.15 percent to a high of 6.19 percent.

\(^{202}\) See discussion supra ¶¶ 4.04[2], 4.04[3][b], 4.04[3][c].
tion may be critical, possibly leading the executor reluctantly into controversy.203

[b] Multiple-Factor Valuation

The multiple-factor method of valuation204 is the only special-use valuation method that may be employed for qualified real property used in a trade or business other than farming. It is also an elective alternative to formula valuation of qualified property devoted to farming.205 The statute requires the consideration of several factors in the special-use valuation of any qualified real property not valued under formula valuation:

1. The capitalized value of reasonable anticipated earnings206;
2. The capitalized value of the fair rental value based on the farming or other actual use207;
3. Assessed land value in a state that has a differential or use value assessment law for qualifying property208;
4. Comparable sales of land in the geographical area, but in locations in which nonagricultural use is not a significant factor in the sales price209; and

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203 The fair market value of the farm property is crucial for more than mere initial qualification. In the event the tax benefit provided by Section 2032A valuation is recaptured under Section 2032A(c), the fair market value of the real property that may be established at the time of filing the estate tax return controls in the computation of the imposition of additional tax. The recapture tax may equal the difference between the estate tax imposed using Section 2032A and the estate tax liability that would have been imposed had the qualified property been included in the gross estate at fair market value. See infra ¶ 4.04[7][c].

204 IRC § 2032A(e)(8).

205 IRC § 2032A(e)(7)(C)(ii). If an executor elects use of Section 2032A, but does not satisfy the requirements of Section 2032A(e)(7), then Section 2032A(e)(8) applies. Reg. § 20.2056A-4(b)(2)(i). See Estate of Wineman v. Comm’r, 79 TCM (CCH) 2189 (2000).

206 Precisely stated: “The capitalization of income which the property can be expected to yield for farming or closely held business purposes over a reasonable period of time under prudent management using traditional cropping patterns for the area, taking into account soil capacity, terrain configuration, and similar factors.” IRC § 2032A(e)(8)(A). See FSA 9924019 (Mar. 17, 1999) (estimation of zero income because of Section 2032A(c) recapture rule was inappropriate).

207 IRC § 2032A(e)(8)(B).

208 IRC § 2032A(e)(8)(C).

5. Any other factor that tends to establish a value based on actual use of property.\(^\text{210}\)

The statute does not require that each of these factors be applied with equal weight to determine the multiple-factor value of qualified real property. The regulations should recognize that at times one factor may be entitled to more weight than another, even though this may come close to an uncherished “all the facts and circumstances” approach. The factors are not new.\(^\text{211}\) They are frequently employed outside the tax area by appraisers ascertaining the fair market value of real property. The difference is that the statutory factors are to be applied in a manner that results in a valuation approximating a value based on the actual use of the qualified property, eliminating elements of value attributable to factors other than current actual use.

[6] Election and Agreement

In General. Section 2032A valuation of certain real property is an elective alternative to fair market valuation of all qualified real property required to be included in the gross estate. If any property is to be valued pursuant to Section 2032A, the executor must elect the application of the section and file the appropriate agreement.\(^\text{212}\)

The election is made by attaching a notice of election\(^\text{213}\) and the appropriate agreement to the decedent’s federal estate tax return.\(^\text{214}\) The election may be made on a late return if it is the first return filed.\(^\text{215}\) Once made, the election

\(^{210}\) IRC § 2032A(e)(8)(E). However, all factors that are relevant to the particular valuation must be used. Rev. Rul. 89-30, 1989-1 CB 274.

\(^{211}\) See ¶ 4.02[3][b].


\(^{214}\) IRC § 2032A(d)(1). Regulations Section 301.9100-2 provides rules for the extension of the time to make the election if it is not made on time. It allows an automatic twelve-month extension if the Service has not yet begun an examination of the return and if the top of the document states “FILED PURSUANT TO § 301.9100-2.” Regulations Section 301.9100-3 provides an extension of time for making the Section 2032A election that does not meet the requirements of Regulations Section 301.9100-2.
is irrevocable.216 The notice of election must contain the information necessary to indicate satisfaction of the separate eligibility prerequisites of the decedent’s estate and the real property to be valued under Section 2032A.217

If Section 2032A is not initially available to value real property included in a decedent’s gross estate, a protective election may be made pending final valuation for estate tax purposes.218 The protective election is made by filing a notice of election with the estate tax return.219 If the property included in the decedent’s gross estate ultimately qualifies for valuation under Section 2032A, Regulations Section 301.9100-3 served as a basis for extension of time to make a Section 2032A election in the following private letter rulings: Priv. Ltr. Rul. 201224019 (Mar. 12, 2012) (prior reliance on advise of accountant that valid election made); Priv. Ltr. Rul. 201015003 (Oct. 26, 2009) (late election valid on first filed estate tax return); Priv. Ltr. Rul. 200804014 (Sept. 12, 2007) (protective election not perfected); Priv. Ltr. Rul. 200528019 (Mar. 14, 2005) (executor unaware of availability of Section 2032A election); Priv. Ltr. Ruls. 200513014 (Nov. 16, 2004), 201230023 (Apr. 16, 2012) (tax professional failed to advise personal representative to make an election); Priv. Ltr. Rul. 200438036 (May 10, 2004) (farms subsequently included in gross estate).

216 IRC § 2032A(d)(1). Further, additional property may be added. Priv. Ltr. Rul. 8222018 (Feb. 11, 1982).

217 Reg. § 20.2032A-8(a)(3). To facilitate some verification of estate qualification, this notice is to contain the decedent’s name and Social Security number and the adjusted value of the gross estate as well as a list of items of real and personal property used for a qualified use passing from the decedent to qualified heirs. The adjusted value of these items must be shown. Disclosure is required in the notice of periods in the requisite period preceding the decedent’s death, generally eight years, in which the required ownership, qualified use, or material participation by the decedent or his family was absent. Regarding the real property to be specially valued, the notice is to indicate the schedule on the federal estate tax return on which it appears and its item number, legal description, qualified use, fair market value, copies of written appraisals of the fair market value, special-use value, and identification of the method used in determining the special-use value. Additionally, the notice is to contain a statement that the decedent or a family member has owned the real property to be specially valued for the requisite five-year period preceding the decedent’s death, affidavits describing the activities comprising material participation, and the identity of the material participants, as well as the names, addresses, Social Security numbers, and relationships of the persons to whom the specially valued property passes and the fair market value and special-use value of the interests passing to each person. All of these rules are contained in a list of fourteen requirements found in Regulations Section 20.2032A-8(a)(3).

218 Reg. § 20.2032A-8(b). This protective election does not extend the time for payment of estate tax. Letter rulings have allowed a protective election even where a regular election is available. Priv. Ltr. Ruls. 8532003 (Apr. 11, 1985), 8407005 (Nov. 8, 1983). A protective election does not provide an option to file a special-use valuation election at a later time. TAM 9013001 (Mar. 30, 1990). See Estate of Kokernot v. Comm’r, 112 F3d 1290 (5th Cir. 1997) (taxpayer actions constituted waiver of a protective election).

219 Reg. § 20.2032A-8(b). The notice of election is to indicate that it is a protective election pending final valuation. It reveals the decedent’s name and taxpayer identification number and identifies the real and personal property listed on the federal estate tax return that passes to qualified heirs and states the qualified relevant use. Id.
an additional notice of election must be filed within sixty days after the determination is made.\textsuperscript{220} The new notice of election accompanied by the requisite agreement is to be attached to an amended federal estate tax return.\textsuperscript{221}

The written agreement required to be filed by the executor must designate the real property to be valued pursuant to Section 2032A\textsuperscript{222} and signify the consent of the signatories to the imposition of an additional tax under Section 2032A(c).\textsuperscript{223} The required signatories are all the persons in being who have an interest in the real property designated in the agreement, whether or not their particular interests are possessory.\textsuperscript{224} Signatories include owners of remainder and executory interests, holders of general or nongeneral powers of appointment, takers in default of the exercise of powers, joint tenants of the decedent, directors of a corporation, and trustees of a trust holding an interest in the qualified real property.\textsuperscript{225} However, the rule does not apply to owners of undivided interests in property where only the decedent’s undivided interest is included in the decedent’s gross estate and the other co-owners do not acquire the decedent’s interest at the decedent’s death.\textsuperscript{226} Creditors of the estate are not required signatories solely by reason of their status as creditors, and an heir who has the power under local law to challenge a will and thereby affect disposition of the property is not a person with an interest in property under Sec-

\textsuperscript{220} Reg. § 20.2032A-8(b); Priv. Ltr. Rul. 8706006 (Oct. 10, 1986); TAM 9230002 (Apr. 9, 1992); TAMs 9441003 (Oct. 14, 1994) and 9508002 (Nov. 2, 1994) (involving sixty-day periods commencing with a closing letter). See Priv. Ltr. Rul. 200804014 (Sept. 7, 2007) (Regulations Section 301.9100-3 extension of the sixty-day period to make Section 2032A election granted).

\textsuperscript{221} Reg. § 20.2032A-8(b). The new notice of election is to contain the fourteen requirements required by Regulations Section 20.2032A-8(a)(3). See supra note 217. The amended return is to be filed with the same office as the original return.

\textsuperscript{222} IRC § 2032A(b)(1)(D).

\textsuperscript{223} IRC § 2032A(d)(2). The requirements for a properly executed agreement are found in Regulations Sections 20.2032A-8(c)(1) and 20.2032A-8(c)(2). The imposition of additional tax under Section 2032A(c) is discussed infra ¶ 4.04[7]. Although the statute does not specify a time period in which the appropriate agreement must be filed, the agreement must be filed within the time specified for the election by the executor. Reg. § 20.2032A-8(a)(3); Estate of Gunland v. Comm’r, 88 TC 1453 (1987).

\textsuperscript{224} IRC § 2032A(d)(2). The interest may be present or future, vested or contingent. See Reg. § 20.2032A-8(c)(2); Estate of Smoot v. Comm’r, 892 F2d 597 (7th Cir. 1989); TAM 9038002 (June 8, 1990) (signature of remote contingent qualified heir not required).

\textsuperscript{225} IRC § 2032A(d)(2). See also Rev. Rul. 85-148, 1985-2 CB 199 (spouse’s inchoate dower interest).

\textsuperscript{226} Estate of Pullian v. Comm’r, 84 TC 789 (1985); Estate of Bettenhausen v. Comm’r, 51 TCM (CCH) 488 (1986); TAM 9027004 (Mar. 22, 1990) (all involving tenancies in common). But see Priv. Ltr. Rul. 8645004 (July 28, 1986) (one partner could not sign for the partnership).
tion 2032A solely by reason of that right.\footnote{Reg. § 20.2032A-8(c)(2); Priv. Ltr. Rul. 8536004 (May 20, 1985) (signature of secured creditor heir not required).} Each person signing the agreement consents to the imposition of recapture tax with respect to real property valued pursuant to Section 2032A in which the person has an interest. Qualified heirs consent to personal liability\footnote{See IRC § 2032A(c)(5); Priv. Ltr. Rul. 8422008 (Feb. 2, 1984). A qualified heir may request from the Secretary a statement of the maximum amount of any additional estate tax for which the qualified heir may be personally liable. If the qualified heir furnishes a bond in that amount, the qualified heir is discharged from personal liability. IRC §§ 2032A(e)(11), 2032A(c)(5).}; persons other than qualified heirs consent to collection of the additional tax from the qualified real property.\footnote{Reg. § 20.2032A-8(c)(1).} In addition, the agreement must designate an agent for the signatories with whom the Service may deal on all matters involving continued qualification and the special lien under Section 6324B.\footnote{Reg. §§ 20.2032A-8(c)(1), 20.2032A-8(c)(4).}

In 1984, Congress relaxed these stringent requirements with the addition of Section 2032A(d)(3) to the Code.\footnote{Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 1025, 98 Stat. 494, 1030 (1984), reprinted in 1984-3 CB (Vol. 1) 1, 538.} Under that provision, if the election of special-use valuation or the written agreement submitted with the election evidenced “substantial compliance”\footnote{IRC § 2032A(d)(3). Prior to 1984, Form 706 did not indicate all the information required to be filed with a Section 2032A election. Consequently Congress provided that estates of individuals dying before 1986 that provided “substantially all” of the necessary information required under Form 706 were allowed a period of ninety days after being notified of their errors by the Treasury to perfect their defective elections. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1421, 100 Stat. 2085, 2716 (1986), reprinted in 1986-3 CB (Vol. 1) 1, 633. The election could be made on a late-filed return as long as that return was the first return filed. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1014(f), 102 Stat. 3342, 3562 (1988), reprinted in 1988-3 CB 1, 222. The “substantially all” test was more easily satisfied than the “substantial compliance” test. Prussner v. United States, 896 F2d 218 (7th Cir. 1991). The “substantially all” test was satisfied in Prussner (failure to attach a recapture agreement satisfied the “substantially all” test, even though it did not satisfy the Section 2032A(d)(3) “substantial compliance” test); Estate of Doherty, 982 F2d 450 (10th Cir. 1992) (failure to provide written appraisal of fair market value); Parker v. United States, 90-2 USTC ¶ 60,038 (ED Ark. 1990) (failure to state property’s fair market value where required, reveal a family member’s interest in property, and property not properly identified). The test was not met in Estate of Collins v. United States, 91-1 USTC ¶ 60,060 (WD Okla. 1991) (failure to submit notice of election and appraisals); Estate of Merwin v. Comm’r, 95 TC 168 (1990).} with the Section 2032A requirements, the election or agreement was considered valid, but only if the technical defect or flaw was cured within ninety days from the time of the Service’s notification to the executor that the defect or flaw existed.\footnote{IRC § 2032A(d)(3)(B) (prior to amendment in 1997).} In keeping with the legislative
The legislative history of the 1984 Act gives examples of such technical defects or flaws. See Staff of Joint Comm. on Tax’n, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 1124.

An election has been treated as satisfying the substantive compliance requirement in the following: Rev. Rul. 85-84, 1985-1 CB 326 (lack of a full legal description of the property where the property was nevertheless described with reasonable clarity); Priv. Ltr. Rul. 8617005 (Dec. 31, 1985) (no separate notice of the election, although all appropriate information included with the return); Priv. Ltr. Rul. 8647002 (Aug. 6, 1986) (lack of a full legal description of the property where documents submitted provided reasonably clear description); Priv. Ltr. Rul. 8725002 (Mar. 18, 1987) (failure to include written appraisal of fair market value of property); TAM 9038002 (Sept. 21, 1990) (beneficiary with remote interest did not sign agreement); TAM 9225002 (Jan. 30, 1992) (choice of valuation method but insufficient substantiation); TAM 9228005 (Mar. 31, 1992) (signature on recapture agreement as qualified heir but not as trustee); TAM 9245002 (June 12, 1992) (signature as qualified heir but not as shareholders, partners, or trustees); TAM 9346003 (Aug. 9, 1993) (same).

The substantive compliance requirement was not met where there was an election in the following: Priv. Ltr. Rul. 8650002 (Sept. 5, 1986) (no separate notice of election with the return and no appropriate information with the return); Priv. Ltr. Rul. 8704002 (Sept. 25, 1986) (property not designated with reasonable clarity).


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In 1997, Congress further liberalized the Section 2032A election provisions by amending Section 2032A(d)(3) to permit signatures to be added to the recapture agreement after it is filed and required information to be supplied late, as long as the election was made and the agreement was submitted within the prescribed time. The executor again has a reasonable period of time, not exceeding ninety days after being notified of the failure to provide the required information or signatures, to make the necessary corrections.

**Effect of Election and Agreement.** If the election is made and the appropriate agreement filed, all “qualified real property” included in the gross estate must be valued pursuant to Section 2032A.

However, this mandate is not so broad as it seems. Property is not qualified real property unless it is designated in the agreement that the executor is required to file. Any real property capable of satisfying all the prerequisites for classification as “qualified real property” may possibly be excluded from mandatory Section 2032A valuation by excluding it from the agreement. Although the election need not include all real property eligible for valuation under Section 2032A, the regulations purport to require that sufficient property to satisfy the threshold requirements of Section 2032A(b)(1)(B) be valued under the election. Real property with an adjusted value equaling 25 percent of the adjusted value of the gross estate must, according to the regulation; Estate of Collins v. United States, 91-1 USTC ¶ 60,060 (WD Okla. 1991) (failure to submit notice of election and appraisals); Estate of Merwin v. Comm’r, 95 TC 168 (1990) (failure to attach notice of election or recapture agreement); Killion v. Comm’r, 55 TCM (CCH) 1004 (1988) (almost no information filed); Estate of Doherty v. Comm’r, 982 F2d 450 (10th Cir. 1992) (failure to substantiate either fair market valuation or special-use valuation of property).


240 IRC § 2032A(b)(1)(D).

241 IRC § 2032A(b)(1)(B). Adjusted value is discussed supra ¶ 4.04[3][b][i].

242 IRC § 2032A(b)(3)(B). Adjusted value is discussed supra ¶ 4.04[3][b][i].

243 IRC § 2032A(b)(3)(A). Adjusted value is discussed supra ¶ 4.04[3][b][i].
tions, be valued under Section 2032A. This requirement is not in the statute. Its wisdom and perhaps its validity are questionable.\footnote{44}{How will this regulation be administered when the application of Section 2032A(e)(10) or Section 2035(c)(1)(B), either alone or in combination, results in satisfaction of the 25 percent estate qualification test but there is insufficient real property included in the gross estate to satisfy the regulation requirement? Is special valuation prohibited when the real property that must be specially valued under the regulation exceeds the Section 2032A(a)(2) limit? This requirement should be dropped.}

At the time the election is filed, a special lien in the amount of the estate tax saved by special-use valuation is imposed on the real property valued under Section 2032A by Section 6324B.\footnote{45} Other security may be substituted for this lien.\footnote{46} The lien continues with respect to an interest in qualified real property as long as there is any potential liability for recapture tax with respect to the interest.\footnote{47} The contingent liability for recapture tax may be extinguished by satisfaction, lien unenforceability because of lapse of time, expiration of ten years after the decedent’s date of death, or death of the potentially liable qualified heir.\footnote{48}

[7] Recapture

What Congress gives, Congress may take away. Section 2032A was enacted to encourage the continued use of real property in family farms and other small business operations.\footnote{49} If this favored use is not continued for a reasonable time after the decedent’s death, the estate tax saved by special-use valuation may be recaptured in whole or in part. Recapture is accomplished by the imposition of an additional tax.\footnote{50} The “gotcha”\footnote{51} has invaded the estate tax.

\footnote{44} How will this regulation be administered when the application of Section 2032A(e)(10) or Section 2035(c)(1)(B), either alone or in combination, results in satisfaction of the 25 percent estate qualification test but there is insufficient real property included in the gross estate to satisfy the regulation requirement? Is special valuation prohibited when the real property that must be specially valued under the regulation exceeds the Section 2032A(a)(2) limit? This requirement should be dropped.

\footnote{45} IRC § 6324B(a). Standing timber valued under Section 2032A will be subject to this lien to the same extent as the land on which it stands. HR Rep. No. 201, 97th Cong., 1st Sess. 38, 175 n.27 (1981), reprinted in 1981-2 CB 352, 385.

\footnote{46} IRC § 6324B(d). See Reg. § 20.6324B-1(c).

\footnote{47} IRC § 6324B(b). This lien will be transferred to qualified exchange property or qualified replacement property when the qualified real property is discharged from the lien. HR Rep. No. 201, 97th Cong., 1st Sess. 38, 174 ns. 24–25 (1981), reprinted in 1981-2 CB 352, 384.

\footnote{48} This lien, which is in lieu of any lien under Section 6324, must be filed as provided in Section 6323(f) to have priority against any purchaser, holder of a security interest, mechanic’s lien, or judgment lien creditor. See IRC § 6324B(c)(1), which makes reference to Section 6324A(d)(1). The priority this lien has, once filed, is specified in Sections 6324A(d)(1) and 6324A(d)(3). See IRC § 6324B(c)(1).


\footnote{50} IRC § 2032A(c)(1).

\footnote{51} See IRC §§ 1245 and 1250 for examples of the income tax “gotcha.”
An additional estate tax is imposed, generally within ten years after the
decedent’s death, if the qualified heir (1) disposes of an interest in property
valued under Section 2032A to one other than a member of the qualified heir’s
family or (2) ceases to use the qualified property or a portion thereof for the
qualified use. Death of the qualified heir usually terminates potential recapture liability.

[a] The Ten-Year Period

Any potential liability for additional tax generally lapses at the end of the
ten-year period immediately following the date of the decedent’s death. Generally, if property qualifying for special-use valuation is sold or converted to a nonqualified use more than ten years after the decedent’s death, no additional tax is imposed.

The ten-year period begins on the date of the decedent’s death or on the
date the qualified heir commences qualified use if within two years of the date
of the decedent’s death. A qualified heir has a two-year period following the
death of the decedent in which to commence qualified use of the real property
without triggering recapture. The ten-year period is justifiably extended by
the period that elapses after death and before commencement of qualified use.
The period of potential liability for the recapture tax may be further extended
when property valued under Section 2032A is involuntarily converted and
qualified replacement property acquired. The period is extended by any pe-

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252 IRC § 2032A(c)(1).
253 IRC § 2032A(c)(1)(A).
254 IRC § 2032A(c)(1)(B). Form 706-A, “United States Additional Estate Tax Return,” is used to report the additional tax due because of the application of Section 2032A(c). The qualified heir must file Form 706-A if there was any taxable event even if no tax is due or if the property valued under Section 2032A is involuntarily converted or exchanged even if the conversion or exchange is nontaxable. Instructions for Form 706-A, United States Additional Estate Tax Return at 3 (Rev. December 2008). The form must be filed and the tax paid within six months after the taxable disposition or cessation of qualified use. Id. A qualified heir may apply for an automatic six-month extension of time to file Form 706-A by filing Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes (Rev. July 2008). See ¶ 2.02[1][c], text accompanying notes 14 and 15. See also Le Fever v. Comm’r, 100 F3d 778 (10th Cir. 1996) (taxpayers estopped under the “duty of consistency” doctrine from avoiding recapture by contending that the property had not met the requirements of Section 2032A at the time of the election).
255 IRC § 2032A(c)(1).
256 IRC § 2032A(c)(1).
257 IRC § 2032A(c)(7)(A).
period, beyond the two-year period referred to in Section 1033(a)(2)(B)(i), during which the qualified heir is allowed to replace the qualified real property.\footnote{IRC § 2032A(h)(2)(A). The Section 1033(a)(2)(B)(i) period is “2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized.” This two-year period may be extended upon a showing of reasonable cause for qualified heir’s inability to replace the converted property within the specified period. Reg. § 1.1033(a)-2(c)(3). The ten-year recapture period is extended by any additional time granted. If the qualified heir replaces the converted qualified real property with qualified replacement property within two years after the close of the taxable year in which any gain on the conversion is realized, the recapture period is not extended. Additionally, if no gain is realized on the conversion, the ten-year recapture period is not extended because the two-year period referred to in Section 1033(a)(2)(B)(i) begins to run only after the close of the taxable year in which gain on the conversion is realized.

\footnote{HR Rep. No. 1380, 94th Cong., 2d Sess. 3, 26 (1976), reprinted in 1976-3 CB (Vol. 3) 735, 760. See Reg. § 20.2032A-3(c)(2).}

\footnote{IRC § 2032A(e)(1).}

\footnote{HR Rep. No. 1515, 94th Cong., 2d Sess. 610 (1976), reprinted in 1976-3 CB (Vol. 3) 807, 960. Property acquired or passed from a decedent is discussed supra ¶ 4.04[3][b][viii].}

\footnote{Reg. § 20.2032A-8(a)(2). When the holder of the present interest possesses a power of appointment, the remainderperson may or may not be treated as a qualified heir. The remainderperson’s status depends on whether any permissible appointee is a non-family member. Cf. Rev. Rul. 82-140, 1982-2 CB 208.

\footnote{Reg. § 20.2032A-3(c)(2).}

The statutory rule that the recapture event must precede the death of the qualified heir for an additional tax to be imposed with respect to the interest of that heir may be subject to one very important qualification if successive interests in qualified property are involved. If two or more qualified heirs acquire successive interests in property valued under Section 2032A, potential liability for the imposition of additional tax does not abate on the death of a qualified heir until the death of the last qualified heir.\footnote{HR Rep. No. 1380, 94th Cong., 2d Sess. 3, 26 (1976), reprinted in 1976-3 CB (Vol. 3) 735, 760. See Reg. § 20.2032A-3(c)(2).}

The critical inquiry is whether the heir with the succeeding (future) interest is a qualified heir. Qualified heir status generally requires property to have passed to the individual from the decedent.\footnote{IRC § 2032A(e)(1).}

Generally, qualified property passing in trust is deemed to have passed to a qualified heir to the extent that the qualified heir has a present interest in the trust.\footnote{HR Rep. No. 1515, 94th Cong., 2d Sess. 610 (1976), reprinted in 1976-3 CB (Vol. 3) 807, 960. Property acquired or passed from a decedent is discussed supra ¶ 4.04[3][b][viii].}

A future interest in trust property, under the general rule, is not considered to have passed, and, therefore, the remainderperson is not treated as a qualified heir. However, a remainder interest is treated as being received by a qualified heir if it is not contingent on surviving a nonfamily member and is not subject to divestment in favor of a nonfamily member.\footnote{Reg. § 20.2032A-8(a)(2). When the holder of the present interest possesses a power of appointment, the remainderperson may or may not be treated as a qualified heir. The remainderperson’s status depends on whether any permissible appointee is a non-family member. Cf. Rev. Rul. 82-140, 1982-2 CB 208.

\footnote{Reg. § 20.2032A-3(c)(2).}

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of a qualified heir unless the decedent’s interest in qualified property was required to be included in the qualified heir’s gross estate. This would support the exception calling for no abatement of recapture tax liability until the death of those holding successive interests, but this also creates another problem. If one who holds a present interest also possesses a general power of appointment over the property, the death of the power holder should result in abatement of any potential liability for recapture tax with respect to the qualified real property subject to the general power of appointment. The successive interest rule should be applied only to successive holders if the property is not required to be included in the gross estate of the preceding holder. If a decedent’s spouse and child acquire qualified property from the decedent as tenants in common, the death of either tenant within ten years frees that tenant’s interest in the qualified property from potential liability for the recapture tax. Under these facts, a sale of the deceased tenant’s interest in the qualified property to an unrelated third party within ten years of the decedent’s death is not an event giving rise to the imposition of an additional tax. Sale by the surviving tenant of that tenant’s interest in the qualified property to an unrelated third party within ten years of the decedent’s death is an event that results in the imposition of an additional tax.

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265 How should the successive interest rule be applied when otherwise qualified real property is placed in trust income to A for life, remainder to B, and C possesses a general power of appointment over the entire trust corpus? Is the general power of appointment to be treated as an interest in the property? (Section 2041 and Regulations Section 20.2032A-8(c)(2) treat a general power of appointment as if it were an interest in property.) Assuming the general power is to be treated as an interest in property for purposes of Section 2032A, then the question is whether the power “interest” overrides the present income interest and remainder interest. Should the override depend on whether the power is one that may be exercised by will or by deed? It seems if the property passing into trust is subject to a general power of appointment presently exercisable to the extent that the income and remainder interests are subject to divestment at the will of the power holder, the property ought to be treated as passing to the power holder and the successive interest rule should not be applied.

266 HR Rep. No. 1380, 94th Cong., 2d Sess. 3, 26 (1976), reprinted in 1976-3 CB (Vol. 3) 735, 760. In Thompson Estate v. Comm’r, 100 Aftr2d 2007-5792 (2d Cir. 2007), the court explained that the reallocation of burden does not require the court to adopt an erroneous value offered by the taxpayer if the court rejects the Service’s value; the burden of disproving the taxpayer’s valuation can be satisfied by evidence in the record impeaching, undermining, or indicating error in the taxpayer’s valuation.

267 The additional tax imposed will be one half of the amount that would have been imposed had both tenants survived and joined in the sale. Property acquired by two or more qualified heirs from the decedent as joint tenants with right of survivorship should be treated like a tenancy in common. Upon the death of the first to die, the value of that decedent’s proportionate interest will be included in that decedent’s gross estate. See IRC § 2040(a). That portion should not be subjected to recapture tax if the surviving joint ten-
Death of a qualified heir after disposal of qualified real property to a member of the qualified heir’s family does not affect any potential liability for recapture tax on the property transferred.\textsuperscript{268}

[b] Recapture Events

[i] Dispositions. Not all dispositions of property valued under Section 2032A within the prescribed ten-year period invoke the additional estate tax. A disposition to a member of the qualified heir’s family\textsuperscript{269} does not result in the imposition of the recapture tax\textsuperscript{270}; nor, in general, does a testamentary dispo-

\textsuperscript{268} For example, if A inherited qualified property from the decedent and sold it to B, a member of A’s family, B thereafter is the qualified heir. IRC § 2032A(e)(1). The death of A after the sale to B would not affect the potential recapture liability with respect to the qualified property held by B at A’s death.

\textsuperscript{269} “Family” here includes only the qualified heir’s ancestors, spouse, and lineal descendants, as well as the lineal descendants of the qualified heir’s parents and spouse and the spouses of all those lineal descendants. See IRC § 2032A(e)(2); Rev. Rul. 85-66, 1985-1 CB 324. A member of the qualified heir’s family need not be a member of the decedent’s family, but, after the disposition, the member of the qualified heir’s family is treated as the qualified heir of the decedent with respect to the transferred property or property interest. IRC § 2032A(e)(1). See also Rev. Rul. 89-22, 1989-1 CB 276 (recapture tax applied where the transferee was not a member of qualified heir’s family, even though the transferee was a member of the decedent’s family).

\textsuperscript{270} IRC § 2032A(c)(1)(A); cf. TAM 9333002 (Apr. 20, 1993). If the qualified heir makes a gift of an interest in qualified real property to a member of the qualified heir’s family, valuation for gift tax purposes is not affected by the possible imposition of a recapture tax. Rev. Rul. 81-230, 1981-2 CB 186. Section 2032A is not applicable to Chapter 12, the gift tax, nor is there a comparable provision in Chapter 12. A cash lease of property to a qualified heir does not constitute a “disposition” to a qualified heir. Williamson v. Comm’r, 974 F2d 1525 (9th Cir. 1992). But see infra text accompanying notes 283–288. The qualified heir’s family member must enter into an agreement to be personally liable for any additional taxes imposed by Section 2032A(c), and the agreement must be attached to Form 706-A, United States Additional Estate Tax Return. Form 706-A, United States Additional Estate Tax Return,” Schedule C (Rev. December 2008). IRC § 2032A(d)(2). See supra ¶ 4.04[6].
tion by a qualified heir.\footnote{271}{The death of the qualified heir before disposition generally eliminates any potential additional tax. IRC § 2032A(c)(1). For a discussion of the exception to this rule, see the discussion supra ¶ 4.04[7][a], text accompanying note 260.}

In addition, a contribution of a qualified conservation easement does not constitute a disposition.\footnote{272}{IRC § 2032A(c)(8) (applying to qualified conservation easements granted after 1997). See Estate of Gibbs v. United States, 161 F3d 242 (3d Cir. 1998) (a sale of such an easement is not a “contribution”); Priv. Ltr. Rul. 200840018 (May 13, 2008) (same).}

The additional tax is imposed if the qualified heir sells or exchanges any interest\footnote{273}{Estate of Gibbs v. United States, 161 F3d 242 (3d Cir. 1998) (sale of development easement was a disposition even though the development easement was not a property interest under state law). Cf. Rev. Rul. 88-78, 1988-2 CB 330 (grant of leasehold interest for oil and gas in place, extradition of oil or disposition of oil and gas royalty rights not disposition of property valued under Section 2032A); Priv. Ltr. Rul. 200608012 (Nov. 3, 2005) (conveyance of water rights and granting of easement not disposition or cessation of qualified use).} in qualified property to a nonfamily member in a taxable transaction within the proscribed period. Nontaxable sales and exchanges under Section 1031 or Section 1033 will result in additional tax only to the extent that the transferor liquidates the property; there is no recapture tax when the qualified property involuntarily converted or exchanged for like-kind property is exchanged solely for real property or the proceeds of conversion are timely reinvested in real property to be used for the same qualified use as the qualified real property exchanged or converted.\footnote{274}{IRC §§ 2032A(h), 2032A(i). If some “boot” gain is recognized, there is recapture tax. See infra ¶ 4.04[7][c], text accompanying notes 317–321. Priv. Ltr. Rul. 8526032 (Apr. 1, 1985) (Section 1031 like-kind exchange); Priv. Ltr. Rul. 9604018 (Oct. 30, 1995) (same); Priv. Ltr. Rul. 9945046 (Aug. 12, 1999) (same); TAM 9333002 (Apr. 20, 1993) (foreclosure did not constitute an involuntary conversion). The provision relating to exchanges applies to exchanges after December 31, 1981, regardless of the decedent’s date of death. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 421(k)(3), 95 Stat. 172, 313 (1981), reprinted in 1981-3 CB 256, 331. If land is condemned, perhaps the proceeds may be used to improve the remaining land that originally qualified for special-use valuation. That might preclude nonrecognition of gain; the government has taken the position that the construction of improvements on land already owned by the taxpayer does not constitute replacement with property of a like kind within the meaning of Section 1033(g), because “land is not of the same nature or character as a building.” Rev. Rul. 67-255, 1967-2 CB 270, 271. This position has been rejected by one court. Davis v. United States, 411 F. Supp. 964 (D. Haw. 1976), aff’d on other grounds, 589 F2d 446 (9th Cir. 1979).} A gift of qualified property to a non-family member within the proscribed period will also trigger the imposition of the additional tax. Measurement of the recapture tax in instances of transfers for less than full consideration is discussed later.\footnote{275}{See infra ¶ 4.04[7][c], especially text accompanying note 318.} Severance of, or disposition of a right to sever, any standing timber treated as real property rather than as a
crop under a Section 2032A(e)(13)(A) election is to be treated as a disposition.\footnote{IRC § 2032A(c)(2)(E). Although the statute expressly treats “severance” as a “disposition,” should severance followed by use on the farm be treated as a disposition resulting in the imposition of recapture tax? For example, if timber on qualified woodland is severed and used to fence the remaining woodland, should the recapture tax be imposed?}

Mere changes in the form of business ownership are not intended to result in the imposition of the additional tax.\footnote{HR Rep. No. 1380, 94th Cong., 2d Sess. 3, 25 n.3 (1976), reprinted in 1976-3 CB (Vol. 3) 735, 759; Priv. Ltr. Rul. 8416016 (Jan. 13, 1984). Similarly, a partition of property is not a recapture event even if the interests received are commensurate with those given up. TAM 9113028 (Mar. 29, 1991).} The transfer of qualified property by the qualified heir tax-free to a corporation under Section 351 or to a partnership or a limited liability company under Section 721 does not constitute a disposition resulting in the imposition of the additional tax if three conditions are satisfied: (1) The qualified heir retains the same equitable\footnote{The regulations should clarify the requirement that the qualified heir retain “the same equitable interest in the property” transferred to a corporation or a partnership. Except for a transfer to a wholly owned corporation, it would be impossible to retain the same equitable interest in the property. Seemingly, the legislative history means that the qualified heir not liquidate in whole or in part the heir’s interest; that is, that no Section 351(b), Section 731, or Section 707(a)(2)(B) boot be received in return for the transfer of the qualified property.} interest in the qualified property after the transfer; (2) the qualified heir’s interest in the corporation or partnership after the transfer is an interest in a “closely held business,” as that term is defined in Section 6166(b);\footnote{A qualified heir’s interest in a partnership is a closely held business interest if the heir owns at least 20 percent of the total capital interest in the partnership or if the partnership has 45 (fifteen prior to 2002) or fewer partners. IRC § 6166(b)(1)(B). If the qualified heir owns at least 20 percent of the value of the voting stock or is one of 45 (fifteen prior to 2002) or fewer shareholders, the interest in the corporation is classified as an interest in a closely held business. IRC § 6166(b)(1)(C). See supra ¶ 4.04[3][b], note 66.} and (3) “the corporation or partnership consents to personal liability for the recapture tax if it disposes of the real property or ceases to use the property for qualified purposes during the period in which recapture may occur.”\footnote{HR Rep. No. 1380, 94th Cong., 2d Sess. 3, 25 n.3 (1976), reprinted in 1976-3 CB (Vol. 3) 735, 759. See Priv. Ltr. Rul. 201129016 (Apr. 6, 2011) (transfer of farmland to LLC).}

The second requirement, that the heir’s interest in the partnership or corporation be a closely held interest, should not apply if all shareholders or partners are members of the qualified heir’s family. A qualified heir may give or sell separate interests in a parcel of qualified property to an infinite number of family members without triggering additional tax. The only limitation is proclivity for prolificacy.
If a qualified heir sells the interest in the partnership or a corporation to a nonfamily member, the qualified heir should incur liability for any recapture tax that is imposed. Sale by the qualified heir should not result in recapture tax liability at the corporate or partnership level. If the corporation or partnership owning qualified real property disposes of it to a person who is not a member of the qualified heir’s family, the liability for recapture tax should also be discharged by the qualified heir or heirs who own the closely held business interests. Sale by the corporation or partnership to a member of the contributing qualified heir’s family should not trigger imposition of the additional tax. Furthermore, if property held by a corporation or partnership is exchanged for like-kind property or is involuntarily converted, the recapture tax should be avoided to the extent that like-kind property is received in the exchange or the real property acquired with the proceeds is used for the same qualified use as the qualified real property exchanged or converted.

[ii] **Cessation of qualified use.** The additional tax is imposed if within the recapture period the property valued pursuant to Section 2032A ceases to be devoted to the use originally qualifying the property for special-use valuation.

As was the case with respect to qualification of property for Section 2032A treatment, the question of whether the leasing of a farm constitutes a qualified use raises some complicated issues. Again, if the lease creates an element of risk to the qualified heir, there should be no cessation of qualified use. Generally, a net cash lease of the property, even to a member of the qualified heir’s family, constitutes a cessation of use and triggers the recapture

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281 See the discussion supra text accompanying note 274.

282 IRC § 2032A(c)(1)(B). Participation in “Payment-in-Kind” and other related land diversion programs offered to farmers by the Department of Agriculture will not have an adverse effect on qualifying for or maintaining Section 2032A treatment for either the owner decedent or the qualified heir. Ann. 83-43, 1983-10 IRB 29 (Mar. 7, 1983). Cf. TAM 9212001 (Mar. 20, 1992).

283 See supra ¶ 4.04[3][b], text accompanying notes 45–49.


However, if a surviving spouse or a lineal descendant of a decedent who qualified for Section 2032A treatment leases a farm or business to a member of the family of such spouse or descendant for a net cash lease, there is no cessation of qualified use or triggering of the recapture tax.

Conversion to another use or mere disuse may constitute cessation of a qualified use. Conversion of qualified real property used as a farm for farming purposes at the decedent’s death to use in a trade or business other than farming results in the imposition of the additional tax, but the exact outer reaches of this rule are unclear. It is possible that if the actual use of qualified real property is varied at all in the recapture period, the additional tax will be imposed. For example, if land devoted to use as a fruit stand is converted to use

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286 Williamson v. Comm’r, 974 F2d 1525 (9th Cir. 1992) (cash lease to family member); Stovall v. Comm’r, 101 TC 140 (1993) (same); Fisher v. Comm’r, 65 TCM (CCH) 2284 (1993) (same); Shaw v. Comm’r, 62 TCM (CCH) 396 (1991) (same); Martin v. Comm’r, 783 F2d 81 (7th Cir. 1986) (cash lease to nonfamily member); Hohenstein v. Comm’r, 73 TCM (CCH) 1886 (1997) (same after qualified heir physically incapacitated); Hight v. Comm’r, 58 TCM (CCH) 1457 (1990) (same). A cash rental to a family member constitutes a cessation of qualified use that triggers a recapture tax, even though a cash sale to a family member of a qualified heir would not trigger such tax. IRC § 2032A(c)(1)(A).

See also Minter v. United States, 19 F3d 426 (8th Cir. 1994) (cash lease to family-held corporation satisfying Regulations Section 20.2032A-3(b)(1) pre-death requirements constituted post-death qualified use).

287 See HR Rep. No. 795, 100th Cong., 2d Sess. 590 (1988), which explains the rationale for the spousal rule as follows:

Under present law, property may qualify for special use valuation if the decedent leases the property to a member of his family. The recapture tax is imposed, however, if the property is not used in a qualified use by the qualified heir. Thus, if a decedent leases the qualified real property to a member of his family and the property passes to his spouse, a recapture tax will be imposed under present law unless the spouse begins to use the property in a qualified use.

The committee believes that the surviving spouse should not be subject to more onerous rules than the decedent...

288 IRC § 2032A(c)(7)(E). Under the rule a legally adopted child of an individual is treated as a child by blood. Id. The rule applies to leases entered into after 1976. The Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 504(c), 111 Stat. 788, 854 (1997), reprinted in 1997-4 CB 1457, 1540. To provide relief where a tax has previously been triggered as a result of a cash lease, the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 581, 115 Stat. 38, 93 (2001), reprinted in 2001-3 CB 9, 65, provides that a claim for refund or credit of any overpayment of tax resulting from the application of Section 2032A(c)(7)(E) is allowed if the claim is filed prior to June 7, 2002, a date one year after the date of the enactment of the 2001 Act.

The Service, relying on United States v. Zacks, 375 US 59 (1963), initially took the position that such retroactivity did not waive the general statute of limitations for refund claims (Section 6511(a)), thus substantially limiting any such refund claims. TAM 9843001 (July 8, 1998).

289 IRC § 2032A(c)(6)(A).
as a processing plant, the additional tax may be imposed. But conversion from producing to processing would seem more significant. The normal rotation of crops on a farm should not trigger recapture; of less certain consequences would be the conversion to a vineyard of farmland that, until the decedent’s death, had been used to raise various grains. Literally, the statute can and should be interpreted to interdict conversions only when they involve a shift from a Section 2032A(b)(2)(A) use to a Section 2032A(b)(2)(B) use.290

Generally, the qualified heir’s mere failure to use property valued under Section 2032A for its qualified use during the recapture period results in imposition of a recapture tax.291 There are exceptions to this rule. A qualified heir is allowed a grace period of two years immediately after the decedent’s death in which to begin qualified use of the real property without triggering a recapture tax.292 Failure to use the property for its qualified use after the grace period expires and before the end of the recapture period may result in the imposition of the recapture tax.293 When an interest in qualified property is involuntarily converted,294 cessation of qualified use during the replacement period specified in Section 1033(a)(2)(B) does not trigger a recapture tax.295 Seasonal inactivity on property devoted to a qualified use by the qualified heir should not constitute cessation of qualified use. As a general rule, qualified use of property ceases and an additional tax is imposed if, in any eight-year period ending after the decedent’s death within the recapture period, tacking on periods when the decedent or any qualified heir held the property, there have been periods aggregating more than three years in which either holder (decedent or qualified heir) or a member of their families did not materially participate296 in the operation of the farm or other business.297

If an interest in qualified property is involuntarily converted, the period of time between the involuntary conversion298 and acquisition of qualified replace-

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290 IRC § 2032A(c)(6)(A).
291 IRC § 2032A(c)(1)(B).
292 IRC § 2032A(c)(7)(A)(i). See Priv. Ltr. Rul. 8240015 (June 29, 1982) (requiring the qualified heir to personally commence such use during the two-year period).
293 HR Rep. No. 201, 97th Cong., 1st Sess. 38, 173 (1981), reprinted in 1981-2 CB 352, 384. The grace period terminates on the earlier of commencement of qualified use by the qualified heir or the date two years subsequent to the date of the decedent’s death.
294 Section 2032A(h)(3)(A) defines “involuntary conversion” as a compulsory or involuntary conversion within the meaning of Section 1033.
295 IRC § 2032A(h)(2)(C)(i). The replacement period specified in Section 1033(a)(2)(B) is the period beginning on the earlier of the date of disposition of the converted property or the earliest date of the threatened condemnation and ending on the later of two years after the close of the taxable year in which any gain on the conversion is realized or at any later date that the Secretary approves.
296 Material participation is discussed supra ¶ 4.04[3][c][ii].
298 See IRC § 2032A(h)(3)(A).
ment property is disregarded in the determination of any eight-year period ending after the decedent’s death or the more-than-three-year period. Additionally, no recapture tax is to be imposed if the qualified heir commences use of the qualified property within two years of the decedent’s death. The Service should take the position that the grace period of up to two years should be disregarded in determining any eight-year period as well as the more-than-three-year period. The consecutive eight-year period may include seven years before the decedent’s death and one year after death, or other combinations. Periods aggregating more than three years are all that is required; the periods need not be consecutive. Assume, for example, a decedent dies on January 1, 1997, holding qualified property that is valued pursuant to Section 2032A in the computation of the decedent’s gross estate. Assume that neither the decedent (who has been dead a while) nor a member of the decedent’s family materially participated in the qualified use for the last six months of 1992 and again for nineteen months in 1995 and 1996. If the qualified heir or a member of the qualified heir’s family does not materially participate in the qualified use of the property for the last eleven and one-half months of 1999, the recapture tax will be imposed, assuming, of course, that the qualified heir survives the critical date and that the property involved was not involuntarily converted during the requisite eight-year period.

When qualified property is held by a qualified heir, active management by an eligible qualified heir, or in certain instances the eligible qualified heir’s fiduciary, will be treated as material participation. A qualified heir is an eligible qualified heir if the heir is the decedent’s surviving spouse, is under age 21, is disabled, or is a student. A qualified heir who is an eligible

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299 See IRC § 2032A(b)(3)(B).
300 IRC § 2032A(b)(2)(C)(i).
301 IRC § 2032A(c)(7)(A)(i).
302 Active management is discussed supra ¶ 4.04[3][c][iii].
303 If the qualified heir is an eligible qualified heir because the heir is not yet age 21 or is disabled, active management by a fiduciary of the eligible qualified heir will be treated as material participation by the heir. In all other instances, the eligible qualified heir must personally engage in the active management of the farm or other business. IRC § 2032A(c)(7)(B). Active management by a member of the eligible qualified heir’s family will not suffice.
304 IRC § 2032A(c)(7)(B).
305 IRC § 2032A(c)(7)(C)(i).
306 IRC § 2032A(c)(7)(C)(ii).
307 IRC § 2032A(c)(7)(C)(iii). A qualified heir is disabled if the qualified heir has a mental or physical impairment that renders the heir unable to participate materially in the operation of the farm or other business. IRC § 2032A(b)(4)(B).
308 IRC § 2032A(c)(7)(C)(iv). A qualified heir is a student if the heir is a full-time student at an organization described in Section 170(b)(1)(A)(ii) during each of five calendar months during the calendar year. IRC §§ 2032A(c)(7)(D), 151(c)(4).
qualified heir by virtue of being under age 21, disabled, or a student remains an eligible qualified heir only during the period such heir is under age 21, disabled, or a student, as the case may be.

[c] Measuring the Recapture Tax

[i] Introduction. The amount of the additional tax imposed on the occurrence of a recapture event is essentially the estate tax that was saved by special-use valuation, that is, the amount of tax that was avoided when the qualified real property was included in the gross estate at its special-use value rather than at its fair market value. Thus, the additional tax, when added to the estate tax initially paid, will never exceed the federal estate tax that would have been imposed had all property in the gross estate been included at its fair market value. Interest on the additional tax is payable only if the payment is not timely or if the qualified heir elects to increase the basis of the property. Consequently, even if the entire tax saving under Section 2032A is recaptured and assuming no elected basis increase, the decedent’s beneficiaries will have had, in effect, an interest-free loan from the government in the amount of the additional tax imposed for the period extending nine months after the decedent’s death until as much as six months after the occurrence of the recapture event.

Disregarding a special rule for the disposition of certain timber, and speaking more explicitly, the amount of the additional tax imposed is the lesser of two amounts: (1) the "adjusted tax difference" attributable to the affected interest, and (2) the excess of the amount realized in an arm’s-length sale or exchange of the interest over the Section 2032A value of the interest sold or exchanged. When qualified real property or any interest therein is transferred, triggering recapture other than in a sale or exchange at arm’s length, or ceases to be used for a qualified use, fair market value at the date of

309 IRC § 2032A(c)(7)(B).
310 See supra ¶ 4.04[7][b].
311 In a letter ruling, the Service has taken the position that, in computing the recapture tax, the actual value of the property at the date of death can be redetermined even if the statute of limitations has run on the decedent’s return. However, the recapture may not exceed the Section 2032A(a)(2) limit. Priv. Ltr. Rul. 8403001 (Sept. 9, 1983).
312 See IRC § 1016(c)(5)(B). The elective basis adjustment for additional tax imposed is discussed infra ¶ 4.04[7][h].
313 The special rule is discussed infra ¶ 4.04[7][c][v].
314 IRC § 2032A(c)(2)(A)(i).
315 IRC § 2032A(c)(2)(A)(ii). The Section 2032A value of the interest actually sold or exchanged is determined on a pro rata basis. See IRC § 2032A(c)(2)(D)(i).
the recapture event replaces the amount realized in the second of the two measures.\textsuperscript{316}

When qualified real property is involuntarily converted and the cost of the qualified replacement property\textsuperscript{317} is less than the amount realized on the conversion, or when qualified real property is exchanged not solely for qualified exchange property,\textsuperscript{318} a recapture tax is imposed.\textsuperscript{319} However, the amount of the additional tax imposed is reduced if all or a part of the amount realized is reinvested in or exchanged for real property to be used for the same qualified use as the original qualified real property converted or exchanged. The reduction permitted is the amount that bears the same ratio to the additional tax as the cost of the qualified replacement property bears to the amount realized on the involuntary conversion\textsuperscript{320} or as the fair market value of the qualified exchange property bears to the qualified real property exchanged.\textsuperscript{321}

[ii] \textbf{The adjusted tax difference.} The amount of the adjusted tax difference attributable to an interest acquired by a qualified heir is essentially the additional federal estate tax that would have been imposed with respect to that interest had the interest been included in the gross estate at its fair market value rather than at its special-use value. Since the tax is actually imposed on the entire taxable estate, a formula is provided to determine tax attributable to any interest or portion. Thus, the adjusted tax difference attributable to an interest is defined as an amount that bears the same ratio to the adjusted tax difference with respect to the estate as the excess of the fair market value of the interest over the special-use value of the interest bears to a similar excess determined for all qualified real property.\textsuperscript{322} The adjusted tax difference with respect to the estate is the excess of what would have been the estate tax liability, but for Section 2032A, over the estate tax liability.\textsuperscript{323} The estate tax liability, as that term is used here, is the tax imposed by Section 2001 reduced by credits allowable against the tax.\textsuperscript{324} The formula describing the adjusted tax

\begin{footnotesize}
\begin{enumerate}
\item No recapture tax is imposed by Section 2032A(c) if the amount realized in an involuntary conversion or like-kind exchange is all reinvested in or exchanged solely for qualified real property. See IRC §§ 2032A(h)(1)(A)(i), 2032A(i)(1)(A). These sections are discussed in greater detail supra ¶ 4.04[7][b][i].
\item IRC § 2032A(h)(1)(B).
\item IRC § 2032A(i)(1)(B). The fair market values are determined at the time of the exchange.
\item IRC § 2032A(c)(2)(B).
\item IRC § 2032A(c)(2)(C).
\item IRC § 2032A(c)(2)(C). The repealed Section 2011 state death tax credit may come into play here if a Section 2011 credit was allowed at the decedent’s death. See ¶ 3.03. If a state did not impose additional death tax in such circumstances, the Section 2011 credit
\end{enumerate}
\end{footnotesize}
difference attributable to an interest in the estate may be better understood in terms of the following equation:

\[
\text{adjusted tax difference attributable to the interest} = \frac{\text{excess of fair market value of the interest over } \S 2032A \text{ value of the interest}}{\text{excess of fair market value of all qualified real property over } \S 2032A \text{ value of all qualified real property}} \times (\S 2032A \text{ minus estate tax liability with } \S 2032A)
\]

Assume that a decedent who died in 2013 not survived by a spouse had, utilizing Section 2032A, a taxable estate of $7 million on which a tax of $700,000 was imposed. The estate included qualified real property with a fair market value of $4 million, which was taken into account in the gross estate at its special-use value of $3 million. The qualified real property was devised to two of the decedent’s children in equal shares. Assume that one child sells his share of the qualified real property to an unrelated third party for a price of $2 million five years after the decedent’s death. The additional tax imposed is the lesser of the adjusted tax difference and the amount realized less the special-use value of the interest. The first amount, the adjusted tax difference, is $200,000, computed using the preceding formula:

\[
\text{adjusted tax difference attributable to the interest} = \frac{\$2,000,000 - \$1,500,000}{\$4,000,000 - \$3,000,000} \times (\$1,100,000 - \$700,000) \times 325
\]

used in the computation is the lesser of the maximum allowable credit under Section 2011(b) if there had been no Section 2032A election or the state death taxes actually paid. Cf. Rev. Rul. 82-35, 1982-1 CB 128 (computation of a Section 6324B lien). If a state did impose a recapture tax, the Service has taken the position that the Section 2011 credit used in the computation is the lesser of the maximum credit allowable under Section 2011(b) if there had been no Section 2032A election or the sum of the state death taxes actually paid and the potential state recapture tax. TAM 9940005 (June 2, 1999). Cf. Rev. Rul. 82-35, supra. The later position is at variance with the legislative history, which does adjust the credit to take account of the state recapture tax because it does not treat such recapture tax as a state death tax. See HR Rep. No. 201, 97th Cong., 1st Sess. 38, 167 n.14 (1981), reprinted in 1981-2 CB 352, 381.

The federal estate tax imposed is computed as follows:

<table>
<thead>
<tr>
<th></th>
<th>With § 2032A</th>
<th>Without § 2032A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable estate</td>
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<td>$8,000,000</td>
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<tr>
<td>§ 2001(b)(1) tent tax</td>
<td>$2,745,800</td>
<td>$3,145,800</td>
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<tr>
<td>§ 2001(b)(2) amount</td>
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</tr>
<tr>
<td>Tax imposed</td>
<td>$2,745,800</td>
<td>$3,145,800</td>
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<tr>
<td>§ 2010 credit</td>
<td>($2,045,800)</td>
<td>($2,045,800)</td>
</tr>
<tr>
<td>Tax payable</td>
<td>$700,000</td>
<td>$1,100,000</td>
</tr>
</tbody>
</table>

See Priv. Ltr. Rul. 8350035 (Sept. 1983) for another illustration of this computation.
4.04[c] = \( \frac{\$500,000}{\$1,000,000} \times \$400,000 \) = $200,000

The second amount, the amount realized ($2 million), less the actual-use value of the interest sold ($1,500,000) equals $500,000. Therefore, the amount of additional tax imposed on the sale is $200,000, the adjusted tax difference of the selling child’s interest, which is the lesser of the two amounts.\(^{326}\)

[iii] Recapture of portions of an interest. The first recapture event involving a portion of an interest in qualified real property acquired from a decedent requires application of the general rule used to compute the amount of the additional tax imposed. When the qualified heir disposes of a portion of an interest in qualified real property acquired from the decedent or there is cessation of qualified use of only a portion of the interest acquired from the decedent, the amount of the additional tax imposed under the general rule may not exceed the amount realized with respect to the portion of the interest disposed of, or the fair market value of the portion of the interest where applicable, reduced by the Section 2032A value of the portion of the interest where applicable, reduced by the Section 2032A value of the portion of the interest involved in the recapture event. Thus, the general rule imposes additional tax in an amount equal to the lesser of (1) the adjusted tax difference, and (2) the excess of the fair market value of or amount realized on the portion of the interest over the Section 2032A value of the portion of the interest. The Section 2032A value attributed to the portion of the interest involved in the recapture event is a pro rata share of the Section 2032A value of the entire interest acquired by the qualified heir from the decedent.\(^{327}\) The recapture tax imposed on a portion of the interest is the same as the recapture tax imposed on the disposition of the entire interest, except where the amount realized or fair market value, as the case may be, of the interest reduced by the pro rata Section 2032A value attributed to the portion is less than the adjusted tax difference.\(^{328}\)

\(^{326}\) If the child had sold the interest for $1,600,000, the first amount, the adjusted tax difference remains the same as in the example above, $200,000; but the second amount (the amount realized, $1,600,000, less the special-use value of the interest, $1,500,000) equals $100,000. Under these facts, the second amount is the lesser, so the amount of additional tax imposed is $100,000.

\(^{327}\) IRC § 2032A(c)(2)(D)(i).

\(^{328}\) Thus, disposition or cessation of use of a portion of an interest may result in a recapture of the adjusted tax difference attributable to the entire interest in qualified property. HR Rep. No. 1380, 94th Cong., 2d Sess. 3, 26 (1976), reprinted in 1976-3 CB (Vol. 3) 735, 760.

For example, assume a decedent not survived by a spouse has a taxable estate in 2013 of $7 million on which a tax of $700,000 is imposed. See supra note 325. The estate includes only one parcel of qualified real property with a fair market value of $4 million.
In contrast, computation of the recapture tax involving the second or any subsequent portion of the same interest requires that the adjusted tax difference be reduced by the additional tax imposed on all prior transactions involving that interest. Thus, the formula for the additional tax on subsequent dispositions of portions of the same interest is the lesser of (1) the adjusted tax difference less the additional tax imposed on prior transactions involving the interest, and (2) the excess of the fair market value of or amount realized on the portion of the interest over the Section 2032A value of the portion of the interest.

**[iv] Successive interests.** The statute does not specifically discuss the imposition of additional tax when two or more qualified heirs acquire successive interests in qualified real property. Presumably, if all qualified heirs with interests in a particular parcel of qualified real property join in a sale of the qualified real property to an unrelated third party, the amount of additional tax imposed should be divided on the basis of the amount realized by each qualified heir possessing an interest in that parcel of real property. In the event the qualified real property is held in trust, the tax should be paid out of the proceeds of sale if the proceeds of sale are received by the trustee.

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included in the gross estate at its special-use value of $3 million. The parcel of qualified property is devised to the decedent’s son. Assume that the son sells one third of the qualified real property to an unrelated third party for $2 million five years after the decedent’s death. The additional tax imposed is the lesser of (1) the adjusted tax difference attributable to the entire parcel acquired by the son from the decedent, or (2) the amount realized, less the pro rata share of the special-use value of the interest attributed to the portion of the parcel sold. The first amount, the adjusted tax difference, is $400,000, computed as follows:

\[
\frac{4,000,000 - 3,000,000}{4,000,000 - 3,000,000} \times (1,100,000 - 700,000) = 400,000
\]

See supra note 325. The second amount, the amount realized, $2 million, less the pro rata share of the special-use value of the entire parcel attributed to the portion of the parcel sold, $1 million ($3 million \(\times \frac{1}{3}\)), equals $1 million. The amount of additional tax imposed on the sale of one third of the parcel to a third party is therefore $400,000, the lesser of the $400,000 and $1 million amounts. See Priv. Ltr. Rul. 8434085 (May 23, 1984); Priv. Ltr. Rul. 8531004 (1985).

IRC § 2032A(c)(2)(D)(ii). A similar adjustment is made when the special rule for disposition of timber applies. See infra ¶ 4.04[7][c][v].

It is unclear whether an allocation would prorate the tax on the basis of the actuarial values of their respective interests computed at the date of the decedent’s death or the date of the sale.

Discharge of the additional tax by the trustee with trust funds may result in a constructive distribution from the trust to the qualified heirs possessing the qualified interests in the property with income tax consequences. See IRC §§ 661, 662.

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Section 2032A
When two or more qualified heirs acquire successive interests in qualified real property and any one qualified heir disposes of the qualified heir’s interest or portion thereof, the additional tax is imposed. The amount of tax imposed will generally be only the tax computed under the general rule attributable to the interest in qualified real property of that heir. 332 Although there is no authority, if one qualified heir has the power to extinguish the successive interests of other qualified heirs and does so in a transaction resulting in the imposition of an additional tax, the power holder should be responsible for any additional tax that is imposed.

A successive interest holder may incur personal liability prior to the time the holder’s interest ripens into a possessory interest. For example, one qualified heir may acquire from the decedent a legal life estate in qualified real property and, while in possession of the property, cease to use the entire parcel for a qualified use. This event will trigger the imposition of additional tax with respect to any successive interests in this parcel of qualified real property acquired from the decedent. Qualified heirs with successive interests may be required to discharge the liability prior to the time their respective interests ripen into possessory interests. It is entirely possible that an extension of time for payment of the additional tax will be allowed in this situation, similar to that provided by Section 6163 for remainder or reversionary interests required to be included in the gross estate prior to the termination of the preceding interest or interests in the property. If no extension is provided, the qualified heirs acquiring successive interests in qualified real property may experience difficulty in raising money to discharge the additional tax liability, a factor that may prevent their consenting to Section 2032A valuation of real property otherwise qualifying for special-use valuation.

[v] Special rule for dispositions of timber. Disposition, severance, or disposition of a right to sever any standing timber on qualified woodland333 classified as qualified real property334 is treated as a disposition of a portion of the qualified heir’s interest in all qualified real property acquired from the decedent.335 The amount of additional estate tax imposed on a first disposition or

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332 A disposition of an interest in qualified property resulting in the imposition of an additional tax on one qualified heir, where other qualified heirs also have an interest in the same parcel of real property, should trigger the tax attributable to the interest of that qualified heir, not the interests of other qualified heirs in the same parcel of real property.

333 IRC § 2032A(c)(13)(B). This section is discussed supra ¶ 4.04[3][c], text accompanying notes 107, 108.

334 IRC § 2032A(c)(13)(A). See supra ¶ 4.04[4].

severance is the lesser of two amounts: (1) the amount realized, and (2) the amount of additional tax that would be imposed if the qualified heir disposed of the heir’s entire interest in the qualified woodland. This latter amount is the lesser of (1) the adjusted tax difference attributable to the qualified heir’s entire interest in the qualified woodland, and (2) the excess of the amount realized over the special-use value of the qualified heir’s entire interest in the qualified woodland. Computation of the recapture tax involving any subsequent disposition or severance of standing timber on qualified woodland requires that the amount of additional estate tax that would be imposed if the qualified heir disposed of the entire interest in the qualified woodland be reduced by the amount of additional estate tax imposed on all prior dispositions or severances of standing timber on qualified woodland. In addition, if the qualified heir actually does dispose of the qualified woodland itself, the amount of additional estate tax imposed on the disposition is reduced by the amount of additional estate tax previously imposed on the disposition or severance of standing timber on that qualified woodland.

[d] Imposition of Only One Additional Tax

Only one additional tax may be imposed on any portion of an interest in qualified real property acquired from a decedent by a qualified heir. If there has been a recapture event described in Section 2032A(c)(1)(B), such as the cessation of qualified use, that triggers the imposition of an additional tax with respect to a portion of an interest, the sale thereafter to an unrelated third party of the same portion of the interest, although a recapture event described in Section 2032A(c)(1)(A), will not result in the imposition of any additional tax. This rule may operate to the advantage of a qualified heir. Assume a qualified heir acquires one parcel of qualified real property from a decedent. Subsequent to the decedent’s death, this parcel declines in value until its fair market value equals its special-use value. At that point, the qualified heir ceases to use the property for the qualified use, and the cessation of qualified use is a recapture event. The additional tax imposed under Section 2032A(c)(1)(B) amounts to

336 IRC § 2032A(c)(2)(E)(ii)(I). In any case other than an arm’s-length sale, the fair market value of the timber severed or disposed of is used. The effect of this special rule is to treat the sale or disposition to the extent of the amount realized as a sale of the entire property and not a portion of the property, which is the general rule on recapture of a portion of an interest. Compare supra ¶ 4.04[7][c][iii], especially text accompanying notes 327, 328.
337 IRC § 2032A(c)(2)(E)(ii)(II).
338 IRC § 2032A(c)(2)(A).
339 IRC § 2032A(c)(2)(E)(ii)(II).
340 IRC § 2032A(c)(2)(E).
341 IRC § 2032A(c)(3).
zero, because the fair market value of the parcel on the date the additional tax is imposed equals its special-use value.\textsuperscript{342} The subsequent sale of the same parcel by the qualified heir within ten years of the decedent’s death to a non-family member for an amount in excess of the special-use value does not result in the imposition of additional tax, because a second additional tax may not be imposed upon the occurrence of the second recapture event involving the same parcel of qualified real property.\textsuperscript{343}

[c] Due Date for the Additional Tax

The additional tax imposed under Section 2032A(c) is due and payable within six months after the recapture event.\textsuperscript{344} The six-month period expires on the date numerically corresponding to the date of the recapture event.\textsuperscript{345} No interest is imposed in the event that the recapture tax is paid when due.

Any additional tax imposed should, if there is reasonable cause, qualify for an extension of time for payment for a reasonable period under Section 6161(a)(2)(A) as a tax imposed by Chapter 11.\textsuperscript{346} Although the estate of the decedent may qualify for deferral of payment under Section 6166 for the estate tax imposed by Section 2001, payment of the additional tax does not qualify for Section 6166 deferral. The additional tax is imposed by Section 2032A(c). Since it is neither a tax imposed by Section 2001 nor a deficiency in the tax imposed by Section 2001, Section 6166 is inapplicable.\textsuperscript{347}

[f] Liability for the Additional Tax

The qualified heir is personally liable, generally for a ten-year period following the decedent’s death, for any additional tax imposed with respect to the qualified heir’s interest in qualified real property unless a bond is furnished in lieu of personal liability.\textsuperscript{348} The qualified heir who incurs personal liability

\textsuperscript{342} IRC § 2032A(c)(2)(A)(ii).

\textsuperscript{343} IRC § 2032A(c)(3).

\textsuperscript{344} IRC § 2032A(c)(4). Form 706-A, United States Additional Estate Tax Return, is used to report the additional tax due because of the application of Section 2032A(c).

\textsuperscript{345} Presumably, if there is no date in the sixth month following the date of the recapture event corresponding to the date of the recapture event, the last day of the sixth month is the due date.

\textsuperscript{346} Under Section 6161(a)(2), an extension of time for payment of estate tax may be granted for a reasonable period, not in excess of ten years, for reasonable causes.

\textsuperscript{347} See IRC §§ 6166(a)(1), 6166(h).

\textsuperscript{348} IRC § 2032A(c)(5). See also IRC § 2032A(c)(11). The ten-year period begins on the date of the decedent’s death or on the date the qualified heir commences qualified use if within two years of the date of the decedent’s death. See IRC § 2032A(c)(7)(A), discussed supra ¶ 4.04[7][a]. Furthermore, the ten-year period may be extended where the
need not acquire the qualified property directly from the decedent. A qualified heir may dispose of an interest in qualified real property to a family member without the imposition of an additional tax.\textsuperscript{349} Thereafter, the member of the qualified heir’s family to whom the property is transferred becomes “the qualified heir” with respect to the interest transferred\textsuperscript{350} and incurs personal liability for the recapture tax, even though the family member may have purchased the property for its full fair market value.\textsuperscript{351}

A qualified heir may be discharged of personal liability for recapture tax by furnishing a bond. The bond must cover the requisite period of time and be in an amount equal to the maximum additional tax that may be imposed with respect to the interest in qualified real property.\textsuperscript{352} Upon written request, the qualified heir must be provided a determination of the maximum amount of additional tax that may be imposed with respect to the interest.\textsuperscript{353} The Secretary is required to furnish the determination of the amount within one year of the request at the latest, but preferably as soon as possible.\textsuperscript{354}

\textbf{[g] Statute of Limitations}

The additional tax imposed under Section 2032A(c) has its own statute of limitations, which takes precedence over any other law or rule of law.\textsuperscript{355} The statutory period for assessment of an additional tax expires three years after the date the Service is notified of the recapture event.\textsuperscript{356} If qualified real property is the subject of a Section 1031 like-kind exchange\textsuperscript{357} or a Section 1033 involuntary conversion,\textsuperscript{358} the limitations period expires three years after the Service is notified of the exchange, replacement, or intention not to replace the qualified property is involuntarily converted. This extension is discussed more fully supra ¶ 4.04[7][a], text accompanying notes 258, 259.

\textsuperscript{349} See IRC § 2032A(c)(1)(A).
\textsuperscript{350} IRC § 2032A(e)(1).
\textsuperscript{351} HR Rep. No. 1380, 94th Cong., 2d Sess. 3, 26, 27 (1976), reprinted in 1976-3 CB (Vol. 3) 735, 760, 761. The special estate tax lien for potential recapture tax remains on the property also. The lien is discussed supra ¶ 4.04[6], text accompanying notes 245–248.
\textsuperscript{352} IRC § 2032A(e)(11).
\textsuperscript{353} IRC § 2032A(e)(11).
\textsuperscript{354} IRC § 2032A(e)(11).
\textsuperscript{356} IRC § 2032A(f)(1). Stovall v. Comm’r, 101 TC 140 (1993) (notification is not limited to a Form 706A; response to a Service questionnaire will suffice).
\textsuperscript{357} See IRC § 2032A(i).
\textsuperscript{358} See IRC § 2032A(h).
converted property.\footnote{IRC § 2032A(f)(1).} Even if the occurrence of a recapture event results in the imposition of an amount of additional tax equaling zero under Section 2032A(c)(2), prudence dictates notification be given to the Service to start the statute of limitations running.\footnote{IRC § 2032A(c)(1).}

[h] Basis Adjustment for Additional Tax

If Section 2032A applies to value property, the basis of the qualified property in the hands of a qualified heir is its value determined under Section 2032A.\footnote{IRC § 1014(a)(3).} If the additional estate tax is imposed under Section 2032A(c)(1), the qualified heir, for a price, may elect to increase the basis in the qualified real property by an amount equal to the difference between the fair market value of the interest on the applicable valuation date and the special-use value of the interest.\footnote{IRC § 1016(c)(1).} On a partial disposition of qualified real property, only a commensurate amount of increasing adjustment is made to the qualified heir’s basis.\footnote{IRC § 1016(c)(2)(A).} The adjustment is in an amount that bears the same ratio to the increase that would be allowed if the qualified heir disposed of the entire interest as the recapture tax actually imposed on the partial disposition bears to the total potential recapture tax.\footnote{IRC § 1016(c)(2)(A).} If the additional estate tax is imposed with re-

\footnote{\footnote{IRC § 1040(c).} Generally, this will increase the basis of the qualified real property to its fair market value on the date of the decedent’s death or the alternate valuation date, whichever was employed. However, in some instances the qualified heir’s basis in the qualified real property will be increased above the fair market value on the applicable valuation date. See IRC § 1040(c).}

\footnote{IRC § 1016(c)(2)(A). A partial disposition is limited to the situations discussed supra ¶ 4.04[7][c][iii]. IRC § 1016(c)(2)(B).}

\footnote{IRC § 1016(c)(2)(A). This ratio formula is illustrated as follows:}

\[
\text{amount of increase} = \frac{\text{recapture tax actually imposed on the partial disposition}}{\text{potential recapture tax if the entire property had been disposed of under § 2032A}} \times \frac{\text{fair market value on the applicable valuation date less the special-use valuation under § 2032A}}{}.
\]
spect to qualified replacement property\textsuperscript{368} or qualified exchange property\textsuperscript{369} previously acquired in an involuntary conversion under Section 1033 or an exchange to which Section 1031 applied, the basis adjustment under Section 1016(c)(1) is made by reference to the property involuntarily converted or exchanged.\textsuperscript{370}

Any increase in basis under Section 1016(c) is deemed to occur immediately prior to the event resulting in the imposition of the additional tax.\textsuperscript{371} Therefore, if a disposition triggers recapture, the increased basis is used for purposes of determining gain or loss on that disposition. No retroactive changes in depreciation or other deductions or credits may be made to reflect the increased basis.\textsuperscript{372}

There is a price, literally, for making the elective increase to basis: The qualified heir must pay interest on the additional estate tax from the time the estate tax return was required to be filed\textsuperscript{373} until the date the additional tax is paid.\textsuperscript{374}

\section{4.05 SECTION 2033. PROPERTY IN WHICH THE DECEDENT HAD AN INTEREST}

\subsection{[1] Introduction}

Section 2033 requires that there be included in the gross estate the value of all property to the extent of the decedent’s interest therein. It would be simpler to refer to property owned by the decedent, and such a statement might well reflect the typical layman’s notion of the gross estate for tax purposes. However, the provision is framed more precisely to avoid any possible inference that only the value of property owned outright by the decedent is to be included. It is the value of property to the extent of any interest therein of the decedent that is to be included.

If the value of property interests must be included in a decedent’s estate under Section 2033, such interests must first be identified and then their value ascertained. In the discussion here, and in the discussion that follows of other

\begin{footnotes}
\footnotetext{368} IRC § 2032A(h)(3).
\footnotetext{369} IRC § 2032A(i)(3).
\footnotetext{370} IRC § 1016(c)(4).
\footnotetext{371} IRC § 1016(c)(3).
\footnotetext{373} IRC § 6075.
\footnotetext{374} IRC § 1016(c)(5)(B).
\end{footnotes}
Code sections defining “gross estate,” only the identification question is emphasized. Applicable valuation principles are explored in an earlier part of this chapter in connection with Sections 2031, 2032, and 2032A.

This discussion concerns only property interests that are brought into a decedent’s gross estate by Section 2033. Sometimes, under other sections that are part of the statutory definition of “gross estate,” a decedent’s retention until death of an interest in property that the decedent has transferred during life will cause something more than the value of the retained interest to be included. Such a possibility will not be further anticipated in this section.

[2] Beneficial Interest

The interest of the decedent that gives rise to tax liability under Section 2033 is, of course, a beneficial interest. If one held title to property only as a guardian or trustee or in some other fiduciary capacity, the person did not have an interest in property that is recognized by Section 2033. If legal title to property was in the decedent, the estate must establish that the decedent had no beneficial interest, which may present a difficult problem of proof.

[a] State Law

If the federal estate tax is imposed on property in which the decedent had an interest, what law determines whether the decedent had an interest and, if so, the extent of the interest? It is still essentially accurate to say, as the Supreme Court did fifty years ago, “State law creates legal interests and rights.

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1 See IRC §§ 2036, 2037, 2039, 2040, 2042. Also, of course, if a decedent’s attempted lifetime transfer was ineffective, the decedent’s interest in the property will be included under Section 2033. See Estate of Fox v. Comm’r, 69 TCM (CCH) 1719 (1995); Broadhead Trust v. Comm’r, 31 TCM (CCH) 975 (1972).

2 Reg. § 20.2033-1(a).


The federal revenue acts designate what interests or rights, so created, shall be taxed. Consequently, the estate tax, as is true of all federal taxes, is not to be dealt with in a federal vacuum. Instead, it is a federal exaction superimposed on locally determined rights and interests.

At one time, the Commissioner seized on this principle to attempt to include as property of the decedent under Section 2033 some state gift taxes paid by the decedent on transfers during life where state law deemed such payments prepayment of inheritance taxes. The Commissioner was unsuccessful in the attempt and reversed the position in Revenue Ruling 81-302.

On the other hand, the meaning to be accorded the term “interest” in Section 2033 (and that term elsewhere or any other term in the estate tax statute) is a purely federal question; local nomenclature and characterization are not controlling. Thus, if a state statute undertook to say that the rights of the remainderperson of a trust do not constitute an interest in property, this would by no means foreclose a court deciding a federal estate tax case from interpret-
ing the term “interest” to encompass such rights. State law would govern the relationship of the remainderperson to the trust property; but whether the relationship fixed by local law amounted to an interest in the property would present a purely federal question.\footnote{Cf. Price v. United States, 470 F. Supp. 136 (ND Tex. 1979), aff’d per curiam, 610 F2d 383 (5th Cir. 1980).}

[b] State Decrees

If there is uncertainty regarding a decedent’s relationship to property, a federal court in an estate tax case may have to decide that underlying issue, even though it is determined by local law, as a necessary part of settling any federal estate tax controversy. Thus, a federal court may decide whether the decedent had title to property only as a trustee or whether instead had a beneficial interest in the property. But it will apply state statutory and common-law principles in the decision of that underlying issue. Suppose, after a decedent’s death, such an issue is litigated in the state probate courts and decided before adjudication of estate tax liability. Does that settle the matter, or can it be reopened in a subsequent estate tax case? The state court might have held, for example, that the decedent was only a trustee and that the property belonged to child A for whom the trustee held it, rather than that the decedent had full ownership of the property so that it would pass to child B, who was residuary legatee under the decedent’s will. Strange as it must surely seem, even though the state court decision, if final, fixes the interests of A and B and does so on the ground that the decedent had no beneficial interest, the beneficial interest question can probably be relitigated in the federal tax controversy. It cannot be reopened in any way that will affect the rights of A or B, which are res judicata and fixed under the local court’s decision. But the court deciding the tax controversy can decide, contrary to the local decision, that the decedent had a beneficial interest in the property and that it is therefore subject to estate tax under Section 2033. In Commissioner v. Estate of Bosch,\footnote{Comm’r v. Estate of Bosch, 387 US 456 (1967).} the Supreme Court indicated it will not give finality in a tax controversy to a state court’s decision on an underlying state law issue, unless the local decision is by the state’s highest court.\footnote{The Bosch principle does not apply, however, to a determination of rights and interests settled by local adjudication and res judicata at a time before events that raise a federal tax question occur. Rev. Rul. 73-142, 1973-1 CB 405. See Priv. Ltr. Rul. 200543037 (July 12, 2005) (state court order given effect). See also Ufford, “Bosch and Beyond,” 60 ABAJ 334 (1974), discussing procedures instituted by some states to broaden access to the highest court of the state in an effort to comply with Bosch. In addition, retroactive changes of legal effects of a transaction through judicial nullification of a transfer or a document do not have retroactive effect for federal tax purposes and thus do not alter results under Section 2033. Priv. Ltr. Rul. 9609018 (Nov. 27, 1995). Cf. Estate of Hill v.}
What has just been said may seem outrageous and, indeed, in this respect *Bosch* seems to rest on a false analogy to the philosophy supporting the doctrine of *Erie Railroad v. Tompkins*.

The doctrine permitting reexamination of local decisions in federal tax cases seems more supportable when the difficulty that engendered the rule is understood. Within a family group (children *A* and *B* in the prior example), it may be far less important whether *A* or *B* gets the property than whether some part of the property goes to the government in the form of federal estate tax. Therefore, it may be wondered whether state court litigation in which the rights of parties are seemingly asserted is really adversarial in nature, or worse, whether it is collusive, or whether it may not even edge up toward outright fraud; hence it may also be wondered whether the local decision handed down should be viewed at all as an adjudication of the interests of the parties litigant. At best, the government, which is really an interested party to the extent that the local litigation may bear on estate tax liability (none in the prior example, if the decedent was a mere trustee for *A*), will not have been an actual party whose cause is heard by the local court. Before the Supreme Court undertook to lay down the broad principle now established, the lower courts labored to mark off identifiable circumstances in which the Tax Court was not bound by local adjudications; but the result was largely confusion.

If the current answer seems draconian, at least the Supreme Court has not disturbed the settled principle that state law is determined by state statute and the decisions of the highest court of the state. In fact, it extends that principle to accord full recognition to state determinations of the rights of parties, if the determinations are made by a state’s highest court.

However, in the absence of such decisions, only “proper regard,” not finality, is to be given a prior lo-

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14 *Erie RR v. Tompkins*, 304 US 64 (1938). *Erie* held that only the highest court of a state can make a final determination of what the state’s common-law principles are. But any court whose decision becomes final, if it has not been defrauded or otherwise imposed upon by way of collusion, has settled the property interests at issue in the case, even if it has done so in a way later found to be at variance with the law of the state. Application of *Erie* to these federal tax questions has been criticized. See, e.g., Brown & Hinkle, “Tax Effects of Non-Tax Litigation: Bosch and Beyond,” 27 NYU Inst. on Fed. Tax’n 1415, 1421–1423 (1969); Note, “Bosch and the Binding Effect of State Court Adjudication Upon Subsequent Federal Tax Litigation,” 21 Vand. L. Rev. 825, 840–841 (1968); Note, “Taxation: The Role of State Trial Court Decisions in Federal Tax Litigation,” 21 Okla. L. Rev. 227, 229–230 (1968); Note, “Binding Effect of State Court Judgment in Federal Tax Cases,” 21 Sw. LJ 540, 544–545 (1967).


cal decision. The results reached by federal courts in giving proper regard to such decisions have varied. While it might be hoped that the proper regard admonition would cause tax courts to accord recognition to prior local decisions except in fishy circumstances, there is only slight indication that this will be the case. In fact, the lower courts labor under a confusion as to the meaning of the phrase “proper regard,” which leaves them in somewhat the same uncertainty they were in before *Bosch*.

The three problems alluded to very briefly here—the importance of state law, the interpretation of a term in a federal statute, and the significance of a local decision—are all-pervasive in federal tax matters and surface again in many places throughout this book.

[3] **Routine Inclusions**

Drawing the perimeter of Section 2033 presents some difficult questions regarding the full reach of the section, which questions are dealt with subsequently in this discussion; but in many instances the applicability of the section is not questionable.

If the decedent is the sole owner of real property, the property’s value is included in the decedent’s gross estate. This is so even if the property is not subject to administration, because, under local law, title passes directly to the heirs or devisees. Thus, while it is generally accurate to suggest that Section 2033 essentially describes the “probate” estate, the two concepts are not identical. Moreover, “homestead” or similar state law exemptions that may shield property from some state taxes or creditors’ claims do not keep the value of

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18 Estate of Nilson v. Comm’r, 31 TCM (CCH) 708 (1972).

19 Lake Shore Nat’l Bank v. Coyle, 296 F. Supp. 412, 418 (ND Ill. 1968), rev’d on other grounds, 419 F2d 958 (7th Cir. 1970), refers to “proper regard,...whatever that means.”

20 Estate of Cone v. Comm’r, 60 TCM (CCH) 137 (1990).

21 Reg. § 20.2033-1(a).

22 Nor are estate tax gross estate concepts the same as “estate” concepts for income tax purposes. Compare Reg. § 1.661(a)-2(e) with Reg. § 20.2033-1.
property out of the gross estate. The regulations provide that a cemetery lot owned by a decedent is included in the decedent’s gross estate, but only that part of the lot that is not designed for the interment of the decedent and members of the decedent’s family. The thought here may be that with respect to such a plot of ground, the decedent can take it with her.

Tangible personal property solely owned by the decedent is also clearly swept into the decedent’s gross estate by Section 2033. As a pure question of law, there is no doubt that jewelry, automobiles, boats, furniture, and other personal and household effects owned by the decedent are includible in the decedent’s gross estate under Section 2033. However, the factual question of whether a particular item was owned by the decedent can be very troublesome. Indeed, some day a court may be asked to determine whether the decedent or the surviving spouse was the owner of the marital bed.

Many intangible property interests raise no questions. Thus, Section 2033 includes in the gross estate currency in the decedent’s safe-deposit box, unless it can be shown that it was not the decedent’s. Likewise, the balance in one’s personal checking and savings accounts and any credit balance in one’s personal account with a brokerage firm are includible. Note that a joint tenancy

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23 Reg. § 20.2033-1(b); Estate of Johnson v. Comm’r, 718 F2d 1303 (5th Cir. 1983), appropriately reversing a controversial contrary Tax Court holding at 77 TC 120 (1981); Estate of Hinds v. Comm’r, 11 TC 314 (1948), aff’d on another issue, 180 F2d 930 (5th Cir. 1950); Priv. Ltr. Rul. 8651001 (Aug. 8, 1986). This is clearly supported by the Supremacy Clause of Article VI of the U.S. Constitution. Cf. Carli v. Comm’r, 84 TC 649 (1985).

24 Reg. § 20.2033-1(b).

25 Cf. Estate of Fried v. Comm’r, 445 F2d 979 (2d Cir. 1971), cert. denied, 404 US 1016 (1972). Some estate planners, in drafting wills, suggest that the testator not make any disposition of household furniture, fearing that the Service agent will use the language of the will as authority to establish factually that the decedent was the owner of all the furniture and household effects. Inter vivos documentation of actual ownership should be maintained.

26 Estate of Trompeter v. Comm’r, 97 AFTR2d (RIA) 1447, unpub. op. (9th Cir. 2006) (decedent did not own unaccounted for gold coins).


28 Checks executed by a decedent while living but honored after death that are not incurred for adequate and full consideration or are not payable to charitable payees are included in a decedent’s gross estate under Section 2033. Rosano v. United States, 245 F3d 212 (2d Cir. 2001); McCarthy v. United States, 806 F2d 129 (7th Cir. 1986); Estate of Dillingham v. Comm’r, 88 TC 1569 (1987); Estate of Gagliardi v. Comm’r, 89 TC 1207 (1987); Estate of Newman v. Comm’r, 111 TC 81 (1998), aff’d per curiam, 99-2 USTC ¶ 60,358 (DC Cir. 1999). Cf. Metzger v. United States, 38 F3d 114 (4th Cir. 1994) (a gift tax case applying the relation back doctrine to the date checks were written but in circumstances where decedent was alive when checks honored); Rev. Rul. 96-56, 1996-2 CB
account, like other joint tenancy interests in property, would not be included under Section 2033, since the decedent’s interest terminates at death, but would be tested for inclusion under Section 2040. Investment-type intangibles, such as stocks and bonds and certificates of deposit, if owned solely by the decedent, are obvious Section 2033 inclusions, as are amounts due to the decedent on notes, secured or not, arising out of the decedent’s lifetime loans or deferred-payment sales.

29 See ¶ 4.12.  
30 Estate of Fortunato v. Comm’r, 99 TCM (CCH) 1427 (2010) (beneficial interest of stock ownership determined by the facts and circumstances). This includes municipal and other bonds whose interest is exempt from federal income taxation. Reg. § 20.2033-1(a); Rev. Rul. 81-63, 1981-1 CB 455. See also Estate of Bograd v. Comm’r, 55 TCM (CCH) 11 (1988), where bearer bonds were included in the decedent’s gross estate, even though such bonds could not be located. A storm of controversy over whether public housing bonds under the Federal Housing Act of 1937 had to be included in a decedent’s gross estate was quieted by the Deficit Reduction Act of 1984, which required inclusion. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 641, 98 Stat. 494, 939 (1984), reprinted in 1984-3 CB (Vol. 1) 1, 447. The Supreme Court resolved the dispute for cases arising prior to the 1984 Act holding that such bonds were not exempted from the estate tax. United States v. Wells Fargo Bank, 485 US 351 (1988).

Special rules attend the transfer of certain U.S. bonds, which raise the questions concerning their ownership. See the comments in the discussion of Section 2040 at ¶ 4.12[2].


32 Such notes and other claims are included even if they are canceled by the decedent’s will. Reg. § 20.2033-1(b); Rev. Rul. 81-286, 1981-2 CB 177. See also Leopold v. United States, 1972-1 USTC ¶ 12,837 (CD Cal. 1972), aff’d on other grounds, 510 F2d 617 (9th Cir. 1975). In Estate of Musgrove v. Comm’r, 33 Fed. Cl. 657 (1992) (decedent transferred money to his son in exchange for a promissory note that provided that it would be forgiven as of decedent’s death if no prior demand for repayment had been made. Following Buckwalter v. Comm’r, 46 TC 805 (1966), the transfer was held to be a loan made for less than adequate and full consideration, not an annuity, and included in the decedent’s gross estate pursuant to Section 2033). If, however, the obligation to pay the “self-canceling” notes is extinguished at the decedent’s death and this was a part of the bargained-for consideration of the sale, there is in substance an annuity and no Section 2033 or Section 2039 (see ¶ 4.11) inclusion. Estate of Moss v. Comm’r, 74 TC 1239 (1980), acq. 1981-1 CB 2. Cf. Estate of Costanza, 81 TCM (CCH) 1693 (2001) (inadequate consideration received resulted in a Section 2511 gift), rev’d, 320 F3d 595 (6th Cir. 2003) (remanded on adequacy of consideration).
[4] Income Items

For some purposes, the tax laws seek to differentiate property from the income from property as well as property from the value of a right to be paid for services.\footnote{33} One may wonder, therefore, whether income rights of the decedent at death must be treated as property in which the decedent had an interest within the scope of Section 2033. They must.

Salary due at death is a classic example of an item of “income in respect of a decedent” that, under Section 691, is taxed as income to the decedent’s estate or other recipient when received.\footnote{34} But, as with other such items, this does not foreclose its treatment as a property interest for estate tax purposes.\footnote{35}

Bonuses payable to the decedent at the time of death are included in the decedent’s gross estate,\footnote{36} and this is the case even though the right to the bonus is subject to contingencies until the time of the decedent’s death.\footnote{37} However, bonuses in which a decedent has no interest at death but that are awarded

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\footnote{33}{See, e.g., IRC §§ 351, 721, concerning the transfer of “property” for corporate stock or a partnership interest; Reg. §§ 1.351-1(a)(1)(i), 1.721-1(b)(1). See also Hempt Bros. v. United States, 490 F2d 1172 (3d Cir.), cert. denied, 419 US 826 (1974); United States v. Frazell, 335 F2d 487 (5th Cir. 1964).


\footnote{36}{Estate of King v. Comm’r, 20 TC 930 (1953); Estate of McKitterick v. Comm’r, 42 BTA 130 (1940).

\footnote{37}{Cf. Goodman v. Granger, 243 F2d 264 (3d Cir.), cert. denied, 355 US 835 (1957). If such bonuses or other employee-type benefits are payable to persons other than the decedent or the decedent’s estate, they may not be includible under Section 2033. Estate of Tully v. United States, 528 F2d 1401 (Ct. Cl. 1976). This would appear to be the case even if the decedent had the right until death to alter the beneficiary. Dimock v. Corwin, 19 F. Supp. 56 (EDNY 1937), aff’d on other grounds, 99 F2d 799 (2d Cir. 1938), aff’d, 306 US 363 (1939). However, the question is largely academic because, absent an express exemption such as appeared in repealed Section 2039(c), in such circumstances inclusion would probably result under other sections. See IRC §§ 2037, 2038, 2039, 2041; Estate of Bogley v. United States, 514 F2d 1027 (Ct. Cl. 1975); Rev. Rul. 76-304, 1976-2 CB 269; Rev. Rul. 78-15, 1978-2 CB 289; Comment, “Estate Taxation of Employer Death Benefits,” 66 Yale LJ 1217 (1957).}
only subsequent to death at the employer’s discretion, are not included in the decedent’s gross estate even if they are paid to the decedent’s estate.\footnote{38}

Compensation due for services other than as an employee (such as fees due a lawyer, accountant, or physician) are treated the same as salary.\footnote{39} At first glance, it would seem that deferred compensation arrangements would be included in the decedent’s gross estate, except that under most such arrangements the decedent’s interest terminates at death and the proceeds of such payments (normally in the form of an annuity of a lump sum) are paid to third parties, with the result that an instant after death, the decedent has no interest in the payments. This does not preclude gross estate inclusion.\footnote{40} If the decedent’s estate was the recipient of the proceeds or held a reversionary interest in such proceeds, Section 2033 would arguably include the proceeds and would definitely include the reversionary interest in the decedent’s gross estate.\footnote{41}

Rent accrued at death on real or personal property owned by the decedent is a Section 2033 gross estate inclusion.\footnote{42}


\footnote{39} See Reg. § 1.691(c)-1(d), Ex. 1. If the payment of a fee is contingent, there is no right to recovery in quantum meruit, and all rights the decedent might otherwise have to payment terminate at the time of death, and the decedent would have no Section 2033 property interest. Estate of Nemerov v. Comm’r, 15 TCM (CCH) 855 (1956). On the other hand, in the more usual case, the estate would be entitled to recover the reasonable value of services performed by the attorney before the decedent’s death, and that right is a Section 2033 interest. Rev. Rul. 55-123, 1955-1 CB 443. A contractual right to payment for a portion of contingent attorney fees is included under Section 2033. Estate of Curry v. Comm’r, 74 TC 540 (1980). If all services under a contingent-fee agreement have been performed but, for instance, a favorable judgment not yet rendered at death is a condition to payment, a Section 2033 property interest in the decedent exists at death, even though its valuation may be difficult. Duffield v. United States, 136 F. Supp. 944 (ED Pa. 1955). Cf. Aldrich v. Comm’r, 46 TCM (CCH) 1295 (1983), where a Section 2032 election established valuation.

\footnote{40} See ¶ 4.11[5], discussing the inclusion of annuity arrangements within Section 2039. A lump-sum amount with a third-party designated beneficiary where the decedent had the power to alter the beneficiary until death is included in the decedent’s gross estate under Section 2038. Cf. Rev. Rul. 76-304, 1976-2 CB 269.

If the annuity or lump sum were paid to the decedent’s surviving spouse, it would qualify for a marital deduction. See IRC § 2056, especially ¶ 5.06[7][c], note 193. Cf. IRC § 2056(b)(7)(C); ¶ 5.06[8][d], text accompanying notes 339–341.

\footnote{41} The reversionary interest would be included under Section 2033. As to the proceeds themselves, see infra ¶ 4.05[6], note 76, questioning whether inclusion occurs under Section 2033 or Section 2041.

Accrued interest, whether it be on savings in a bank account, on a bond, on a note arising out of an installment sale, or on some less formal credit extension or loan made by the decedent during life, is a Section 2033 gross estate inclusion.

Dividends on shares of stock that are payable to the decedent at the time of death are also a part of the decedent’s gross estate. However, a decedent’s right to a dividend does not accrue with the mere passage of time in the manner of interest on a bond. Instead, the decedent has no right to a dividend until the dividend is declared by the board of directors of the corporation and, even then, since the dividend is made payable on a future date only to stockholders of “record” on a date somewhere between the “declaration” and the “payment” date, the right does not arise until the record date.

[5] Partial Interests in Property

[a] Shared Interests in Property

A decedent may, at the time of death, share property with another. If the interest is one that the decedent can pass on to others, it is generally an inter-

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44 The instruction for Schedule C of Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return (Rev. August 2012), does not make clear that interest on a note, for example, is to be included. Nevertheless, it is appropriate practice to state as separate items the principal amount of the note and interest accrued to the date of death. Cf. Reg. § 20.2032-1(d)(1).

45 If D dies owning stock on which a dividend has been declared, but not yet received by D, the dividend is separately included in D’s gross estate only if D’s death followed the record date. Reg. § 20.2033-1(b). On the record date the dividend becomes separate property in which D had an “interest.” This conforms to practice in the marketplace. Before the record date, the stock trades cum dividend, and, to some extent at least, the forthcoming dividend is reflected in the price and value of the stock. After the record date—strictly speaking, five days before the record date with respect to listed securities to take account of major stock exchange settlement procedures—the stock trades ex-dividend; the dividend has become the property of the one who held the stock on the record date, and the owner is entitled to it even if the owner then sells the stock. If the owner relinquishes the stock by death after the record date, both the value of the dividend and of the stock (presumably now a lower value no longer reflecting the forthcoming dividend) are a part of the owner’s gross estate. Reg. § 20.2031-2(i); Estate of McNary v. Comm’r, 47 TC 467 (1967). These comments relate only to Section 2033 and to date-of-death value under Section 2031. Some problems under other Code provisions are examined elsewhere. For example, if the record date follows the decedent’s death, the dividend is generally not treated as a property interest covered under Section 2033, even if the alternate valuation date is elected. Reg. § 20.2032-1(d)(4). But see Estate of Fleming v. Comm’r, 33 TCM (CCH) 1414 (1974).
est within the scope of Section 2033.\textsuperscript{46} Thus, if the decedent and another owned Blackacre as tenants in common, the interest will pass as the decedent directs by will or by laws of intestacy. A decedent’s interest in community property is a similar inheritable or bequeathable interest and is not now differentiated from a tenancy in common for gross estate purposes.\textsuperscript{47} The value of both types of interests is includible in the gross estate under Section 2033.

On the other hand, some interests in shared property are treated differently. During life, the co-owners’ rights in property owned as joint tenants with right of survivorship or as tenants by the entirety are similar to the rights of tenants-in-common, except that a tenant by the entirety cannot make an independent disposition of the tenant’s interest. But, in contrast to tenancies in common, other joint owners’ rights cease on death and the property becomes that of the surviving tenant or tenants. These interests are not inheritable and, as they are not subject to the decedent’s testamentary direction, are not interests covered by Section 2033.\textsuperscript{48} To rule them out under Section 2033 is not to say, however, that they are without estate tax significance. Shared property interests that carry survivorship rights are the subject of specific estate tax provisions.\textsuperscript{49}

\textbf{[b] Successive Interests in Property}

Tenants in common share all the rights in property concurrently; each owns a percentage of the entire property, but not a specific portion that can be identified. On the other hand, property can also be divided into interests that are successive in point of time rather than concurrent. Suppose A owns Blackacre outright but, for good consideration, A leases it to B for twenty years. Both A and B now have interests in Blackacre that, upon death, may be taxable under Section 2033. Thus, if B dies when the lease term has ten years still to run, B’s estate includes the value of the leasehold. If A were to die at that


\textsuperscript{47} But see IRC § 811(e)(2) (1939); Fernandez v. Wiener, 326 US 340 (1945). During the period that Section 811(e)(2) was effective, just prior to the enactment of the marital deduction now found in Section 2056, community property was accorded estate treatment quite like that now accorded jointly held property under Section 2040. Much Section 2033 litigation arises over the question of whether property is held as community property. See, e.g., Parson v. United States, 460 F2d 228 (5th Cir. 1972); Murrah v. Wiseman, 449 F2d 187 (10th Cir. 1971); Kern v. United States, 491 F2d 436 (9th Cir. 1974); Hundemer v. United States, 293 F. Supp. 1063 (ED La. 1968); Estate of Lepoutre v. Comm’r, 62 TC 84 (1974); Jackson v. United States, 88-1 USTC ¶ 13,750 (ND Tex. 1987); Wilmington Trust Co. v. United States, 4 Cl. Ct. 6 (1983), aff’d per curiam, 85-2 USTC ¶ 13,625 (Fed. Cir. 1985); Rev. Rul. 74-284, 1974-1 CB 276.

\textsuperscript{48} Even if they were, their value would seem to be zero, if they are properly viewed as expiring rather than being transmitted at death.

\textsuperscript{49} See IRC § 2040, discussed at ¶ 4.12.
time, A’s estate would include the value of A’s reversionary interest in the property, which is the value of the property reduced by the current outstanding interest in B. Both are inheritable interests in property well within the scope of Section 2033.

In the foregoing example, B has a terminable interest in property that will end when the twenty-year lease has run its course. But a property interest may terminate upon the occurrence (or even nonoccurrence) of an event instead of upon the mere passage of time. Thus, B might have a life estate in Blackacre or, more commonly these days, B might be the life beneficiary of a trust. In these cases, B has no interest that B can transmit to others at B’s death and any such interest that terminates with B is not a Section 2033 interest in property. But if the arrangement was that B’s interest would terminate upon some other event, such as on the death of C who survived B, the value of B’s interest at B’s death, an estate pur autre vie, would be a Section 2033 inclusion, the value and duration of which now would have to be determined with reference to C’s life expectancy.

For purposes of Section 2033, a reversionary interest in property that the decedent has transferred is not distinguished from a remainder interest in property that has been transferred to the decedent by another. If A has a reversionary interest that will take effect upon the happening of an event (instead of simply upon the expiration of a period of time), this, too, is a property interest within Section 2033. A reversionary interest may, however, be contingent. If A’s reversion is contingent upon A’s surviving B and B in fact survives, A has no inheritable interest within Section 2033 because A’s reversionary interest expires when A dies. But if A’s reversion is dependent, for instance, upon C’s

50 Any reversionary or remainder interest in property, if it is not a contingent interest that terminates upon the decedent’s death, Rev. Rul. 55-438, 1955-2 CB 601, is within the scope of Section 2033. Estate of Hamilton v. Comm’r, 35 TCM (CCH) 1609 (1976). However, it may present a difficult valuation problem. Karlson v. Comm’r, 1974-2 USTC ¶ 13,014 (SDNY 1974). Cf. Estate of Jennings v. Comm’r, 10 TC 323 (1948).

51 But see Priv. Ltr. Rul. 8820003 (Feb. 8, 1988) (under local law, the Rule in Shelley’s Case converted a life estate to a fee simple includible in the decedent’s gross estate). In the past, B’s death in these circumstances has been a neutral federal tax event because the estate and gift taxes have been exactions on the transmission of wealth. Numerous red flags must now be raised to caution against possible liability for the tax on generation-skipping transfers. See Chapters 12–18.

52 Williams v. United States, 41 F2d 895 (Ct. Cl. 1930). See also Estate of Williams v. Comm’r, 62 TC 400 (1974); Estate of Dickinson v. Comm’r, 41 TCM (CCH) 787 (1981); Rev. Rul. 74-492, 1974-2 CB 298. On the other hand, a life tenant of a farm, for example, may own the crop on the land, even an unharvested crop; if so, the value of the crop is includible, for the life tenant’s interest in it does not expire at death. Martin v. United States, 121 Ct. Cl. 829, 1952-1 USTC ¶ 10,844 (1952). Similarly accumulated income to which a decedent income beneficiary had a legal right even after death is included in the decedent’s gross estate. Estate of Mitchell v. Comm’r, 41 TCM (CCH) 1290 (1981).

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not surviving B and both are still living when A dies, the reversion does not expire on A’s death and is includible in A’s gross estate under Section 2033.

A person’s death may prevent the acquisition of property that would otherwise have come to the person. Suppose A dies leaving all of A’s property to B and B dies shortly thereafter while A’s estate is in probate. Clearly, B’s interest in A’s estate is no more includible under Section 2033 than if it were a life interest or contingent remainder cut off by death.54

In contrast to the situation in which a decedent’s death may terminate the decedent’s interest in property, there are some situations in which the death may assure or enlarge the interest. Suppose A creates a trust, income payable to B for life, remainder to C or C’s estate, subject however to the contingency that if D predeceases both B and C, the remainder is to go to E. If C dies survived by B and D, what is included in C’s gross estate? The problem is that immediately before C’s death, C’s remainder was contingent on D’s not predeceasing C. Upon C’s death, with D surviving, C’s remainder is assured. Is C’s includible interest the contingent remainder or the assured remainder? It seems settled now that the identification (and therefore the valuation) of C’s includible interest must take account of the fact that C’s death terminated the contingency and assured the ultimate fruition of C’s interest.55 Perhaps the most compelling argument in favor of this result is the fact that until death there is no decedent and no estate to be determined; therefore, it is necessary to look at Section 2033 property interests as of the moment after death.56 In a sense this is the logical converse of the proposition that a contingent remainder extinguished by death is to be disregarded. Nevertheless, the question is difficult and the accepted rule comes close to an inheritance tax approach, looking to

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54 See Comm’r v. Rosser, 64 F2d 631 (3d Cir. 1933); Priv. Ltr. Rul. 8538007 (1985). Similarly, A’s will might provide that B would receive property only if B survived A and, in addition, that in the event of their simultaneous deaths, A would be presumed to have survived B. In such a case, if A and B died simultaneously, nothing would pass from A to B, and A’s property would not be included in B’s estate. The same result would follow, even if no such presumption was expressed in A’s will, if the administration of A’s estate was subject to the Uniform Simultaneous Death Act of 1993, 8B ULA 141, under which each person is presumed to be the survivor with respect to that person’s property unless the person’s will provides to the contrary. See Rev. Rul. 66-60, 1966-1 CB 221; Rev. Rul. 76-303, 1976-2 CB 266.

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what is received by survivors rather than what is transmitted by the decedent. Certainly the decedent, C, never had the *assured* remainder interest.

Is a partial interest in property that can be extinguished at any time by the action of another person a Section 2033 property interest? For example, if A creates a trust, income payable to B for twenty years, remainder to C or C’s estate, both B and C have includible interests if either should die during the twenty-year period. Is the result altered by A’s retention of a power to revoke the trust? It is the Treasury’s position that the interests of B and C are taxable interests.\(^7\) The ruling may have a brittle technical underpinning but should be seriously questioned. As a practical matter and for estate tax and gift tax purposes, A remains the owner of the whole property. There is a logical inconsistency in saying that others have recognizable interests in it, if “the whole is equal only to the sum of its parts.”\(^8\)

[c] Cautions

The foregoing remarks require two areas of caution and some further elaboration.

1. The only question that has been considered here is includability under Section 2033; a decedent’s possession of terminable rights relating to income or enjoyment or of reversionary rights, even if in either case they expire at death, will sometimes be a reason for gross estate inclusion under other Code sections.\(^9\)

2. A further word of caution relates to the nontaxability of beneficial interests in the decedent that terminate at the decedent’s death. It is this concept that gives rise to what reformers have called “generation skipping.” Thus, if, by will, a parent creates a trust with income pay-

\(^7\) Rev. Rul. 67-370, 1967-2 CB 324. The ruling treats the power to revoke as immaterial for purposes of identifying taxable interests and, on the related valuation question, indicates that such subordinate interests are to be accorded more than nominal value. Cf. ¶ 4.13[7][a], note 81. For valuation of irrevocable remainder interests, see Reg. §§ 20.2031-7(a), 20.2031-7(d), 20.2031-7A. On occasion, if an interest is very remote, it has been held that nothing is includible in the gross estate. Estate of Cardea v. Comm’r, 5 TC 202 (1945), acq. and nonacq. 1946-1 CB 1, 5, aff’d, 173 F2d 19 (3d Cir. 1949). Although remoteness of the interests should bear only on the question of valuation, Estate of Hill v. Comm’r, 193 F2d 724 (2d Cir. 1952); Estate of Henry v. Comm’r, 4 TC 423 (1944), acq. and nonacq. 1945 CB 4, 8, aff’d on other grounds, 161 F2d 574 (3d Cir. 1947), the opposite pragmatic result seems supportable.

\(^8\) A remote interest is one of those interests to be taken into account in identifying the entire ownership of property; whereas if one person owns “the whole thing,” there is no room for other interests. Cf. IRC § 2037(b) (last sentence).

\(^9\) See especially discussion of IRC §§ 2036, 2037 at ¶¶ 4.08, 4.09. See also Reg. § 20.2036-1(c)(1)(i) discussed at ¶ 4.08[8], note 210, on the interrelationship of Section 2033 and Section 2036.
able to a child for life, remainder to a grandchild, the trust property may be taxed under the federal estate tax in the first and third generations but not the second. Failure to impose an estate tax at the death of one who may have enjoyed a life interest is quite in keeping with the general philosophy of the current estate tax, which, as other comments in this section suggest, looks to the transmission of property by the decedent. There is a shifting of interests when a life tenant dies, but the shift cannot be said to constitute a transmission by the life tenant. Chapter 13 of the Code, which taxes that shift and some related generation-skipping transactions as well, is considered in Chapters 12 through 18 of this treatise. Although the tax imposed on generation-skipping transfers is a separate tax, nevertheless there are numerous statutory interrelationships with the estate and gift taxes.

3. An explanatory word should be addressed to the question whether several rights or interests in property, no one of which would be a sufficient reason for a Section 2033 inclusion, may together amount to an ownership interest. Income tax lawyers will think of Helvering v. Clifford, in which tax ownership was attributed to a trust settler even though the settler lacked legal title and many other ownership attributes. There has been a growing common-law estate tax ownership concept, but the estate tax has not experienced the same judge-made ownership development under Section 2033 as had occurred for income tax purposes under the predecessor of Section 61 before the enactment of the statutory grantor trust provisions. A power of appointment, even a general power, is not recognized as an interest in property under property law, and it is accorded similar nonrecognition under Section 2033. If one has a right to the current income from property and a testamentary power to appoint it to anyone the person chooses, does the person have enough of the bundle of rights to be a Section 2033 owner? The Supreme Court has held not; neither the terminating income interest nor the power alone is

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60 See YMCA v. Davis, 264 US 47, 50 (1924).
64 5 A. Casner, American Law of Property § 23.4, at 467 (1952).
taxable under Section 2033, and the Supreme Court has refused to give them Section 2033 status together.66

[6] Insurance Proceeds Under Section 2033

Proceeds of insurance on a decedent’s life are the subject of a special estate tax statutory rule.67 However, the decedent may be the owner of a life insurance policy on the life of another person, such as the decedent’s spouse or business partner, who survives the decedent. The special provisions of Section 2042 do not apply to insurance on the lives of others; but an insurance policy is property, and the value of the decedent’s interest in it will be included in the decedent’s gross estate under Section 2033.68

Inclusion results under Section 2033 even in a situation in which the insured and one who is both the owner of the policy and the primary beneficiary die simultaneously if their affairs are governed by the Uniform Simultaneous Death Act or a similar statute.70 If the owner of the policy is not the primary

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67 See discussion of Section 2042 at ¶ 4.14. Among other things, Section 2042 includes insurance proceeds on the decedent’s life that are “receivable by his executor,” even though Section 2033 might include such proceeds without the aid of Section 2042. See Mimnaugh v. United States, 66 Ct. Cl. 411, 1 USTC ¶ 339 (1928), cert. denied, 280 US 563 (1929), involving such inclusion under a statutory forerunner of Section 2033.

68 On the valuation of insurance policies, see Reg. § 20.2031-8 and the discussion at ¶ 10.02[2][b][ii]. If the decedent owned a policy of insurance on the life of another, election of the alternate valuation date can greatly increase the amount to be included in the gross estate. If the insured dies within six months after the decedent’s death, value under the alternate date election will include the added increment occasioned by the death of the insured. Rev. Rul. 63-52, 1963-1 CB 173. The amount to include is not increased, however, with respect to added values arising from the payment of premiums or interest earned on the policy after the decedent’s death. Rev. Rul. 55-379, 1955-1 CB 449.

69 Estate of DuPont v. Comm’r, 233 F2d 210 (3d Cir.), cert. denied, 352 US 878 (1956); Estate of Donaldson v. Comm’r, 31 TC 729 (1959); Estate of Fujishima v. Comm’r, 103 TCM (CCH) 1023 (2012) (decedent was record owner of policy, but case not clear whose life the policy insured).

70 Under the Uniform Simultaneous Death Act of 1993, the normal presumption is that the owner of property survives in the event of a simultaneous death. See supra ¶ 4.05[5][b], note 54. However, an overriding presumption assumes that the insured survives if the insured and the primary beneficiary die simultaneously. Thus, if the insured and one who is both an owner and primary beneficiary of a policy die simultaneously, the insured is deemed to have survived. Taxpayer-estates, originally ignoring this overriding presumption, argued that the decedent (owner-primary beneficiary) had no beneficial interest in the policy, because the secondary beneficiaries received the proceeds as a result of the simultaneous deaths. This argument, which would have resulted in the policy’s being included in the estate of neither the insured nor the owner, has been uniformly rejected.
beneficiary of the proceeds, nothing is included in the owner’s estate under Section 2033 when owner and insured die simultaneously.\(^71\)

If the decedent owned a community property interest in a policy on the life of another person, one half of the value of the policy will be included in the decedent’s gross estate.\(^72\)

If, before death, the decedent has acquired an interest in the proceeds of an insurance policy on the life of another person who predeceased the decedent, the nature of the interest will determine whether anything is to be included in the decedent’s gross estate with respect to such proceeds. For example, if all the decedent ever acquired was an annuity for life, nothing would be included in the decedent’s gross estate\(^73\) even if, after the decedent’s

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\(^71\) Under the normal presumption of the act, the owner is presumed to have survived the insured. Thus, at the instant of the insured’s death, the right to the proceeds passes irrevocably to the beneficiary from the owner and it is a lifetime transfer subject to gift tax. Goodman v. Comm’r, 156 F2d 218 (2d Cir. 1946). But with respect to decedents dying after December 31, 1976, it is pulled back into the owner decedent’s estate under Section 2035(a). See ¶ 4.07[2].

\(^72\) This commonly occurs in a community property state when a husband and wife own a community property policy on the husband’s life and the wife predeceases the husband. United States v. Stewart, 270 F2d 894 (9th Cir. 1959), cert. denied, 361 US 960 (1960); California Trust Co. v. Riddell, 136 F. Supp. 7 (SD Cal. 1955); Rev. Rul. 67-228, 1967-2 CB 331. Cf. Rev. Rul. 80-242, 1980-2 CB 276. But see United States v. Waechter, 195 F2d 963 (9th Cir. 1952), questionably relying on a state court decision, since overruled, that purported to interpret Washington law.

\(^73\) Estate of Minotto v. Comm’r, 9 TCM (CCH) 556 (1950). However, if the decedent was given the option to receive the proceeds in a lump sum or in some other manner and the decedent elected an annuity with subsequent payments to a third party after the dece-
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death, benefits continue to be paid to others. Similarly, if the decedent was entitled only to interest on the proceeds for life, and the proceeds were to be paid to a third party at the decedent’s death, nothing would be included in the decedent’s estate under Section 2033, as in both cases all the rights would expire at the decedent’s death.

An area of controversy has grown up around the situation in which the decedent is entitled only to interest on insurance proceeds for life and the proceeds are to be paid to the decedent’s estate upon the decedent’s death. Although it is tempting to equate these rights with outright ownership so as to include the entire value of the proceeds in the decedent’s estate under Section 2033, close analysis reveals that the decedent’s rights are only (1) temporary enjoyment of the interest income that ends at death, and (2) a right by will to say who shall have the proceeds, exercisable through the control of disposition of property that becomes a part of the probate estate. Neither is a Section 2033 property interest.

This is not to say that the decedent’s estate would not be taxed on the proceeds but only that it would not be taxed under Section 2033. In one early case, the court correctly refused inclusion under Section 2033 but erred with respect to the application of other Code provisions. Second Nat’l Bank of Danville v. Dallman, 209 F2d 321 (7th Cir. 1954). There, the decedent additionally had a lifetime power to designate a contingent beneficiary ultimately to receive the proceeds. This right was never exercised and, since it was a pre-1942 power of appointment, its nonexercise occasioned no estate tax. See discussion of Section 2041 at ¶ 4.13. However, the court refused to regard the decedent’s power in effect to direct disposition of the proceeds by will as a testamentary power. It may be true, as the court said, that the decedent was powerless to divert the proceeds from the estate, except by the exercise of the lifetime power that was not exercised. Upon payment of the proceeds to her estate, however, her will did direct the ultimate disposition of the proceeds, pretty clearly amounting to an exercise of a general testamentary power over the proceeds. This analysis of the problem was clear to the Fifth Circuit, which rejected the rationale of the Seventh Circuit in Second National Bank. Keeter v. United States, 461 F2d 714 (5th Cir. 1972), rev’d 323 F. Supp. 1093 (ND Fla. 1971). See Rev. Rul. 55-277, 1955-1 CB 456, rejecting the Seventh Circuit’s analysis of the “powers” issue. See also Note, “Tax Evasion Through Settlement Options: Another Defeat for Substantial Ownership in Estate Taxation,” 64 Yale LJ 137 (1954). There is some indication the government has not abandoned its Section 2033 argument on the facts here considered. See Keeter, supra, at 719 n.3. If the Fifth Circuit view on the “powers” issue prevails, the Section 2033 argument becomes relatively insignificant, especially since, different from the facts in the two cases cited, future controversy is more likely to evolve around post-1942 pow-
4-175  THE GROSS ESTATE ¶ 4.05[7][b]

[7] Business Interests

[a] Corporations and Proprietorships

If a decedent’s business was incorporated, Section 2033 includes in the gross estate the value of the decedent’s shares of stock, which may be viewed as investment assets.\(^{77}\) This is so even if the decedent is the sole shareholder of the corporation. The value of a decedent's interest in an unincorporated business is, of course, a part of the decedent’s gross estate as well. In the case of a sole proprietorship, no entity stands between a decedent and the business assets. The decedent’s Section 2033 interest in property therefore encompasses the ownership of all the various assets of the business.\(^{78}\)

Various business-type property interests lie between a sole proprietorship and a closely held corporation, and, generally, the value of each is included in a decedent’s gross estate under Section 2033. For instance, several persons may own a piece of rental property as tenants-in-common, which may not make them partners for tax purposes\(^{79}\) but which gives them essentially a business-type investment. The decedent’s proportionate interest in such property, the same as in any tenancy in common, is an interest in property to be included in the decedent’s estate.

[b] Partnership Interests

A decedent’s interest in a partnership is likewise a business property interest included in the decedent’s gross estate. The interest to be included in the estate may vary, however, depending on the decedent’s rights in the partnership at death. For example, if the decedent owned a one-quarter interest in a partnership with no agreement as to what would occur if a partner died, state law would likely accord the decedent’s estate a right to one quarter of the partnership’s assets, essentially a tenancy-in-common interest. However, the dece-

\(^{77}\) If the decedent also owns bonds issued by the corporation, the value of the bonds is likewise included, whether treated as equity or debt securities, a distinction that is immaterial for estate tax purposes. See, e.g., Gooring Amusement Co. v. Comm’r, 236 F2d 159 (6th Cir. 1956), cert. denied, 352 US 1031 (1957). Valuation of such interests is discussed at ¶ 4.02[3][e]. But see Estate of Fortunato v. Comm’r, 99 TCM (CCH) 1427 (2010) (decedent had no beneficial interest and hence no property interest in corporation).

\(^{78}\) Cf. Williams v. McGowan, 152 F2d 570 (2d Cir. 1945). The difference in what we look to in a close corporation and in a proprietorship is largely formal; however, the important valuation question is approached in much the same way in either case. Reg. §§ 20.2031-2(f), 20.2031-3; Rev. Rul. 68-609, 1968-2 CB 327; Rev. Rul. 59-60, 1959-1 CB 237. See ¶ 4.02[3][f].

\(^{79}\) IRC § 761(a); Reg. § 1.761-1(a).
dent should not be viewed as owning any specific assets; instead, the decedent has a proportionate share of *each* asset, including partnership goodwill, which injects a "going concern" element into the identification of the Section 2033 interest.\footnote{Uniform Partnership Act § 701, 6 ULA 175 (West 2001); Kihchel v. United States, 105 F. Supp. 523 (WD Pa. 1952). Income tax analysis may vary. See generally IRC §§ 736(b), 741, 751. An issue may arise as to what specific assets the partnership owns. Heath v. United States, 1968-1 USTC ¶ 12,508 (D. Colo. 1967). Similarly, an issue may arise whether a partnership exists; if it does not exist, the decedent’s interest in the individual assets is included in the decedent’s gross estate. Estate of Kjorvestad v. Comm’r, 81-1 USTC ¶ 13,401 (DND 1981). Difficult problems of valuation occur with respect to the goodwill of the partnership and the effect of the decedent’s death on its value. Estate of Goodall v. Comm’r, 391 F2d 775 (8th Cir. 1968); Estate of Leopold Kaffie v. Comm’r, 44 BTA 843 (1941), nonacq. 1942-1 CB 25; Blodget v. Comm’r, 18 BTA 1050 (1930), acq. IX-2 CB 6. Valuation problems also arise with respect to the fact the decedent owned a one-quarter interest that would qualify for discounts as a minority interest and for lack of marketability. See ¶¶ 4.02[4][c], 4.02[4][d].} Alternatively, the partnership agreement might provide that a deceased partner’s estate would receive a flat dollar amount for the interest. If so, the agreed amount may identify and measure the interest to be included in the decedent’s gross estate.\footnote{Estate of Weil v. Comm’r, 22 TC 1267 (1954), acq. 1955-2 CB 10. Note that in this situation, the concepts of identification and valuation for purposes of Section 2033 generally merge. See the comments on agreements in the discussion of Section 2031 at ¶ 4.02[2][c] and in the discussion of Section 2703 at ¶ 19.04. In Priv. Ltr. Rul. 9151045 (Sept. 26, 1991), the right of a withdrawing managing partner to future annual payments of $100,000 was characterized as a private annuity or a similar form of debt rather than as a retained interest in the entity that would be subject to the Chapter 14 special valuation rules. The Service concluded that this was so because the partnership agreement provided that a withdrawing partner would no longer hold any interest or right to participate in partnership profits or losses.} And, of course, an agreement might provide that the decedent’s estate would receive such a share of profits or a fixed dollar amount in addition to the value of the de-
dent’s proportionate interest in the partnership’s assets. In these circumstances, both amounts are included in the decedent’s gross estate as interests in property.\textsuperscript{83}

If a partnership does not terminate at the death of a partner and the estate becomes a partner in a continuing business, the value of the decedent’s partnership interest is still to be included in the decedent’s gross estate, and value then may be partially determined by the partnership’s potential to earn future profits.\textsuperscript{84} Under such an agreement, the decedent’s right to future profits is not an interest in property to be separately included under Section 2033 because the decedent’s estate is merely a continuing partner, which may not only share in profits but must also be liable for losses. A mere right to participate in a business is clearly distinguishable from a right to a portion of future earnings.\textsuperscript{85}

[c] Limited Liability Companies

A decedent’s interest in a limited liability company is similarly a business property interest included in the gross estate. A limited liability company has been described as “a cross between a close corporation and a limited partnership.”\textsuperscript{86} At present, every state and the District of Columbia has adopted legislation for the creation of such an entity.\textsuperscript{87} In similar fashion to a corporation,
the limited liability company protects its owners (called members) from the debts and liability of the entity. However, it may also have several traits of a partnership. Overall, in many jurisdictions, limited liability companies may offer a variety of estate planning advantages over other business entities.

[8] Compensation for Death

A decedent’s death may be caused by the unlawful or wrongful conduct of another. At early common law, any cause of action the decedent had against the wrongdoer was ended by the decedent’s death. One statutory change that has been made in the common law takes the form of a “survival” statute under which a decedent’s rights against a tortfeasor can be enforced after death; the cause of action “survives.” The English change in the early common law was effected by the enactment of Lord Campbell’s Act. Lord Campbell’s Act and its later copies are called wrongful death acts, and, in lieu of continuing the decedent’s rights, they confer a fresh cause of action on survivors that may be enforced for their own benefit. It is well settled that rights to recover under such “wrongful death act” statutes do not represent any interest in property of the decedent under Section 2033, because it is rights of others, not the dece-

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88 The Service for many years was unclear whether a limited liability company should be treated as a partnership or a corporation for tax purposes. This issue was resolved, however, with the issuance of a revenue ruling holding that a Wyoming limited liability company could be classified as a partnership. Rev. Rul. 88-76, 1988-2 CB 360. With the replacement of the formal classification tests by the “check-the-box” regulations, limited liability companies with more than one member are easily granted partnership status for federal tax purposes. Cf. Pierre v. Comm’r, 133 TC 24 (2009) (single-member LLC under “check-the-box” regulations was treated as an entity qualifying for discounts in a gift tax transfer). See also Reg. §§ 301.7701-1(a)(1), 301.7701-2(a), 301.7701-3(a), 301.7701-3(b)(1); Field, “Checking in on ‘Check-The-Box’,” 42 Loy. LA L. Rev. 451 (2009); Scocca, “The ‘Check-The-Box’ Treasury Regulations: The Calm Before the Storm,” 29 Rutgers LJ 201 (1997).


92 Fatal Accidents Act of 1846, 9 & 10 Vict., ch. 93.
dent, that may be enforced against the wrongdoer, even though such rights grew out of the decedent’s death.\textsuperscript{93}

Some early cases held that survival statute rights, since they were not terminated by death, constituted Section 2033 interests in property includible in the decedent’s gross estate.\textsuperscript{94} But later cases refused to distinguish survival ac-

\textsuperscript{93} Maxwell Trust v. Comm’r, 58 TC 444 (1972), acq. 1973-2 CB 2; Rev. Rul. 54-19, 1954-1 CB 179. This includes survival benefits under no-fault insurance. See Rev. Rul. 82-5, 1982-1 CB 131. Note, however, that a wrongful death claim then becomes an interest held by the survivor; if the survivor dies while the claim is outstanding, it is included in the survivor’s estate at the value as of the date of the survivor’s death. Estate of Houston v. Comm’r, 44 TCM (CCH) 284 (1982).

\textsuperscript{94} This logical proposition was accepted in Connecticut Bank & Trust Co. v. United States, 330 F. Supp. 997 (D. Conn. 1971); the Connecticut Bank decision was reversed by the Second Circuit, 465 F.2d 760 (2d Cir. 1972). The prior conflict between “survival” and “wrongful death act” statutes often resulted in interesting underlying conflict-of-laws questions that pointed up the importance of local law. In Maxwell Trust v. Comm’r, 58 TC 444 (1972), acq. 1973-2 CB 2, the decedent’s death in a plane crash occurred in Japan owing to the negligence of a Washington-based corporation. The decedent was an Iowa resident, but suit was brought in Illinois. The case was settled, but the Tax Court, in determining the decedent’s estate tax consequence, concluded that if the Illinois court had rendered judgment, it would have applied Japanese law (wrongful death act) to allow recovery. According the same consequence to the settlement of the case, there was no inclusion under Section 2033. An application of Iowa law (survival act) would have involved enforcement of Section 2033 rights of the decedent with attending adverse tax consequences. In contrast, in Connecticut Bank, supra, the decedent was killed in Virginia as a result of the negligence of a New Jersey corporation; he was a resident of Connecticut, but suit, which was brought in New York, was settled without a trial. The district court, in determining the decedent’s estate tax consequences, concluded that the New York court would have deferred to the state of domicile of the decedent and applied Connecticut law (survival act) to allow recovery. The settlement, therefore, represented a taxable Section 2033 interest of the decedent. The conflict-of-laws question was not an issue on appeal, but the Second Circuit reversed on the applicability of Section 2033. An interesting extension of the wrongful death exclusion was recognized in Rev. Rul. 68-88, 1968-1 CB 397, in which a recovery under the Virginia uninsured motorist act was excluded (after a determination that it was not life insurance under Section 2042) on the ground that it merely reflected rights to recover under the state’s wrongful death statute.

There was a matter relating to survival-type statutes that had been given inadequate judicial and administrative consideration. Interests includible in a decedent’s estate are to be identified at the date of death; they are likewise to be valued as of that time. See discussion of Section 2032 at ¶ 4.03 for alternate valuation dates. Therefore, if a decedent’s death occurred under circumstances that gave rise to a right of recovery under a survival-type statute, the prior Section 2033 inclusion would be the somewhat speculative value at the time of the decedent’s death of what may be recovered by suit or settlement in the subsequent enforcement of the decedent’s rights. This could well be much less (but possibly more) than what is ultimately recovered. However, there seems to be an uncritical assumption that the actual recovery fixes the amount to include. Connecticut Bank & Trust Co., supra. See also Maxwell Trust, supra, which expresses the same view of amounts recovered under a survival statute. Admittedly, to require a speculative valuation as of the date of death is awkward; but valuation difficulties are a generally accepted part
tions from wrongful death actions and held that survival recoveries are not in-cludible in a decedent’s gross estate under Section 2033. The Commissioner ruled that recoveries under survival statutes as well as wrongful death acts are not includible in a decedent’s gross estate under Section 2033. However, recoveries under survival statutes for a decedent’s pain, suffering, or related expenses during the decedent’s lifetime are not within the exclusion.

The exclusion of wrongful death recoveries is supportable on the ground that the decedent never had an interest in the amounts recovered. It is likewise clear that, in general, the decedent could not control the disposition of the amounts recovered. These two factors are also characteristic of some death benefits payable outside the area of negligence or intentional torts, and they support a similar exclusion for post-death payments. Thus, a fairly early ruling excluded Social Security benefits payable to a decedent’s widow and children. Similar results were later reached regarding payments under state workers’ compensation acts, the Federal Railroad Retirement Act, and the Federal Coal Mine Health and Safety Act of 1969; amounts paid under the

of the administration of the federal transfer taxes. See Smith v. Shaughnessy, 318 US 176, 180 (1943), where valuation of a contingent remainder is discussed. But see Robinette v. Helvering, 318 US 184 (1942), in which an interest of uncertain value was ignored but only in a manner that worked against the taxpayer. The problem is discussed at ¶ 10.01[c]. For income tax purposes, purely speculative values are more likely to be ignored. See Burnet v. Logan, 283 US 404 (1931); Dorsey v. Comm’r, 49 TC 606 (1968). If the present statute presents a problem, legislative change might be considered; Congress could require a hindsight approach to require inclusion of what in fact was recovered. Cf. IRC § 2056, which permits a marital deduction for dower upon a post-death assertion of dower rights. Rev. Rul. 72-8, 1972-1 CB 309.

Connecticut Bank & Trust Co. v. United States, 330 F. Supp. 997 (D. Conn. 1971); Lang v. United States, 356 F. Supp. 546 (SD Iowa 1973); Estate of Vanek v. United States, 1973-2 USTC ¶ 12,943 (SD Iowa 1973). The Second Circuit’s theory in Connecticut Bank & Trust Co., seemingly open to question, is that until death no rights arose that could represent property of the decedent under Section 2033 or property over which he had a Section 2041 power. It is arguable that rights arose at the time of the tort, although their value may have been affected by the decedent’s death. See Goodman v. Granger, 243 F2d 264 (3d Cir.), cert. denied, 355 US 835 (1957); Keeter v. United States, 461 F2d 714 (5th Cir. 1972).


Rev. Rul. 75-126, 1975-1 CB 296; Rev. Rul. 75-127, 1975-1 CB 297. The rulings also state that there is no inclusion under Section 2041.


Rev. Rul. 56-637, 1956-2 CB 600.


Public Safety Officers’ Benefit Act\textsuperscript{103}; and allowances paid to survivors because of a decedent’s death in the armed forces have likewise been excluded.\textsuperscript{104} Seemingly a closer question, the same result has also been reached in instances in which a decedent employee has an agreement with an employer that if the employment relationship continued until the employee’s death, the surviving spouse would be paid a fixed sum or an annuity. Although such payments have been held to be outside the reach of Section 2033,\textsuperscript{105} the cases so holding deal only with circumstances in which the decedent had no interest in the payments, such as a contingent right to receive payments at a future time,\textsuperscript{106} or any control over the determination of who was to receive the payments.\textsuperscript{107}

As a matter of statutory interpretation, it is difficult to quarrel with the results reached regarding death benefits discussed here, whether they be based on tort, contract, or independent statutes such as workers’ compensation acts. Still, in some of these circumstances, perhaps especially those involving contractual employee death benefits but only less directly workers’ compensation awards, the wealth enjoyed by survivors is traceable to the lifetime efforts of the decedent.\textsuperscript{108} The question may be raised, therefore, whether Congress should differentiate death payments, taxing just those employee death benefits and similar awards traceable to the decedent’s “good doing” and continuing to exclude wrongful death payments that emanate only from another’s “wrong doing.” The question is not rhetorical and, against initial impulse, the answer may well be no. Whether something should be subject to estate tax raises more sophisticated questions than whether there is some rational basis for saying a decedent had an interest in it when the decedent died or that the decedent generated the wealth enjoyed by others after the decedent’s death.

\textsuperscript{103}Rev. Rul. 79-397, 1979-2 CB 322.

\textsuperscript{104}Rev. Rul. 55-381, 1955-2 CB 381; Rev. Rul. 76-501, 1976-2 CB 267, involving death payments arising out of death while on active duty or from a service-connected disability.

\textsuperscript{105}See, e.g., Hinze v. United States, 1972-1 USTC \$ 12,842 (CD Cal. 1972); Harris v. United States, 1972-1 USTC \$ 12,845 (CD Cal. 1972); Kramer v. United States, 406 F2d 1363 (Cl. Ct. 1969); Molter v. United States, 146 F. Supp. 497 (EDNY 1956). If the decedent had a right to receive payments during life, inclusion might turn on Section 2039, discussed at \textsuperscript{106} 4.11. See Estate of Wadewitz, 339 F2d 980 (7th Cir. 1964); Estate of Bahen v. United States, 305 F2d 827 (Cl. Ct. 1962); Rev. Rul. 75-505, 1975-2 CB 364.

\textsuperscript{106}In Goodman v. Granger, 243 F2d 264 (3d Cir.), cert. denied, 355 US 835 (1957), decedent had such an interest.

\textsuperscript{107}See Harris v. United States, 1972-1 USTC \$ 12,845 (CD Cal. 1972).

\textsuperscript{108}See the judicial soul-searching in Estate of Porter v. Comm’r, 442 F2d 915 (1st Cir. 1971), properly decided for the government under Section 2035 but ranging over the other sections defining the gross estate as well. See also Note, “Employer-Financed Widow’s Benefits—Definition of Transfer Extended,” 1971 U. Ill. LF 343.
4.06 SECTION 2034. DOWER OR CURTESY INTERESTS

The important thing about Section 2034 is that it forecloses argument that a decedent’s gross estate should be reduced by the value of a surviving spouse’s dower or curtesy or similar interest in the decedent’s property. Reaching fairly well back into estate tax antiquity,1 Section 2034 is accorded the kind of unquestioned deference that used to be a right of old age, even though it has never received the expressed blessing of the Supreme Court. It has been sustained against constitutional attack by some lower courts,2 and properly so, because whatever interest the survivor has by way of dower, curtesy, or some statutory equivalent, upon the decedent’s death there is a ripening of the interest and a shifting of property rights from the decedent that is, and rather clearly can properly be, regarded as a suitable occasion for a federal excise, even one based essentially on the decedent’s transmission of property at death.3

Most likely, the present language of Section 2033 would include the entire value of property owned by a decedent without reduction for a surviving spouse’s dower or curtesy interest, which, at most, imposes conditional restrictions on disposition of property owned by the decedent; these restrictions, in turn, are not operative until the decedent dies and are never operative if the decedent’s spouse predeceases. This reduces Section 2034 to a status of cautious redundancy.4

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1 The provision was first enacted in 1918. Revenue Act of 1918, Pub. L. No. 65-254, § 402(b), 40 Stat. 1051, 1097 (1918).
2 See, e.g., Mayer v. Reinecke, 130 F2d 350 (7th Cir.), cert. denied, 317 US 684 (1942); United States v. Waite, 33 F2d 567 (8th Cir. 1929), cert. denied, 280 US 608 (1930); Allen v. Henggeler, 32 F2d 69 (8th Cir. 1929).
3 See, e.g., Mayer v. Reinecke, 130 F2d 350 (7th Cir.), cert. denied, 317 US 684 (1942); United States v. Waite, 33 F2d 567 (8th Cir. 1929), cert. denied, 280 US 608 (1930); Allen v. Henggeler, 32 F2d 69 (8th Cir. 1929).
4 This was not always so. Before there was an express provision on dower, the earliest forerunner of Section 2033 spoke in terms of the inclusion in the gross estate of property interests of the decedent that were “subject to the payment of charges against his estate and the expenses of its administration and...subject to distribution as part of his estate.” Revenue Act of 1916, Pub. L. No. 64-271, § 202, 39 Stat. 756, 777 (1916). In any instance in which dower was protected against such expenses or charges or was not distributed as part of the estate, the surviving spouse’s dower interest was thus excluded from the decedent’s gross estate. Under such circumstances, estate tax liability was held to turn on whether the wife elected to take protected dower or received an unprotected interest under the will. Schuette v. Bowers, 40 F2d 208 (2d Cir. 1930). Moreover, after express provision for the inclusion of dower and curtesy was made in the Revenue Act of 1918, Pub. L. No. 65-254, § 402(b), 40 Stat. 1051, 1097 (1918), the restrictive language of the predecessor of Section 2033 continued until 1926. Revenue Act of 1926, Pub. L. No. 69-20, § 302(b), 44 Stat. 9, 70 (1926). Thus, the dower provision could still play an affirmative role. For example, if under state law a decedent’s real property passed directly
There may be a question of whether rights accorded to a surviving spouse are “dower or curtesy” or statutory rights in lieu thereof within the meaning of Section 2034. The best general expression on this point seems to be: “It was the legislative intent by Section 2034 to tax only the inchoate interest of the surviving spouse which existed during the decedent’s life, made consummate by the latter’s death.” According to this view, “dower,” as used in Section 2034, does not encompass a spouse’s right to a child’s share of the decedent’s estate, considered not a substitute for dower for lack of any inchoate lifetime interest. However, the current longer reach of Section 2033 renders such distinctions of little or no present importance. For the same reason, it is not now of much estate tax significance that some states have abolished dower and curtesy without providing any rights that are statutory estates in lieu thereof within the scope of Section 2034.

This section, forbidding the exclusion of a surviving spouse’s dower or curtesy or similar interest from the gross estate, does not necessarily mean that the interest will fully enter into the final determination of the estate’s tax liability. When such an interest takes effect, it is treated as “passing” to the surviving spouse, and so, subject to detailed considerations, it may be removed from the taxable estate by way of the marital deduction allowed under Section 2056.

Section 2034 must not be regarded as covering all property interests involving the marital relationship. For one thing, the rights of a surviving spouse with regard to jointly owned property are obviously outside the concept of dower or curtesy or any statutory equivalent and are unaffected by this section. Sections 2033 and 2040 determine the extent to which joint property interests affect the gross estate. It is likewise clear that other interests created by

to his heirs or devisees, it was not “subject to distribution as part of his estate” and therefore escaped inclusion under the basic definition of the gross estate. However, under express language such as is now found in Section 2034, it is held that a surviving spouse’s dower interest in such property is includible, even if it was not includible under the predecessor of Section 2033. Henderson v. United States, 18 F. Supp. 404 (Ct. Cl. 1937). And, under this language, it is immaterial whether she elected dower, took under the will, or asserted no rights whatever in the decedent’s estate. Id.

For a general discussion of dower, curtesy, and statutory rights in lieu thereof, see T. Atkinson, Law of Wills 105 n.6 (West, 2d ed. 1953).


IRC § 2056(c)(3).

Rev. Rul. 72-7, 1972-1 CB 308; Rev. Rul. 72-8, 1972-1 CB 309. See ¶ 5.06.

See ¶ 4.05[5][a].

See ¶ 4.12, especially IRC § 2040(b), discussed at ¶ 4.12[10].
the decedent, rather than by statute, are not covered by Section 2034, even though the interests are created in lieu of statutory rights.13

Furthermore, state community property laws are not statutory equivalents for common-law rules on dower or curtesy within the scope of this section. In many respects, the economic status of a spouse in a community property state is substantially similar to that of a spouse in a common-law state. But in the community property state each spouse does at least have an interest in the community property that can be disposed of by will regardless of which spouse dies first.14 This has always been accepted as a differentiating factor, even though Congress has vacillated on the proper estate tax treatment of community property.15

The integrity of the statutory treatment of dower and curtesy interests under Section 2034 is protected by estate and gift tax rules regarding what may constitute consideration for a lifetime transfer or for an obligation incurred by the decedent for which the estate may claim a deduction.16

¶ 4.07 SECTION 2035. ADJUSTMENTS FOR GIFTS MADE WITHIN THREE YEARS OF DECEDENT’S DEATH

[1] Introduction

For many years, the Section 2035 concepts of “contemplation of death” and “within three years of death” guarded the estate tax against nimble oldsters who sought to rid themselves of their wealth just in time so that when the estate tax collector came to exact what was due, the cupboard would be bare. The Commissioner had little success under the subjective “contemplation of death” test,1 so Congress expanded the rule to an automatic three-year inclu-

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13 Estate of Byram v. Comm’r, 9 TC 1 (1947), acq. 1947-2 CB 1. An inter vivos trust created by a decedent husband under an antenuptial agreement to satisfy his dower obligation to his wife was not included in the husband’s estate.


16 See IRC § 2043(b), discussed at ¶ 4.15[1], IRC § 2053(c)(1)(A), discussed at ¶ 5.03[4][a][i]; Merrill v. Fals, 324 US 308 (1945).

sion rule for all transfers in years after 1976. In 1981, except for details that will be mentioned, Congress reversed course and retracted a significant portion of Section 2035. However, this was not an act of congressional philanthropy. When Congress largely merged the estate tax with the gift tax in 1976, gifts entered the layering process that determines estate tax rates. The result is that if a transfer is subject to gift tax when made, it pushes increments of the estate into higher estate tax brackets, yielding a result much like an estate tax on at least the lifetime value of the gift, reduced by a credit for gift tax earlier paid. The most that can be said is “much like.” This fiscal fornication puts two simple thoughts together to enlarge and complicate the transfer tax family. So there is much more to say here.

Current Section 2035 is essentially two disparate rules: (1) subsection (a) is a limited class gross estate inclusion section subject to a series of exceptions and special rules found in subsections (c) through (e), and (2) subsection (b) includes in the gross estate gift taxes paid on some lifetime transfers.

The first prong of Section 2035 is a product of piecemeal drafting. The rule is principally a composite of pre-1977 law, amendments made by the Tax Reform Act of 1976, further amendments made by the Economic Recovery Tax Act of 1981 (ERTA), and a 1997 streamlining and clarification of prior drafting. The end result is current Section 2035(a) and the exceptions and special rules related to it, which are found in current Sections 2035(c) through 2035(e). However, even after these congressional efforts, a firm grasp of Section 2035(a) can be achieved only by being familiar with the other Code sec-

235. Prior to the substantial integration of the gift and the estate taxes in 1977, inclusion under Section 2035 carried more onerous consequences than under the integrated rules. Id. at ¶ 4.07[6].


4 See infra ¶ 4.07[3][a], text accompanying notes 34–39.

5 See ¶¶ 2.01[1], 2.01[2].


7 See infra ¶ 4.07[2].

8 See infra ¶ 4.07[3].

9 IRC § 2035(d).

10 IRC §§ 2035(a)(1), 2035(c)(3).

11 IRC § 2035(a)(2).


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tions that define the gross estate; accordingly, those sections should be examined prior to a detailed consideration of this section.\textsuperscript{13}

The second prong of Section 2035 is Section 2035(b), which was originally enacted in 1976.\textsuperscript{14} It performs the function of including in the decedent’s gross estate gift taxes paid by the decedent or the decedent’s estate on near-death transfers, regardless of whether the gifted property transferred is included in the decedent’s gross estate.\textsuperscript{15}

[2] The Section 2035(a) Rule (the First Prong)

[a] Section 2035(a) Inclusion

Section 2035(a) requires that property be pulled back into a decedent’s gross estate if there is a transfer of an interest in property or the relinquishment of a power with respect to property inclusion and if the transfer or relinquishment is one that was made by the decedent within three years of death\textsuperscript{16} for less than adequate and full consideration in money or money’s worth.\textsuperscript{17} But the section’s scope is narrowed to apply only if the decedent transfers an interest or relinquishes a power over either (1) an insurance policy that, without the transfer or relinquishment, would have been included in the decedent’s gross estate under Section 2042, or (2) an interest in property or power over property that, if not transferred or relinquished, would have required an amount to be included in the decedent’s gross estate under Section 2036, Section 2037, or Section 2038.\textsuperscript{18} Prior to the 1997 legislation, Section 2035(a) specifically referred only to transfers of property. The relinquishment of powers were treated as transfers of property under case law,\textsuperscript{19} but they were not specifically referred to in the statutory language. The 1997 change clarifies Section 2035(a) to include such relinquishments.\textsuperscript{20} However, in the discussion of the subsection

\textsuperscript{13} See ¶¶ 4.05, 4.06, 4.08-4.14, 4.16.
\textsuperscript{15} See infra ¶ 4.07[3].
\textsuperscript{16} IRC § 2035(a)(1).
\textsuperscript{17} IRC § 2035(d).
\textsuperscript{18} IRC § 2035(a)(2).
\textsuperscript{19} Cf. Rifkind v. United States, 5 Cl. Ct. 362 (1984). Since, for estate tax purposes, a decedent is deemed to own property over which certain powers are held (see IRC §§ 2036(a)(2), 2037(b)(2), 2038), a relinquishment of such powers is in essence a transfer of such property.
when the text uses the term “transfer,” the term encompasses both transfers of property and relinquishments of powers.

[i] Section 2035(a)(1). Transfers made more than three years before the decedent’s death are explicitly outside the scope of Section 2035; however, no amnesty is provided for transfers that may be within other sections.\textsuperscript{[21]} For Section 2035(a) to be applicable, the decedent must have made a transfer while alive and within three years of death. The courts look to local law to determine whether the decedent made a transfer. Once the transfer is established, the date the transfer was effective must be determined in order to establish whether the transfer was outside the three-year period. In general, the transfer occurs when the gift is complete for gift tax purposes.\textsuperscript{[22]}

[ii] Section 2035(a)(2). Prior to ERTA,\textsuperscript{[23]} Section 2035(a) included in a decedent’s gross estate the date-of-death value of any property interest transferred by the decedent within three years of the decedent’s death.\textsuperscript{[24]} Section 2035(a)(2), which applies to estates of decedents dying after 1981,\textsuperscript{[25]} limits Section 2035(a) inclusions to transfers specifically listed in Section 2035(a)(2). Because of these limitations, very few transfers within three years of death are likely to be included in the decedent’s gross estate under Section 2035(a) as it now applies, although when it does apply, the results are likely to be significant to the estate involved.

When Section 2035(a) applies, the overall effect on the determination of a decedent’s gross estate is generally the same as including the appreciation on the transferred property that occurred between the date of transfer and the date of the transferor’s death.\textsuperscript{[26]} Congress concluded that inclusion of post-transfer appreciation on all gifts made within three years of death is generally unnecessary.\textsuperscript{[27]} Outright transfers of property or cash that, if retained, would have been

\textsuperscript{[21]} See, e.g., IRC §§ 2036, 2037, 2038. The three-year cutoff date under Section 2035 has been a part of the law since 1950. A transfer completed on date one of year one is outside the three-year period if the decedent dies on date one of year four. TAM 200432016 (Mar. 10, 2004).

\textsuperscript{[22]} See discussion of Section 2511 at ¶ 10.01. See also infra ¶ 4.07[3][b].


\textsuperscript{[24]} See supra ¶ 4.07[1]. text accompanying note 2.


\textsuperscript{[26]} Gift tax paid with respect to the transfer is also included in the gross estate under Section 2035(b). See infra ¶ 4.07[3].

\textsuperscript{[27]} HR Rep. No. 201, 97th Cong., 1st Sess. 186–187 (1981), reprinted in 1981-2 CB 350, 390–391. Congressional leniency here may well have been motivated by the realization that Section 2035 inclusion would be coupled with a Section 1014 “stepped-up” basis in the property, while noninclusion would be coupled with a Section 1015 “carryover” basis. See infra text accompanying notes 34–39.
included in a decedent’s gross estate under Section 2033 are unaffected by and not included under Section 2035(a). Nor do transfers of property that would otherwise be within the ambit of Section 2039, Section 2040, or Section 2041, even if within three years of death, cause inclusion in a decedent’s gross estate under Section 2035(a). Thus, Section 2035(a)(2) applies only if the interest transferred by the decedent was one that, had it been retained by the decedent, would have enlarged the decedent’s gross estate under Section 2036, Section 2037, Section 2038, or Section 2042.

For example, if a donor gives a $100,000 face value insurance policy on the donor’s life to a donee when it is worth $15,000, the fair market value of the policy, $15,000, is subject to the gift tax. Had the donor retained the policy until death, the proceeds of $100,000 would have been included in the donor’s gross estate under Section 2042. If the gift to the donee occurs within three years of the donor’s death, Section 2035(a) operates to pull the life insurance policy back into the donor’s gross estate at its fair market value on the date of the donor’s death, the proceeds of $100,000. A transfer within three years of a decedent’s death of property that, had it been retained until death, would have been included in the decedent’s gross estate merely by reason of Section 2033 escapes inclusion under Section 2035(a). If, within three years of death, the donor merely gave $15,000 cash outright to the donee, that transfer would not be included in the donor’s gross estate under Section 2035(a). This would be so even if the donee independently purchased an insurance policy on the donor’s life. What if the donor purchased the policy in the donee’s name, or gave the donee the money with the understanding that the donee would buy the policy, or the donee purchased the policy but the donor paid the $15,000 pre-

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28 The 1981 enactment of Section 2035(a)(2) included Section 2041 general powers of appointment within the group of Code sections to which it applied. Section 2041 was appropriately deleted from Section 2035(a)(2) by the Technical Corrections Act of 1982, Pub. L. No. 97-448, § 104(d)(2)(B), 96 Stat. 2365, 2383 (1982), reprinted in 1983-1 CB 451, 460. The intent behind Section 2041 of the estate tax (and Section 2514 of the gift tax) is to equate general powers of appointment to outright ownership of property. If property were owned outright and transferred within three years of death, there would be no Section 2035 inclusion because Section 2033 is not listed within Section 2035(a)(2). Thus, the 1982 legislation, again equating general powers of appointment to outright ownership, appropriately deleted the reference to Section 2041 from Section 2035(a)(2).

But see IRC §§ 2041(a)(1)(B) and 2041(a)(2), which, under some circumstances, make Section 2035 applicable to general powers of appointment. For example, if a taxpayer held a general power of appointment and exercised it inter vivos retaining a life estate but transferring a remainder, and then, within three years of death, the taxpayer gave the retained life estate to the remainderperson, the property would be included in the taxpayer’s gross estate. Inclusion would occur under Section 2041, however, and not under Section 2035.
mium? Later in the text the interrelationship of Sections 2035 and 2042 is dealt with in more detail and the issues just raised are discussed.  

Section 2035(a)(2) speaks of “the value of...property (or an interest therein) [which] would have been included...under section 2036, 2037, 2038, or 2042 if such transferred interest...had been retained by the decedent on the date of his death.” Sometimes the interest transferred within three years of death is identical to the property whose value is included in the decedent’s gross estate. In the Section 2042 life insurance example stated earlier, the interest that is transferred, the life insurance policy, is the very property whose value would have been included had the transfer not occurred. This is also the case under Section 2038.

With respect to other situations enumerated in Section 2035(a)(2), the interest that is transferred is not identical to the property included under Section 2035. For example, if a donor makes a transfer, retains a life estate, and holds the life estate until death, Section 2036(a)(1) pulls the entire trust corpus into the donor’s gross estate. If within three years of death the donor gratuitously transfers the life estate to the remainderperson or some other person, Congress intends Section 2035 to treat the transfer of the interest as not having been made and to include the entire trust corpus in the donor-decedent’s gross estate under Section 2035(a). The same type of analysis is applied where a reversionary interest that, but for the transfer, would have been included under Section 2037 is transferred by a decedent within three years of death. The amount of inclusion under Section 2035(a) is the same as the amount that would have resulted under Section 2037 had the transfer not been made.

The benefits to be derived from elimination of most transfers from the scope of Section 2035(a) are largely illusory, and the statutory change may in some instances result in an overall estate planning disadvantage. Under the current unified estate tax computation, noninclusion of a taxable gift in the decedent’s gross estate generally means only that increases in value between the date of the gift and the date of death escape transfer taxation. Since Section

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29 See ¶ 4.14[9][b]. Things become even more complicated if trusts or controlled corporations are used to carry out the listed transactions. Id. See also Estate of Kurihara v. Comm'r, 82 TC 51 (1984); Rev. Rul. 82-141, 1982-2 CB 209.

30 See ¶ 4.10[8].

31 See ¶ 4.08[8].

32 See ¶ 4.08[8][b]. Although the question might be raised whether inclusion occurs under Section 2035 or Section 2036, a proper interpretation of the statute requires inclusion under Section 2035. See also TAM 199935003 (May 19, 1999) (trustee’s action in commuting a trust constituted a transfer by decedent of a retained life estate triggering Section 2035(a)(2)).

33 See ¶ 4.09[6].

34 Under the current estate tax computation, any substantial lifetime gift may affect estate tax liability. Review the computation method prescribed by Section 2001(b). If a
2035 applies only to transfers within three years of death, even assuming appreciation of the property, it is only post-gift appreciation in value for a maximum period of three years that escapes taxation. In many situations this will not be of significant advantage to the estate. But enter the income tax! Because the property is not pulled into the gross estate, it retains its Section 1015 transferred basis, as opposed to a Section 1014 fair market value basis, for income tax purposes.\(^{35}\) This can result in a significant income tax disadvantage if, at the time of the donor’s death, the gift property had a value substantially higher than its income tax basis at the time of the gift.\(^{36}\)

The difference in income tax bases may provide the rationale for the current scope of Section 2035(a). Section 2035(a)(2) includes property where there is a strong possibility of a substantial post-gift appreciation in value, such as under Section 2042\(^ {37}\) or Section 2038,\(^ {38}\) or where the property pulled into the gross estate differs from (i.e., is substantially greater than) the interest that was transferred, such as under Sections 2036 and 2037.\(^ {39}\) Congress continues to apply Section 2035 and allow a Section 1014 fair market value basis where there is a strong possibility of significantly increased estate tax inclusion, but it has eliminated inclusion in return for a Section 1015 transferred basis where the likelihood of increased estate tax inclusion is less.

\(^{35}\) But see IRC §§ 1014(c), 1014(e).

\(^{36}\) For example, assume a terminally ill donor has some highly appreciated property the donor wishes to give to the donor’s children right now, but the donor wants them to take it with a Section 1014 basis. Rather than transferring the property outright to them, the donor might first retain a life estate in the property (see IRC § 2036) and subsequently relinquish the interest so as to trigger Section 2035 inclusion in the donor’s gross estate. Of course, the substance of the transaction doctrine might be employed to telescope the transfers into a transfer not within Section 2035(a)(2).

\(^{37}\) See the example supra text accompanying note 29.

\(^{38}\) Under Section 2038, there is a possibility that an interest that was subject to the decedent’s power of alteration might sizably increase as a result of the decedent’s death. For example, assume a decedent grantor \(G\) created a trust with income to \(A\) for \(G\)’s life, then a remainder to \(B\) if \(A\) predeceased \(G\) and, if not, a remainder to \(C\); but \(G\) could substitute another for \(C\). If, within three years of death, \(G\) relinquished the power to alter \(C\)’s interest, \(G\) would make a taxable gift of the value of the remainder, which would have significantly less value than the value of the entire corpus. However, the value of the remainder subsequently pulled into \(G\)’s estate under Section 2035(a) would include the full value of the corpus.

A question may be raised as to why Section 2035(a)(2) includes Section 2038, since Section 2038 would include the remainder even without the application of Section 2035. See IRC §§ 2038(a)(1), 2038(a)(2), both referring to relinquishment of such powers within three years of death.

\(^{39}\) See supra text accompanying notes 31–33.
[b] Exceptions to Section 2035(a) Inclusion

[i] Section 2035(d): bona fide sales. Section 2035 is essentially aimed at gratuitous transfers. If, in connection with a transfer, the decedent receives full consideration in money or money’s worth in a bona fide sale, then the transfer amounts only to a substitution or exchange of assets, the gross estate is not reduced, and no estate tax is avoided. The Section 2001(b)(1)(A) element in the estate tax computation, the “taxable estate,” is unaffected by such a transfer, since the potential taxable estate is the same immediately after as immediately before the transfer. Therefore, Section 2035(d) removes from the scope of Section 2035(a) a bona fide sale for an adequate and full consideration in money or money’s worth. When there is a bona fide sale for partial consideration in money or money’s worth, Section 2035(d) is inapplicable and Section 2043(a) provides some inclusion relief.

The statute does not specify what constitutes “adequate” consideration. Moreover, the statute does not precisely say for what the decedent must receive full consideration. Where the interest transferred and the property included are the same, no problem is presented. For example, if a decedent transfers a $100,000 insurance policy on the decedent’s life worth only $15,000 at the time of the transfer in return for a cash payment of $15,000, the Section 2035(d) exception is applicable. The same may not be said where the interest transferred and the property included are not identical.

What if the interest transferred is a Section 2036(a)(1) retained life estate worth $15,000 in a trust with a corpus of $100,000? Is a $15,000 cash payment adequate consideration? The estate tax answer should be no! When confronted with this problem, a court created an estate tax ownership concept requiring consideration equal in value to the potential estate tax inclusion. Thus, the $15,000 received represents only partial consideration, and the date-of-death value of

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40 This exception is discussed in detail at ¶ 4.08[1] in the context of Section 2036. Seemingly, the principles there are equally applicable here. See Priv. Ltr. Rul. 200432015 (Mar. 10, 2004) (transfer of life insurance policy for an LLC interest was not a bona fide sale for adequate and full consideration in money or money’s worth). See Estate of Musgrove v. United States, 33 Fed. Cl. 657 (1995) (cash loaned within one month of lender’s death in exchange for an unsecured demand note, which was canceled at death, was not treated as transferred). Cf. IRC § 691(a)(5).

41 IRC § 2043(a); ¶ 4.15[2].


43 See supra ¶ 4.07[2][a], text accompanying notes 31–33.

44 United States v. Allen, 293 F2d 916 (10th Cir. 1961).

45 Cf. IRC § 2043(a); ¶ 4.15[2].
the trust property (here, assume it is still $100,000) less the consideration received ($15,000) is included. In prior editions of this book, the authors applauded the result but suggested that Congress should tidy up the statute. Congress amended the statute but failed to indicate either approval or disapproval of the prior judicial result. The courts should continue to observe this judicial gloss on the statutory language of Section 2035(d).

[ii] Section 2035(e): certain transfers from revocable trusts. For years, there was controversy whether inter vivos gifts from revocable trusts within three years of the grantor’s death were to be included in the grantor’s gross estate under Section 2035(a). Section 2035(e) resolves this controversy by making Section 2035 (as well as Section 2038) inapplicable to “any transfer from any portion of a trust during any period that such portion was treated under section 676 [the revocable grantor trust rule] as owned by the decedent by rea-

46 Measurement of adequate and full consideration ought to be based on the property potentially included in the gross estate valued at the time of the gift transfer. Under Section 2036, this is the corpus of the trust less any unrelated outstanding life estates; similarly, under Section 2037, this would include the trust corpus less any unrelated interests.

47 IRC § 2043(a). See United States v. Allen, 293 F2d 916 (10th Cir. 1961).


49 If the trustees of the trust could invade trust corpus only for the grantor’s benefit, then it was as though the transfer was made from the trust to the grantor and then by the grantor outright to the third party, with the result that the predecessor of Section 2035(a)(2) would not apply and there was no gross estate inclusion. Jalkut v. Comm’r, 96 TC 675 (1991), acq. 1991-2 CB 1; Estate of Collins v. United States, 94-1 USTC ¶ 60, 162 (ED Mich. 1994); Estate of Frank v. Comm’r, 69 TC (CCH) 2255 (1995) (invasion for grantor by son using power of attorney). The result was consistent with the government’s position in a series of private letter rulings: TAM 9010005 (Nov. 17, 1989), TAM 9010004 (Nov. 17, 1989), and TAM 9017002 (Jan. 5, 1990) (all resulting in no inclusion). Whereas, if the trustees had the power to invade corpus for third parties as well as the grantor, then the transfer was deemed to be made directly from the trust and Section 2035(a)(2) applied to include the transfer in the grantor’s gross estate. TAM 9015001 (Dec. 29, 1989), TAM 9016002 (Dec. 29, 1989), TAM 9049002 (Aug. 29, 1940), and TAM 9226007 (Feb. 28, 1992) (resulting in inclusion).

The latter result seemed to be avoided even though the trustee had broader powers if the property were removed from the trust, titled in grantor’s name, and then gifted to the donee, or if the donor retained the power to designate in writing the persons who would receive such property. McNeely v. United States, 16 F3d 303 (8th Cir. 1994). Cf. Estate of Barton v. Comm’r, 66 TC (CCH) 1547 (1993). See Klimczak, “Gift Giving and Revocable Trusts—The Right Way and the Wrong Way,” 22 Tax Adv. 422 (1991).

50 Section 2035(e) also makes Section 2038 inapplicable in such circumstances. See ¶ 4.10[b], text accompanying notes 87–91. Section 2035(e) applies to estates of decedents dying after August 5, 1997. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1310(c), 111 Stat. 788, 1044 (1997), reprinted in 1997-4 CB 1457, 1736.
son of a power in the grantor.”51 The rule treats all such transfers as being made directly by the decedent. Although Section 2035(e) speaks of “transfers” from a portion of a trust, it should also apply if a transferor relinquishes a power to revoke all or a part of the corpus of a trust.52 This provision does not totally gut the interaction of Section 2035 with Section 2038; Section 2035 still interacts with Section 2038 where a Section 2038 power other than a power to revoke is relinquished within three years of a decedent’s death.53

[c] The Amount to Be Included Under Section 2035(a)

As is true of all the sections defining the gross estate, Section 2035 does not speak simply of transferred property, but looks instead to interests in property that the decedent may have transferred during life.54 Property interests brought into the gross estate by way of Section 2035 do not enjoy any exception from the standard rules on the time of valuation. The interests are to be valued as of the date of death or the alternate valuation date.55 Valuation presents difficulties. For example, when an individual makes a gift within the reach of Section 2035, one cannot know how it may affect the tax liability of one’s estate; in addition to uncertainty whether the gift itself may be included under Section 2035, if it is so included, the value will not be determinable until death.56 Furthermore, questions can arise as to specifically what property is included under Section 2035. For example, assume that a decedent transfers property to a trust within three years of death, that Section 2035 applies to the transfer, and that the trustee sells the property originally transferred and reinvests the proceeds prior to the decedent’s death. The issue is whether the origi-

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51 The rule disregards Section 672(e), under which, for income tax purposes, the grantor is deemed to hold a power to revoke because the grantor’s spouse holds such a power.

52 If Section 2035(e) were interpreted to apply only to actual transfers from the trust, other transactions would be forced to revert to the pre–Section 2035(e) form-over-substance approach discussed supra note 49. Cf. supra ¶ 4.07[2][a], text accompanying notes 19, 20.

53 For example, if grantor G created an irrevocable trust with income to A for G’s life and a remainder to B or C, whomever G selected, and, within three years of death, G relinquished the power over B and C’s interests by splitting the remainder equally between them, either Section 2035(a) acting in conjunction with Section 2038 or Section 2038(a) acting alone would include the entire corpus in G’s gross estate at G’s death. See ¶ 4.10[8], text accompanying notes 89–93.

54 See supra ¶ 4.07[2][a], text accompanying notes 31–33.

55 See IRC § 2031, 2032; ¶¶ 4.02, 4.03; Reg. § 20.2035-1(e). Cf. IRC § 2032A, discussed ¶ 4.04.

56 This difficulty is minimized by the three-year rule and by state statutes apportioning the tax burden, to which reference is made in the discussion of Section 2205 at ¶ 8.04.

Section 2035
nal property or that acquired upon reinvestment is to be valued. This issue is resolved by considering the purposes of Section 2035. Remember that, as modified by Section 2035(a)(2), Section 2035(a) operates to treat certain transfers within three years of death as if they had not occurred if, had they actually not occurred, there would have been inclusion of the property in the transferor’s gross estate under Section 2036, Section 2037, Section 2038, or Section 2042.57 Thus, Section 2035(a) should result in inclusion in the decedent’s gross estate of an amount commensurate with that required to be included by Section 2036, Section 2037, Section 2038, or Section 2042 if the transfer that made them inoperable had not occurred.

For example, if a decedent, within three years of death, transfers an insurance policy on the decedent’s life to a donee and the donee sells this policy and reinvests the proceeds, it is the value of the policy at the decedent’s death, the proceeds payable on the policy, that should be included in the decedent’s gross estate. Admittedly, there are three possible amounts of inclusion under these circumstances: (1) the value of the policy at the date of the decedent’s death; (2) the sale price of the policy; or (3) the value of the subsequently acquired property at the date of the decedent’s death.

In comparable circumstances involving an outright transfer of property, the Service has ruled that the first alternative is the proper result relying on the language of the statute.58 The same result is reached with respect to inclusions under Section 2035(a) of Sections 2036-, 2037-, and 2038-type transfers. Again, the statute seems to justify the result, which is consistent with congressional policy. The congressional intent of Section 2035(a) is to apply Sections 2036 through 2038 as if no Section 2035 transfer had occurred, and it is in keeping with congressional policy simply to include that particular property over which the decedent had held the interest or power. Because no power or interest is held at death (it is relinquished within three years of death), the property included and valued should not be the property owned at death but rather the property over which the decedent held a power or interest.59 Thus,

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57 See supra ¶ 4.07[2][a][ii].
58 Rev. Rul. 72-282, 1972-1 CB 306. Although the statutory language has been amended, the current language would reach the same result. See also Estate of Humphrey v. Comm’r, 162 F2d 1 (5th Cir.), cert. denied, 332 US 817 (1947). The ruling and Humphrey involve outright transfers of property under pre-1982 law, but there is no conceptual or other reason why a different result should apply to a transfer of a life insurance policy, and indeed the ruling hints at no such distinction.
59 When a transfer is to a trust, it may be tempting to think that it is relatively easy to trace the property originally transferred into other assets that make up the fund at the critical date of death. This would support the application of alternative (3) in the text. Actually, as explained later, trust income would have to be excluded, and, if the trustee has made discretionary distributions out of corpus or has acquired new property with accumulated income, identification of assets becomes very difficult. Thus, practical reasons for a different rule for trusts in this setting are lacking, just as are conceptual reasons for the
the property held at the time of the Section 2035 transfer should be included at its date-of-death value.

The gross estate does not include income earned by the property after the gift is made, even if the income is added to the corpus of a trust that was created within the three-year period, provided the decedent had no interest whatsoever in or control over the income when the decedent died.\textsuperscript{60} This may not quite accord with the idea expressed above that Section 2035 is intended to make the transferred property cause the same estate tax result as if the decedent had kept it until death; if the decedent had kept the property, the income might have enlarged the decedent’s estate. Nevertheless, all the decedent could transfer was the decedent’s interest in the property; and, if the decedent never had an interest\textsuperscript{61} in the income earned after the gift, it could not have been the subject of a taxable transfer by the decedent.

Any increase in value that results from improvements made by the donee after the gift need not be included in the decedent’s gross estate.\textsuperscript{62} Post-transfer stock dividends, even if payable before the transferor’s death, at least if they represent a capitalization of post-transfer earnings, are not includible in the gross estate.\textsuperscript{63} On the other hand, shares received in a post-transfer stock split are clearly includible. The in-between problems are not settled and are not precisely answerable under the present statute.\textsuperscript{64}

As an illustration of the difficulties with Section 2035 in determining the amount includible, suppose a donor makes a transfer of an interest in property that results in inclusion of the corpus of a trust in the donor’s gross estate under Section 2035(a). Suppose the corpus is a valuable tract of timber and, between the time of the transfer and the decedent’s death, the trustee sells the timber for $10,000 but retains the land. What is includible in the gross estate? To limit the amount to the date-of-death value of the denuded realty would

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\textsuperscript{60} Burns v. Comm’r, 177 F2d 739 (5th Cir. 1949); Estate of Frizzell v. Comm’r, 9 TC 979 (1947), acq. 1966-1 CB 2. Compare the discussion of what constitutes income for purposes of Section 2032. See ¶ 4.03[2]. However, income earned after a transfer taxed under Section 2036 or Section 2038 may present a difficult problem. See United States v. O’Malley, 383 US 627 (1966). An aging article that deals with problems of this sort is Lowndes & Stephens, “Identification of Property Subject to the Estate Tax,” 65 Mich. L. Rev. 105 (1966).

\textsuperscript{61} This is not an appropriate place for application of an estate tax ownership concept. But see United States v. O’Malley, 383 US 627 (1966); ¶ 4.08[8][a].


\textsuperscript{64} Reg. § 20.2035-1(e).
open an obvious avenue for estate tax avoidance. To value the land as if the trees were still on it would be more supportable but would produce an irksome valuation question. As there is some authority for including the value of what was received by way of conversion of the original gift property,\textsuperscript{65} perhaps the best result would be to include the value of the denuded realty plus the $10,000 cash received by the trustee.

Section 2035 may apply to shared property. For example, where the decedent owned property in joint tenancy or as community property and the property was transferred to a third person subject to a retained life estate in the decedent, and then within three years of the decedent’s death the life estate was also transferred, only the value of the decedent’s fractional interest in the property is included in the gross estate and not the value of the interest transferred by the co-owner.\textsuperscript{66}

Transactions within three years of death relating to transfers with life interests retained, to transfers taking effect at death, to alterable transfers, and to transfers of life insurance are dealt with further in the discussions of Sections 2036, 2037, 2038, 2041,\textsuperscript{67} and 2042, respectively.\textsuperscript{68}

\section*{[d] Special Applications of the Section 2035(a) Rule}

Although Section 2035(a)(2) limits inclusion in the gross estate under Section 2035(a), it does not limit inclusion in the gross estate under Section 2035(a) for all purposes. Section 2035(c)(1) sometimes makes Section 2035(a)(2) inoperative. It requires all transfers within three years of death (other than those made in a bona fide sale for adequate and full consideration)\textsuperscript{69} to be included in the gross estate under Section 2035(a)\textsuperscript{70} for purposes of applying Section 303(b) (relating to stock redemptions).\textsuperscript{71}

\textsuperscript{65} See Estate of Dewitt v. Comm’t, 68 TCM (CCH) 1136 (1994). See also Estate of Kroger v. Comm’t, 145 F2d 901 (6th Cir. 1944), cert. denied, 324 US 866 (1945).

\textsuperscript{66} Estate of Sullivan v. Comm’t, 175 F2d 657 (9th Cir. 1949); Estate of Borner v. Comm’t, 25 TC 584 (1955), acq. 1969-2 CB xxiii (see also 1962-1 CB 4; 1957-2 CB 4); Estate of Brockway v. Comm’t, 18 TC 488 (1952), acq. 1969-2 CB xxiv (see also 1962-1 CB 4; 1955-2 CB 4), aff’d on other issues, 219 F2d 400 (9th Cir. 1954).

\textsuperscript{67} See supra ¶ 4.07[2][a], note 28, for possible inclusion under Section 2041 as opposed to Section 2035, although Section 2041 may act in conjunction with Section 2035.

\textsuperscript{68} See ¶¶ 4.08[8], 4.09[6], 4.10[9], 4.14[7].

\textsuperscript{69} IRC § 2035(d). This is an appropriate result, although one which is difficult to read into the current statutory scheme. It was the result under the prior statute. See R. Stephens, G. Maxfield, S. Lind & D. Calfee, Federal Estate and Gift Taxation ¶ 4.07[2][a], text accompanying notes 40, 41 (Thomson Reuters/Tax & Accounting, 7th ed. 1996).

\textsuperscript{70} The constructive expansion of the gross estate applies only for purposes of the estate’s qualification for benefits offered by these sections. See HR Rep. No. 201, 97th Cong., 1st Sess. 187 (1981), reprinted in 1981-2 CB 352, 390.

\textsuperscript{71} IRC § 2035(c)(1)(A).
(relating to special-use valuation),\textsuperscript{72} and Sections 6321 through 6326 (relating to liens for taxes).\textsuperscript{73} However, any Section 2035(a) transfer (other than a transfer of a life insurance policy) is excepted from the Section 2035(c)(1) rules if the transfer is a de minimis transfer for which no gift tax return is required by Section 6019(1).\textsuperscript{74}

Section 2035(c)(2) goes even further to impose a dual test (both using Section 2035(a) and making it inoperative) for purposes of meeting the 35 percent of the adjusted gross estate test of Section 6166(a)(1) (relating to extension of time for payment).

[3] The Section 2035(b) Rule (the Second Prong)

[a] The Gift Tax Gross-Up Rule

Prior to the Tax Reform Act of 1976, even if lifetime taxable gifts were pulled into the donor’s gross estate under Section 2035, an estate tax saving often occurred because the gross estate was reduced by the amount of any gift tax paid on the transfer. Not surprisingly, if a bit gruesome, these gifts were often “death bed transfers.” The tax saving resulted because only the value of the gift was included in the decedent’s gross estate, not the gift tax paid or payable on the gift.\textsuperscript{75}

In the Tax Reform Act of 1976, Congress enacted current Section 2035(b) to close this loophole as to taxes paid on gifts after 1976 made within three years of death. The provision requires the federal gift tax paid by the decedent or the decedent’s estate on any transfers made after 1976 by the decedent or the decedent’s spouse within three years of the decedent’s death to be included in the decedent’s gross estate. The inclusion of the tax is a “gross-up” of the

\textsuperscript{72} IRC § 2035(c)(1)(B).

\textsuperscript{73} IRC § 2035(c)(1)(C). See Armstrong v. Comm’r, 114 TC 94 (2000) (predecessor of Section 2035(c)(1)(C) applied to hold recipients of gifts within three years of donor’s death liable for transferee liability).

\textsuperscript{74} IRC § 2035(c)(3). Although a transfer under Section 6019(3) to a charity for which no gift tax return is required to be filed would also literally fall within the exception (which only excludes Section 6019(2) transfers), the failure to also exclude transfers covered by Section 6019(3) from the exception appears to be a legislative error unintended by Congress. A technical correction should be made.

\textsuperscript{75} The savings, of course, rested in part on the Section 2012 credit against the estate tax for tax paid on the gift. For a more complete discussion of the “deathbed transfer” device, see R. Stephens, G. Maxfield & S. Lind, Federal Estate and Gift Taxation 4-73 (Thomson Reuters/Tax & Accounting, 3d ed. 1974).
As the introduction suggests, Section 2035(b) may well be looked upon as an entirely separate section, because Section 2035(b) is operative regardless of whether the gift subject to the tax is included in the decedent’s gross estate.

The Section 2035(b) gross-up is affected by the gift-splitting provision of Section 2513. If a decedent’s spouse makes a transfer, the spouses elect gift-splitting, and the decedent dies within three years, the tax the decedent paid will be pulled into the decedent’s estate under Section 2035(b), even though there is, of course, no basis for including any part of the value of the property the spouse transferred in the decedent’s estate. Section 2035(b) is express on this because, without this rule, a collateral death-bed transfer could occur; a survivor’s gift could effect an artificial reduction in the decedent’s gross estate. Further, if the decedent pays all the tax on a split-gift transfer made by spouse, no gift to the decedent’s spouse results, but the full gift tax is included in the decedent’s estate. If the decedent makes a transfer and gift-splitting is elected and the decedent pays the full amount of the tax on the entire transfer, the full tax is again pulled into the decedent’s estate. These literal results under the statute are essential to prevent artificial diminution of the decedent’s estate. Under similar reasoning, the amount of gift tax paid by a decedent’s spouse on transfers split under Section 2513 is not included in the decedent’s gross estate because such payments do not reduce the decedent’s gross estate.

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76 The fact that the gift tax is paid after the decedent’s death by the decedent’s estate does not preclude a “gross-up.” Section 2035(b) expressly applies to federal gift taxes paid by the decedent or the decedent’s estate. But see ¶ 6.04[2], note 18, 6.03[1], note 2.

77 See ¶ 10.03.

78 Estate of O’Neal v. United States, 291 F. Supp. 2d 1253 (ND Ala. 2003) (amount paid by decedent for decedent’s spouse’s gift tax liability on split gifts added to decedent’s estate); Rev. Rul. 82-198, 1982-2 CB 206.


80 See TAM 9729005 (Apr. 9, 1997) (where an individual made a gift to his spouse of the amount of the gift tax, which the spouse then used to pay the gift tax due on a gift that had been split by the couple, the Service asserted substance over form and concluded that the gift tax was actually paid by the individual and was includible in the individual’s gross estate under Section 2035(b)).

81 Step-transaction analysis can, of course, cause a payment by the surviving spouse to be treated as payment by the decedent. Brown v. United States, 329 F3d 664 (9th Cir. 2003) (decedent’s gift to spouse of money that was used the next day to pay gift taxes was treated as payment by decedent).

If the decedent was the donor of a gift that was made after December 31, 1976, and that was required to be included in the decedent’s gross estate, one half of which was considered as made by the decedent’s spouse, generally any tax paid by the spouse reduces the Section 2001(b)(1) tentative estate tax under Section 2001(b)(2). See IRC § 2001(d). This is so even though the amount of the gift tax paid by the surviving spouse is not included in the decedent’s gross estate and occurs even when the spouse pays the
One method of making gifts has been to make net gifts, where, by agreement, the donee pays the donor’s gift tax liability, effectively reducing the amount that the donor is treated as transferring to the donee as a gift.\[^{82}\] In substance, the transaction involves in part a gift by the donor and in part a tax payment made indirectly by the donor arising out of a single transfer to the donee. If the donor dies within three years of such a transfer, the gift tax should be pulled into the decedent’s gross estate under Section 2035(b). It is fair to say the tax is paid “by the decedent” within Section 2035(b).\[^{83}\] A similar issue also arises if gift tax paid by a surviving spouse is recovered under Section 2207A(b). This payment, too, is treated as gift tax paid by the surviving spouse for purposes of Section 2035(b).\[^{84}\] The person from whom the surviving spouse recovers the gift tax under Section 2207A(b) should not be treated as having paid gift tax for purposes of Section 2035(b).

[b] Gifts Made Within Three Years of Death

Questions can be raised as to the date a taxable gift was effective in order to determine whether the transfer was outside the Section 2035(b) three-year entire tax on the split gift. If there is a problem here, it is with the potential gross estate of the survivor; the decedent’s gross estate is not reduced by gift tax paid by the survivor. After the 1976 legislation was enacted, a problem appeared regarding correlation of the Section 2035(b) gross-up and the Section 2513 gift-splitting provision. If a spouse’s gift was attributed one half to the other spouse under Section 2513, that portion would surface as a part of adjusted taxable gifts under Section 2001(b)(1)(b) upon death of the nondonor spouse. But the entire gift might already have formed a part of the donor spouse’s taxable estate by reason of Section 2035. Obviously, this should not be, so Congress enacted Section 2001(e) to remove the attributed portion from the adjusted taxable gifts of the nondonor spouse in these circumstances. Logically, tax paid on that portion is also not to be a part of Section 2001(b)(2) gift tax payable in computing tax on the nondonor’s estate, as the statute also expressly provides. Thus, even though the decedent paid the tax that is included in the decedent’s estate under Section 2035(b), in this situation it is not deemed a tax paid by the decedent for purposes of Section 2001(b)(2). See Rev. Rul. 82-198, 1982-2 CB 206. As framed, the statute seems to create a problem if the nondonor spouse dies first; at that juncture, the questionable portion of the split gift will not be “includible in the gross estate of the decedent’s spouse by reason of section 2035.” The remedial provision is given full effect if the donor spouse dies before the estate tax return of the other is filed or by way of a refund in other cases. Rev. Rul. 81-85, 1981-1 CB 452. The critical question will always be resolved within the presumptive three-year limitation period for filing refund claims. IRC § 6511(a). See also ¶¶ 2.01[1][b], note 20, 2.01[2], note 77.


\[^{83}\] This result was reached in Estate of Sachs v. Comm’r, 88 TC 769 (1987), aff’d on this issue, 856 F2d 1158 (8th Cir. 1988).

\[^{84}\] Estate of Morgens v. Comm’r, 678 F3d 769 (9th Cir. 2012). See ¶¶ 8.07[3], 8.07[4], 10.08[3].
period. In general, the transfer occurs when the gift is complete for gift tax purposes. For instance, the date of the execution of a deed to property has been held to be the date of transfer, even though the deed is not recorded until a later date. In some situations, a transfer of land has been held to occur prior to transfer of actual legal title. Delivery of stock certificates to the donee has been held to be a transfer of stock even though the stock is not transferred on the corporation’s books until a later date. However, execution of a power of attorney over a bank account is not a transfer of the funds in the account, and no transfer occurs until funds are actually disbursed from the account. Similarly, no transfer of funds occurs in a joint bank account until there is a disbursement to the donee.

Stocks, bonds, and notes are not the only intangibles that can be the subject of a transfer taxed under the gift tax. Any contract right is property that may be the subject of such a transfer. There has never been any question that an insurance policy can be transferred in a manner resulting in the imposition of gift tax, and gift tax incurred on procurement of an insurance policy for another within three years of the purchaser’s death results in the inclusion of the gift tax in the purchaser’s gross estate at death.

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85 Cf. TAM 200432016 (Mar. 10, 2004) (a transfer completed on day one is outside the three-year period if decedent dies on day one of year four).

86 This can occur as a result of an actual transfer of an interest in property or a relinquishment of a power over property. See supra ¶ 4.07[2][a], text accompanying notes 19, 20; IRC § 2511, discussed at ¶ 10.01.

87 Estate of Green v. Comm’r, 4 TCM (CCH) 286 (1945); Gerry v. Comm’r, 22 BTA 748 (1931), acq. X-2 CB 26. These cases involve situations in which state law did not require recording in order to transfer title. Cf. Estate of Raab v. Comm’r, 49 TCM (CCH) 662 (1985).

88 Beeler v. Motter, 33 F2d 788 (D. Kan. 1928) (involving an oral gift of land under which donee took possession and made improvements prior to transfer of actual legal title). See also Mather v. McLaughlin, 57 F2d 223 (ED Pa. 1932).


90 Estate of Hite v. Comm’r, 49 TC 580 (1968).


[4] Pre-1982 Section 2035 and Its Background

A provision pulling some completed inter vivos transfers into the gross estate has been in the estate tax statute since its inception in 1916.\textsuperscript{93} The first provision and those that followed until 1926 contained a rebuttable presumption that gifts made within two years of death were made in contemplation of death, which was one of the criteria for inclusion.\textsuperscript{94} A congressional effort in 1926 to strengthen the Commissioner’s hand by making the presumption conclusive\textsuperscript{95} was held unconstitutional by the Supreme Court in 1932\textsuperscript{96} on the premise that to impose a tax on the basis of a factual assumption that the taxpayer is not permitted to rebut is so arbitrary as to offend the Fifth Amendment. Congress thereupon replaced the conclusive presumption with a rebuttable one.\textsuperscript{97} In 1950, the rebuttable presumptive period was extended to three years, and a three-year cutoff date was added that precluded a finding of the requisite motive when that period had expired. The contemplation-of-death criterion and the three-year rebuttable presumption applied to transfers made through December 31, 1976.\textsuperscript{98}

In 1976, Congress eliminated motive or intent as a criterion for inclusion under Section 2035; all tests for inclusion became objective for transfers after 1976.\textsuperscript{99} Additionally, in 1976, Congress required inclusion in the gross estate of gift taxes paid by the decedent or his estate on near-death transfers.\textsuperscript{100} In 1981, Congress dramatically limited the scope of application of Section 2035(a).\textsuperscript{101}

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\textsuperscript{95} Revenue Act of 1926, Pub. L. No. 69-20, § 302(c), 44 Stat. 9, 70 (1926).
\textsuperscript{96} Heiner v. Donnan, 285 US 312 (1932).
\textsuperscript{101} See supra ¶¶ 4.07[2][a], 4.07[2][a][ii].
§ 4.08 SECTION 2036. TRANSFERS WITH RETAINED LIFE ESTATE

Section 2036 is designed to prevent what would otherwise be a simple and effective device for the avoidance of estate tax. It has been explained previously that, if the decedent had a mere life estate or other life interest in property that expired at death, such an interest is not includible in the gross estate under Section 2033. Thus, as far as that section is concerned, a person could gratuitously transfer property in trust, ridding the person of legal title, and yet retain the right to the income from the property for life without having one’s estate suffer any estate tax liability with respect to the property upon death. This, of course, would be a real cake-and-eat-it scheme, but it is frustrated by Section 2036(a)(1). In general, this section includes in the gross estate the entire value of property so transferred by the decedent. Congress also looks disparagingly upon the similar situation where a decedent retains the mere power to determine who, other than oneself, will receive the income. In such a situation, Section 2036(a)(2) operates to pull the property over which the decedent held the power into the decedent’s gross estate.

Section 2036 has also been used by Congress to avert other taxpayer cake-and-eat-it schemes. Section 2036(b) was added to the Code to treat transferors retaining voting rights in a corporation as retaining enjoyment of the corporation to include the stock of the corporation in decedent’s gross estate under Section 2036(a)(1).

[1] Excluded Transfers

[a] Bona Fide Sales for Full Consideration

Section 2036 does not apply to a transfer that is “a bona fide sale for an adequate and full consideration in money or money’s worth.” Historically, in applying this exception the courts have emphasized the language dealing with

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1 See ¶ 4.05[5][b]. Beyond the estate tax frying pan, the Chapter 13 of the Code fire threatens generation-skipping arrangements. See Chapters 12–18.


3 IRC § 2036(a). The reason for this exclusion is the same as that discussed above concerning the similar exclusion from the provisions of Section 2035. IRC § 2035(d). See ¶ 4.07[2][b][i].
“adequate and full consideration in money or money’s worth”⁴; however, more recently the courts have also put emphasis on the “bona fide sale” language, in effect creating a two-part requirement to satisfy the exception.⁵ Thus, to satisfy the exception, the transfer must be both a bona fide sale and the transferor must receive adequate and full consideration in money or money’s worth. There are two principal types of cases under Section 2036: the more typical cases involving transfers of temporal interests generally to family members, and more recent cases involving transfers of contemporaneous interests in entities such as family limited partnerships or family limited liability companies.⁶ The temporal interest cases are primarily concerned with the adequate and full consideration requirement of the exception, while the contemporaneous cases are primarily concerned with the bona fide sale requirement. The estate tax exception, which also applies under several other sections⁷ and which contains the two pronged requirement, is distinguishable from the gift tax rule, which simply measures the amount of a gift by the value of the property transferred, reduced by the amount of consideration received.⁸ Thus, the gift tax rule generally is not dependent upon a bona fide sale.⁹

[i] The bona fide sale requirement. Most of the recent cases considering the bona fide sale for adequate and full consideration exception under Section 2036 involve transfers to family limited partnerships and family limited liability companies in return for an ownership interest in the entity.¹⁰ These cases involve the creation of interests where generally the parties stand on both sides of a transaction transferring assets to the entity and receiving contemporaneous proportionate interests in the entity in return.¹¹ In the contemporaneous interest cases, the courts have either treated the transfers as bona fide sales or usually treated the transfers as a mere “recycling of value,”¹² depending on whether there is a subjective “legitimate and significant nontax reason for cre-

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⁴ See infra ¶ 4.08[1][a][ii]. See, e.g., D’Ambrosio v. Comm’r, 101 F3d 309 (3d Cir. 1996), cert. denied, 520 US 1230 (1997); Wheeler v. United States, 116 F3d 749 (5th Cir. 1997); Estate of Magnin v. Comm’r, 116 F3d 1074 (9th Cir. 1999).
⁵ See infra ¶ 4.08[1][a][i]. But see Estate of Bigelow v. Comm’r, 503 F3d 955 (9th Cir. 2007) (where the Ninth Circuit refused to accept the two-part requirement).
⁶ Cf. IRC §§ 2702(c)(1) and 2702(c)(3), making a distinction between temporal and contemporaneous interests and making Section 2702 inapplicable to the latter types of interests. See Reg. § 25.2702-4(a); ¶ 19.03[2][a], text accompanying notes 41, 42.
⁷ IRC §§ 2035, 2037, 2038. See ¶¶ 4.07[2][b][i], 4.09[2], 4.10[2].
⁸ See IRC § 2512(b), discussed at ¶ 10.02[3].
⁹ But see Reg. § 25.2512-8, discussed at ¶ 10.02[4].
¹⁰ See ¶ 4.02[4][g].
¹¹ See infra ¶ 4.08[1][a][iii], text accompanying notes 38–40. See also ¶¶ 4.02[4][g], note 241, 10.01[2][b], text accompanying notes 23–25, 10.02[2][c][v], considering whether such transfers involve a gift on formation of the entity.
¹² See infra text accompanying note 20.
Cases have found a bona fide sale where there were one or more of a variety of legitimate and significant nontax reasons for the creation of the entity. For example, a bona fide sale has been found (1) where there was a transfer of the management of the assets either for centralized management or for the transferees to manage the assets; (2) where the assets transferred would be managed consistent with the transferor’s investment strategy; (3) where there was a transfer to protect the assets from the transferor’s creditors; (4) where the transfer was to facilitate active management of assets and protecting them from litigants; or (5) where the transfer was to implement a buy and hold investment policy. In the absence of a legitimate and significant nontax motivation for the creation of the entity, the courts have usually labeled transfers to family limited partnerships and limited liability companies as a mere “re-

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13 Bongard v. Comm’r, 124 TC 95, 118 (2005). The Bongard case was an en banc decision by the Tax Court that adopts this test for satisfying the bona fide sale requirement. In Bongard, the Tax Court stated:

In the context of family limited partnerships, the bona fide sale for adequate and full consideration exception is met where the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership, and the transferors received partnership interests proportionate to the value of the property transferred....The objective evidence must indicate that the nontax reason was a significant factor that motivated the partnership’s creation....A significant purpose must be an actual motivation, not a theoretical justification. [Id.]

14 See, e.g., Estate of Thompson v. Comm’r, 382 F3d 367 (3d Cir. 2004) (a good-faith transfer with an objective inquiry whether some significant nontax benefit resulted from the transfer); Kimbell v. United States, 371 F3d 257 (5th Cir. 2004) (a showing of objective evidence supporting the conclusion that the transfer was entered into for substantial business and other reasons); Strangi v. Comm’r, 417 F3d 468 (5th Cir. 2005) (a showing as an objective matter that creation of the partnership served a substantial business or other nontax purpose). See also Estate of Rosen v. Comm’r, 91 TCM (CCH) 1220 (2006) (listing seven factors to consider in determining whether a bona fide sale occurred).


16 Estate of Miller v. Comm’r, 97 TCM (CCH) 1602 (2009); Estate of Stone v. Comm’r, 103 TCM (CCH) 1237 (2012).

17 Kimbell v. Comm’r, 371 F3d 257 (5th Cir. 2004).

18 Keller v. United States, 697 F3d 238 (5th Cir. 2012) (FLP funded under state law even though property not physically transferred); Estate of Shurtz v. Comm’r, 99 TCM (CCH) 1096 (2010); Estate of Kelly v. Comm’r, 103 TCM (CCH) 1393 (2012).

 Courts that find a mere recycling of value conclude that the Section 2036 bona fide sale requirement is not satisfied in circumstances where the factors also indicate that a Section 2036(a)(1) implied agreement to retain the right to income is present. The courts thereby include the transferred assets (not subject to discounts) in the transferor decedent’s gross estate.

The bona fide sale requirement plays a less significant role in the more typical Section 2036 transfer involving a transfer of temporal interests in property or a joint purchase of temporal interests. In the temporal interest situations, greater emphasis is placed on the adequate and full consideration requirement, although the bona fide sale requirement is still significant in uncovering mere sham transactions or applying the step transaction doctrine. Most such transfers involve interfamily transfers where, as in many area of the tax law, closer scrutiny is used than for unrelated party transfers. However, here the bona fide sale question merely boils down to whether “the transferor actually parted with the [temporal] interest and the transferee actually parted with the requisite adequate and full consideration.” For example, if a family member transferee purchased a remainder interest for its actuarial value using independent consideration, the bona fide sale test is met and the exception applies. Alternatively, if the transferor transferred an amount of consideration equal to the actuarial value of a remainder interest in property to the transferee and the transferee then retransferred it back to the transferor for a purchase of the remainder interest or the parties jointly purchased property with the transferee using the transferor’s transferred consideration to buy the remainder interest, the sham or step transaction doctrine should apply to make the exception inapplicable because the transferee did not really part with the consideration and there is not a bona fide sale. In between these two extremes, it is uncertain how far the reach of the bona fide sale requirement will extend.

20 Estate of Harper v. Comm’r, 83 TCM (CCH) 1641 (2002); Estate of Thompson v. Comm’r, 84 TCM (CCH) 374 (2002), aff’d, 382 F3d 367 (3d Cir. 2004).
21 See infra ¶ 4.08[4][c][ii].
22 See infra ¶ 4.08[1][a][iii].
23 See, e.g., Reg. § 20.2053-1(b)(2), discussed at ¶ 5.03[1][b][ii].
24 Wheeler v. United States, 116 F3d 749 (5th Cir. 1997).
26 Estate of Safer v. Comm’r, 80 TC 1145 (1983). See also Priv. Ltr. Rul. 200728018 (Mar. 19, 2007), where the decedent created a purchasing trust that was a completed gift, the purchasing trust purchased a remainder in a temporal trust that the decedent concurrently created, and there was no gift on the creation of the temporal trust. See ¶ 19.03[4][a], note 282. However, the transaction should not be treated as a bona fide sale, because the substance of the transaction is the mere gift of a remainder in the temporal trust. See ¶ 19.03[4][e], note 367. Cf. Estate of Maxwell v. Comm’r, 3 F3d 591 (2d Cir. 1993), aff’d 98 TC 594 (1992).
For example, if the decedent sold a remainder interest for consideration made up of prior annual exclusion gifts made by the decedent over several years, there should be a bona fide sale. But it is questionable whether a bona fide sale exists if the transferor loans the money to a family member transferee purchaser of a remainder interest.

[ii] The adequate and full consideration requirement. Similar to the bona fide sale requirement of the exception, a distinction must be made between cases involving transfers of temporal interests and cases involving transfers to an entity for contemporaneous interests in the entity. In determining whether the adequate and full consideration in money or money’s worth requirement is met in temporal interest transfers, the value at the time of the transfer of the transferred interests that would be included in the gross estate if there were no consideration paid is used as the measure to determine whether the consideration received is sufficient to negate Section 2036. Thus, if A transfers property to R, retaining a life estate, a payment equal to the value of R’s remainder interest should defeat the section. The rationale for stating that such a payment should defeat the section is that such a payment would not operate to deplete A’s gross estate. This is due to the fact that if the proceeds paid for the remainder were invested at an interest rate equal to the rate assumed under the current tables at the time of the transfer, and if A lived for a period of time equal to A’s life expectancy, the value of the accumulated amount at A’s death would equal the value of the corpus originally transferred. At death, A would hold the original value of the corpus and would also have received all the income from the corpus. Thus, there is no artificial diminution of A’s estate such as Section 2036 seeks to proscribe. Cases in the Court of

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27 See ¶ 9.04[1].
28 Cf. TAM 9206006 (Jan. 7, 1992). See infra note 35 and infra ¶ 4.08[7][c], text accompanying notes 186–189.
29 At the time of the transfer, if A has retained a life interest, it diminishes the interest transferred to others and thus is removed from A’s estate. The retained interest is not consideration for the transfer and is also not a transferred interest.
30 See Reg. § 20.2031-7(d)(7), Table S (for transfers after May 1, 2009). For deaths between May 1, 2009, and before July 1, 2009, transitional rules apply. Reg. § 20.7520-1T. See Publications 1457 and 1458 (Rev. May 2009) for examples using the mortality component tables and rates between 0.2 percent and 20 percent.
31 Some authors have agreed: see Moore, “The Use of Life Estates and Remainder Interests in Estate Planning,” 19 U. Miami Inst. on Est. Plan. ch. 12, at ¶ 1201.2 (1985). See also the articles cited infra notes 32, 35.

This argument disregards any actual appreciation or depreciation that occurs in the transferred property whose value under this rationale is “frozen.”
Appeals in the Third,\textsuperscript{32} Fifth,\textsuperscript{33} and Ninth\textsuperscript{34} Circuits have come to this conclusion and parsed Section 2036(a) to hold that the adequate and full consideration requirement is met where consideration is received in a bona fide sale\textsuperscript{35}

\textsuperscript{32} Estate of D’Ambrosio v. Comm’r, 101 F3d 309 (3d Cir. 1996), cert. denied, 520 US 1230 (1997) (sale of a remainder interest to a closely held corporation for an annuity where the court (1) parsed the statute and interpreted the exception to apply to “property to the extent of any interest therein of which the decedent...has made a transfer” to refer only to the remainder interest that was transferred on the exchange and not the full fee simple interest, and (2) used the time value of money approach used in the text to justify its statutory conclusion).


\textsuperscript{33} Wheeler v. United States, 116 F3d 749 (5th Cir. 1997) (sale of a remainder interest to transferor’s sons in return for a note that was paid off prior to transferor’s death where the court determined that the sale was a bona fide sale for adequate consideration using a time value of money approach).

\textsuperscript{34} Estate of Magnin v. Comm’r, 184 F3d 1074 (9th Cir. 1999) (transfer of remainder to family members in consideration for a transfer from father where the court agreed with the D’Ambrosio and Wheeler results of parsing Section 2036(a)). On remand, it was determined that taxpayer had not received adequate and full consideration for the remainder interest, thus triggering Sections 2036(a) and 2043. Estate of Magnin v. Comm’r, 81 TCM (CCH) 1126 (2001).

\textsuperscript{35} Several prior community property widow’s election cases have held that adequate and full consideration is received only if the amount paid as consideration equals or exceeds the entire value of the property (corpus) transferred. Estate of Gradow v. United States, 11 Cl. Ct. 808 (1987) (community property widow’s election where transferor died within three years), aff’d, 897 F2d 516 (Fed. Cir. 1990); Estate of Gregory v. Comm’r, 39 TC 1012 (1963) (transfer in a community property widow’s election where inadequate consideration was received under either test); United States v. Past, 347 F2d 7 (9th Cir. 1965) (transfer in a divorce settlement (not a community property widow’s election) but that reached a comparable result). For a more detailed discussion of the community property widow’s election, see infra ¶ 4.08[7][c]. One community property widow’s election case appears to agree that full payment for the remainder interest satisfies the adequate consideration test. Estate of Christ v. Comm’r, 54 TC 493 (1970), aff’d, 480 F2d 171 (9th Cir. 1973). Several articles prior to the D’Ambrosio line of cases (see supra text accompanying notes 32–34) were critical of the Gradow result: see Jordan, “Sale of Remainder Interests: Reconciling Gradow v. United States and Section 2702,” 14 Va. Tax Rev. 671 (1995); Horowitz, “Economic Reality in Estate Planning: The Case for Remainder Interest Sales,” 73 Taxes 386 (1995); Pennell, “Cases Addressing Sale of Remainder Wrongly Decided,” 22 Est. Plan. 305 (1995).

It can be argued that the community property widow’s election cases are distinguishable from the cases supra notes 32–34 because there was no separate bona fide sale requirement at the time of the widow’s election cases, and they should have concluded that there was no bona fide sale rather than inadequate consideration. See infra ¶ 4.08[7][c], text accompanying notes 186–189.

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for the full value of the remainder interest. Payment of full consideration for R’s remainder interest should likewise be considered full and adequate if A creates an intermediate life estate in B preceding A’s retained interest, because only the remainder interest is potentially includible under Section 2036. If the decedent retained a life estate and transferred a secondary life estate followed by a remainder, the decedent would have to have received both the value of the secondary life estate and the remainder to avoid the application of Section 2036.

The adequate and full consideration requirement is applied in a different manner if there is a transfer of assets for contemporaneous interests in an entity. As a result of potential discounts in the value of the entity interest received, the value of the assets a transferor transferred may exceed the value of the entity interest the transferor received. However the transfer is not treated as a gift under the gift tax, and adequate and full consideration in money or money’s worth is received by the transferor if the transferor received an entity interest with proportionate value in the entity equal to the proportionate value of the assets the transferor transferred to the entity.

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36 If the exception is inapplicable, Section 2043(a) applies. See ¶ 4.15[2]. Elimination of the application of Section 2036 may not be as beneficial to the transferor as at first appears, because the inter vivos transfer creating the trust may trigger the application of gift tax Section 2702, providing a zero valuation for the transferor’s retained income interest. See ¶ 19.03. Unless the remainder (along with any other transferred interest) is transferred to a nonfamily member (see IRC §§ 2702(c), 2704(c)(2); ¶ 19.03[2][ii]) or one of the exceptions to Section 2702 applies (see IRC §§ 2702(a)(2)(B), 2702(a)(3)(A)(ii), 2702(b); ¶¶ 19.03[3][b][i], 19.03[3][d]), there will be a gift for gift tax purposes of the value of the entire corpus less the consideration received for the transferred remainder. For example, if Transferor transfers $1 million to a trust with a retained life estate worth $800,000 and a remainder to Transferor’s Child worth $200,000, and Child pays Transferor $200,000 for the remainder, Transferor makes an $800,000 gift as a result of Section 2702. See ¶ 19.03[2][a], text accompanying note 30.

37 See infra ¶ 4.08[8].

38 See ¶ 4.02[4].

39 See ¶¶ 4.02[4][g], note 241, 10.01[2][b], text accompanying notes 24–26, 10.02[2][c][v].

40 Estate of Stone v. Comm’r, 86 TCM (CCH) 551 (2003). The Stone court imposed a three-pronged test to meet the adequate and full consideration requirement on a transfer of assets to a family limited partnership that has essentially been adopted by most of the other contemporaneous Section 2036(a) cases: (1) all partners held interests proportionate to the fair market value of the assets each contributed to the entity; (2) the value of the contributed assets were properly credited to the capital accounts of such partners; and (3) upon termination of the partnership, each partner was entitled to distributions equal to their capital accounts. Id. See Bongard v. Comm’r, 124 TC 95 (2005); Estate of Black v. Comm’r, 133 TC 340 (2009); Estate of Mirowski v. Comm’r, 95 TCM (CCH) 1277 (2008); Estate of Schutt v. Comm’r, 89 TCM (CCH) 1353 (2005); Estate of Murphy v. United States, 2009-2 USSTC ¶ 60,583 (WD Ark. 2009). Cf. Reg. § 1.704-1(b)(2) (involving capital accounts and maintenance of capital accounts for income tax purposes).
[b] Pre–March 4, 1931, Transfers

Section 2036 is also inapplicable to transfers made before certain critical dates. Section 2036 never applies to a transfer made before March 4, 1931, and it may be inapplicable to transfers made between March 3, 1931, and June 7, 1932.41

[2] Period for Which Interest Is Retained

In order for Section 2036 to apply, the decedent must have retained an interest in the property for a specified period. The period for which the interest must have been retained is discussed before the nature of the interest is considered. To determine whether the decedent has retained an interest in property for the prescribed period, a threefold test is applied. Has the decedent retained an interest:

1. For the decedent’s life?
2. For a period not ascertainable without reference to the decedent’s death?
3. For a period that does not in fact end before the decedent’s death?

The first of the three tests needs little explanation. It would obviously be met if the decedent transfers property in trust providing for income to be paid to the decedent “for his life” and, at death, the corpus to be distributed to others.

Regarding the second and third tests, the section is not limited to a straight life interest situation. Under the second, if the period for which the interest is retained is geared to the time of the decedent’s death, the section applies. For example, assume that under the terms of a trust created by a decedent, the decedent is entitled to the income payable quarterly for life, but the trust agreement specifies that the decedent is to receive none of the trust

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41 IRC § 2036(c). See IRC § 2045; TAM 9140003 (June 19, 1991) (consequences under Section 2036 of a trust created by the decedent before March 4, 1931). The reasons for this exclusionary rule and for the two critical dates are indicated briefly at the end of this discussion, infra ¶ 4.08[9]. There may be a question whether a transfer to a trust is “made” when property is turned over to the trustee, if the trust is revocable. It should not be so viewed. Comm’r v. Estate of Talbott, 403 F2d 851 (4th Cir. 1968), cert. denied, 393 US 1022 (1969). Cf. Wilson v. Comm’r, 56 TC 579 (1971), acq. 1972-1 CB 2. But see Comm’r v. Estate of Canfield, 306 F2d 1 (2d Cir. 1962); Comm’r v. Estate of Ridgeway, 291 F2d 257 (3d Cir. 1961). The question is to be differentiated from that of when a power of appointment is “created.” See Reg. § 20.2041-1(e); United States v. Merchant’s Nat’l Bank of Mobile, 261 F2d 570 (5th Cir. 1958).

42 It is not technically accurate to speak of retention of an “interest.” See discussion infra ¶ 4.08[3], 4.08[5].
income for the calendar quarter in which the decedent dies. In these circumstances, the decedent technically would not be entitled to the income “for his life,” for the decedent would not get the full income from the trust up to the time of death.\footnote{The technicality is not always accorded judicial recognition. Compare Bayliss v. United States, 326 F2d 458 (4th Cir. 1964) (applying Section 2036 on these precise facts on the ground that the decedent had retained an interest “for life”), with Comm’r v. Estate of Arens, 297 F2d 894 (2d Cir.), cert. denied, 369 US 848 (1962).} Nevertheless, the period for which the decedent was entitled to the income would not be “ascertainable without reference to his death.”\footnote{Reg. § 20.2036-1(b)(1).} The section would therefore apply. In this fashion, the statute defeats avoidance schemes that might succeed if the statute used only the language “for his life.” This language also catches a secondary life estate situation in which another interest intervenes before the decedent’s interest takes effect in enjoyment. An example is a transfer by D to X for life, then to D for life, remainder to children. Even if D predeceases X, the value of the property, less the value of X’s outstanding life estate, is included in D’s gross estate, because the period for which D has retained an interest cannot be described without reference to D’s death.\footnote{Reg. § 20.2036-1(b)(1)(ii); Marks v. Higgins, 213 F2d 884 (2d Cir. 1954); Comm’r v. Estate of Nathan, 159 F2d 546 (7th Cir. 1947), cert. denied, 334 US 843 (1948). Cf. Kasishke v. United States, 426 F2d 429 (10th Cir. 1970). As these cases indicate, such provisions may be within the third as well as the second of the three timing tests. The text comment reflects one sharp difference between Sections 2036 and 2038. Section 2036 may apply even if at death the decedent has no currently effective interest, right, or power. In contrast, Section 2038 applies only to interests that are “subject...to...change” when the decedent dies. For a limited situation in which the secondary life estate rule would not be applied, see ¶ 11.03[4][c], text accompanying note 78.}

The third period specified makes the statute applicable to the retention of an interest for a period not stated in terms of the decedent’s life or death if, in fact, the period does not end before death. Thus, a decedent at age 40 might create a trust under which the decedent was entitled to the income for ten years, at the end of which period the trust was to terminate and the corpus was to be distributed to the decedent’s child or the child’s estate. If the decedent then died within the ten-year period, the decedent would have retained an interest for a period that did “not in fact end before his death,” although the decedent had retained an interest not “for his life,” and even though the period for which the interest was retained was “ascertainable without reference to his death.” The regulations under the 1939 Code provided that the retention of an interest for a stated period that happened not to end prior to death resulted in estate tax liability only if the period was such as to evidence the decedent’s in-
tention “that it should extend at least for the duration of his life.”46 As a matter of tax policy, the Treasury’s former position seems supportable, and the legislative history is in accord with the old regulations.47 However, no case has been decided in accordance with the quoted provision in the old regulations, and even when consideration has been given to the legislative history, the section has been applied where the retention of an interest merely does not in fact end before the decedent’s death.48 For many years now, the regulations have omitted any reference to this problem, indicating a stricter Treasury policy in accord with the decisions. Perhaps the statute should be changed, but, until it is, the literal interpretation should prevail. Legislative history is not a substitute for unequivocal statutory language.


Very broadly speaking, paragraphs (1) and (2) of Section 2036(a) make the section applicable if the decedent has transferred property but retained beneficial interests (first paragraph) or control over others’ interests (second paragraph). Each of the alternative concepts requires some scrutiny.

[4] Beneficial Interests in the Decedent

The section is invoked if the decedent retains “the possession or enjoyment of” or “the right to the income from” the transferred property or property interest.49 This, of course, requires a retention of an interest in the very thing transferred, and the decedent’s right to other property, such as an annuity, in return for the

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46 Reg. § 105, § 81.18. Cf. IRC § 673(a), a statutory adoption of this approach for income tax purposes.


48 Estate of Nicol v. Comm’r, 56 TC 179 (1971) (transfer of farm with retention of a five-year lease and death after three years); National Bank of Commerce in Memphis v. Henslee, 179 F. Supp. 346 (MD Tenn. 1959) (trust during minority of another who did not attain majority during decedent’s life); Estate of Yawkey v. Comm’r, 12 TC 1164 (1949), acq. 1949-2 CB 3 (reservation of income rights until children, ages fifteen and sixteen at time of transfer and twenty-three and twenty-four at death, attained the age of twenty-five); Estate of Fry v. Comm’r, 9 TC 503 (1947), acq. 1948-2 CB 2 (reservation of first $15,000 of dividends from transferred property having substantial value); Estate of Cooper v. Comm’r, 74 TC 1373 (1980) (retention of interest coupons for eight years after transfer of bonds with death occurring three years after transfer).

49 But see Estate of Goldstone v. Comm’r, 78 TC 1143 (1982), where a retained life estate was too ephemeral to invoke the provisions of Section 2036(a)(1).
transferred property does not trigger application of Section 2036\[50\] even if the amount of the annuity is closely equated to the anticipated income from the transferred property.\[51\]

[a] Possession or Enjoyment

Although the term “possession or enjoyment” is a quaint relic of earlier legislation, it is clear enough that if, for example, one makes a gift of a valuable painting but reserves the right to keep it for life,\[52\] or makes a gift of a residence but reserves the right to live in it for life, one has made a transfer comprehended by Section 2036. On the other hand, if the transferred property produces income to which the transferor remains entitled, the statutory language expressly treats this “right to the income” exactly the same as a retention of the “possession or enjoyment” of the property. The philosophy underlying these rules is not troublesome; if the transferor retains in the transferor essentially full lifetime benefits from transferred property, the ultimate shifting of enjoyment at the transferor’s death is sufficiently akin to testamentary disposition of property to justify the imposition of estate tax at that time.

If a third person is entitled to all the income from income-producing property, no other person can realistically be said to have the enjoyment of the property even if the person is in a position to derive some benefit from it.\[53\] This essentially sound precept has defanged Section 2036 in some circumstances in which philosophically its bite seems needed. Accordingly, Congress has added a subsection enlarging the statutory concept of enjoyment with regard to interests in incorporated businesses.\[54\]

[b] Right to Income

The term “right to the income” in Section 2036(a)(1) encompasses a right to have the income used for the transferor’s benefit\[55\]; this must be more than a

\[50\] See Rev. Rul. 77-193, 1977-1 CB 273. Compare the situation where the decedent retained an annuity or unitrust interest in the transferred property itself and Section 2036(a)(1) applies. Reg. § 20.2036-1(c)(2). See infra ¶ 4.08[8], text accompanying notes 215–223.

\[51\] Estate of Becklenberg v. Comm’r, 273 F2d 297 (7th Cir. 1959); Estate of Bergan v. Comm’r, 1 TC 543 (1943), acq. 1943 CB 2. See the discussion of private annuities at ¶ 4.11[5].

\[52\] Cf. IRC § 170(a)(3).


\[54\] IRC § 2036(b).

\[55\] There are various forms of income retention. See Estate of Cooper v. Comm’r, 74 TC 1373 (1980); Rev. Rul. 78-26, 1978-1 CB 286; infra ¶ 4.08[8], text accompanying notes 213–222.
mere expectancy, but the transferor need not have a right to receive the income directly. For example, if the decedent transfers property in trust, directing the trustee to use the income from the property to pay decedent’s obligations, including support obligations for the decedent’s dependent, the property is includible in the decedent’s gross estate. The theory is that if the income is required to be used to discharge the decedent’s obligation, it is the same as if the decedent actually received the income during life and then used it in that manner. On the other hand, if trustees of whom the decedent is not one are merely given discretion to use income for the support of the transferor decedent’s dependent, Section 2036 does not apply. Interests or rights must be retained by the decedent, or at least by the decedent in conjunction with another, for Section 2036 to apply. Midway between these circumstances (trustee required to use funds for support and trustee, other than decedent, having

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57 See, e.g., Rev. Rul. 2004-64, 2004-2 CB 7 (corpus of attempted defective grantor trust included in grantor’s gross estate where independent trustee required to reimburse grantor for income taxes payable by grantor on the trust’s income). Compare Priv. Ltr. Rul. 200944002 (July 15, 2009) (no Section 2036 inclusion where reimbursement right). Defective grantor trusts are discussed at ¶ 10.01[e], text accompanying notes 275–279.


59 Cf. Old Colony Trust Co. v. Comm’r, 279 US 716 (1929), applying like theory for income tax purposes. A ruling of questionable validity holds that a trust’s requirement that the trustee use trust funds to pay any federal or state income tax liability incurred by its grantor due to the trust’s status as a grantor trust will not cause the trust’s corpus to be included in the grantor’s estate, notwithstanding that the grantor trust rules make the grantor liable for the income tax payment and thus the trust would be satisfying a liability of the grantor. The ruling simply asserts that because the distributions on the taxpayer’s behalf represent tax payments allocable to the trust’s income, the distributions do not constitute the retention of a right to income as described in Section 2036(a). Priv. Ltr. Rul. 9922062 (Feb. 26, 1999). See Priv. Ltr. Rul. 200120021 (Feb. 13, 2001) (similar power with no Section 2036(a) inclusion but trustee’s power was discretionary).

60 Comm’r v. Estate of Douglass, 143 F2d 961 (3d Cir. 1944); Estate of Mitchell v. Comm’r, 55 TC 576 (1970), acq. 1971-1 CB 2; Estate of Chrysler v. Comm’r, 44 TC 55 (1965), acq. in result only 1970-2 CB xix, rev’d on another issue, 361 F2d 508 (2d Cir. 1966). The estate tax provisions do not include a “related or subordinate party” concept such as appears in the income tax provisions. See IRC § 672(c). However, see Rev. Rul. 95-58, 1995-2 CB 191, considered infra ¶ 4.08[5][a], text accompanying note 100, in which the Treasury attempts to “legislate” such a test into Sections 2036 and 2038.
such discretion) is the situation in which the decedent, as trustee,\(^{61}\) has discretion to use the income of a trust created by the decedent for support of the decedent’s dependents. This is a taxable situation within Section 2036.\(^{62}\) In such circumstances, it is irrelevant whether the trust income was actually used for support purposes; under Section 2036 it is “the right to the income,” which the decedent has if the decedent can direct that it be used for the decedent’s benefit, that brings the section into play.\(^{63}\) It is relevant, however, to consider the extent of the support obligation that may be discharged by income payments. Thus, if in the circumstances, $8,000 a year will discharge the obligation and the trust earns more than that, and the decedent has no direct or indirect interest in the excess income and no control over its disposition,\(^{64}\) the decedent will be viewed as having reserved the right to only a portion of the trust income, and a commensurate amount of the trust corpus will be included in the decedent’s estate.\(^{65}\)

If a decedent’s estate is to be taxed under Section 2036 on the ground that the income of a trust is to be used until the decedent’s death to discharge decedent’s obligation, it is essential that the obligation to be discharged exist. Thus, if trust income may initially be used to support a minor child but the child reaches the age where the support obligation ceases before the decedent’s death, the decedent will not have retained the prescribed right for a period that does not in fact end before the decedent’s death.\(^{66}\) The support obligation may

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\(^{61}\) A question may arise whether decedent was the trustee at the time of death or relinquished such position within three years of death. See TAM 9043074 (July 12, 1990) (a settlor who actively controlled the affairs of a trust was the de facto trustee of the trust). Cf. Estate of Ware v. Comm’r, 480 F2d 444 (7th Cir. 1973); United States v. Allen, 293 F2d 916 (10th Cir. 1961), discussed infra ¶ 4.08[8][b]; IRC § 2035(a)(2).


\(^{63}\) The parallel grantor trust income tax provision is different. See IRC § 677(b).

\(^{64}\) Estate of Pardee v. Comm’r, 49 TC 140, 148 (1967); Estate of McTighe v. Comm’r, 36 TCM (CCH) 1655 (1977).

\(^{65}\) See infra ¶ 4.08[5].

\(^{66}\) See Estate of Pardee v. Comm’r, 49 TC 140, 150 (1967) (decedent, as co-trustee, had the power to use trust corpus to satisfy legal obligation to support his wife, but only after first considering his wife’s needs and other sources of assistance; the portion of the trust corpus needed to satisfy his support obligation was included under Section 2036(a)(1)). Estate of Sullivan v. Comm’r, 66 TCM (CCH) 1329 (1993).

\(^{67}\) Estate of Pardee v. Comm’r, 49 TC 140, 150 (1967). Even if the decedent dies within three years of the cessation of the support obligation, Section 2035(a), acting in conjunction with Section 2036(a), is inapplicable because there is no Section 2035(a) “transfer” or relinquishment of a power over the property at the time of the cessation of the obligation. IRC § 2035(a)(1).
also terminate in other ways. If property is transferred to a trust by a husband in exchange for an effective release of support obligations, such as his wife’s support rights, or if local law would so permit those of his minor children, the obligations cease upon the transfer\(^68\) and, even if the trust income is used thereafter to support the wife and children, it cannot properly be said to be used any longer to discharge obligations of the husband; his support obligations are discharged when the trust is created, and further payments merely discharge his contract. Upon his death, therefore, nothing should be included in his gross estate under Section 2036.\(^69\)

[c] Enjoyment “Retained”

Section 2036 is framed in part in terms of actual possession or enjoyment or the right to income retained by a decedent transferor. However, the question whether there is a retention raises a pragmatic, not a legal, issue, and something may be “retained” in the absence of an enforceable right. It is enough that the decedent has arranged to keep the present use, economic benefit, or income from transferred property either directly or by implication.\(^70\)

[i] Implied retained enjoyment in connection with the transfer of a residence. Is there the necessary implied arrangement or understanding in the case of a residence if the transferor merely continues to live in the residence?\(^71\)

The Commissioner has frequently taken the position that the mere fact of con-

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\(^68\) See, e.g., Sherman, Jr. v. United States, 462 F2d 577 (5th Cir. 1972).

\(^69\) See contra Estate of McKeon v. Comm’r, 25 TC 697 (1956), acq. 1958-2 CB 6, including a part of the value of such a trust on the mistaken impression that includability turned on the question of whether the release of the support rights constituted consideration for the transfer to the trust and, further, mistakenly treating a wife’s relinquishment of support rights as not consideration properly taken into account. On the latter point, see discussion of Section 2043(b) at ¶ 4.15[1][a]. If tax liability turns on something other than the use of trust income for discharge of a support obligation, such as the revocable nature of a trust, the question whether a release of support rights is recognizable consideration for the transfer may of course be relevant. See Chase Nat’l Bank v. Comm’r, 225 F2d 621 (8th Cir. 1955), decided under the revocable transfer provisions of Section 2038, discussed ¶ 4.15[1][a], text accompanying note 26.


\(^71\) If the decedent leases back the residence for adequate consideration, different consequences occur. See infra ¶ 4.08[6][c].

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continued occupancy evidences an implied understanding.\(^\text{72}\) If the transferee is a family member other than the spouse of the transferor,\(^\text{73}\) there is mixed authority whether there was an implied understanding that the transferor would occupy the residence rent-free resulting in inclusion of the residence in the transferor’s gross estate under Section 2036(a)(1). If the family member does not co-occupy the residence with the transferor, courts generally have concluded that the transferor has retained an interest in the residence under an implied agreement with the family member.\(^\text{74}\) If a family member occupies the residence with the transferor, there is a split of authority whether Section 2036(a)(1) applies, with the courts generally looking to surrounding facts, especially whether the transferee assumed an ownership role by paying the property taxes and other expenses related to the property.\(^\text{75}\) The same issue arises in


\(^\text{73}\) If the transferee is the spouse of the transferor, the courts have consistently held that the transferor’s continued occupancy of a residence is not a Section 2036(a)(1) retained interest. Union Planters Nat’l Bank v. United States, 361 F2d 662 (6th Cir. 1966) (stating that the transferor spouse continues to occupy the residence “as a natural incident to the marital relationship” and not as a result of an implied understanding with the transferee); Estate of Brinkley v. United States, 358 F2d 639 (3d Cir. 1966); Bridgforth v. United States, 73-1 USTC ¶ 12,916 (SD Miss. 1973); Estate of Gutchev v. Comm’r, 46 TC 554 (1966); Stephenson v. United States, 238 F. Supp. 883 (WD Va. 1965). Even the Commissioner generally agrees. Rev. Rul. 70-155, 1970-1 CB 189 (stating that “co-occupancy, where the donor and donee are husband and wife, does not of itself support an inference of an agreement or understanding as to retained possession or enjoyment by the donor”).

With an unlimited marital deduction (see ¶ 5.06[1]), the issue is academic, because even if the transferor was deemed to have retained a Section 2036(a)(1) interest, the transferor would be entitled to a marital deduction equal in value to the residence included in the transferor’s gross estate.


\(^\text{75}\) Compare Diehl v. United States, 68-1 USTC ¶ 12,506, 21 AFTR2d 1607 (WD Tenn. 1967), and Estate of Roemer v. Comm’r, 46 TCM (CCH) 1176 (1983) (no implied agreement where transferee paid property taxes), with Estate of Douglas v. Comm’r, 32 TCM (CCH) 5 (1973) (implied agreement where transferor paid property taxes). See also Estate of Spruill v. Comm’r, 88 TC 1197 (1987) (no implied agreement but no indication of who paid the property taxes); Rev. Rul. 78-409, 1978-2 CB 234 (stating that the Service would not follow Diehl and that “where the decedent’s possession and enjoyment of the residence continue without limitation,” the decedent has retained a Section 2036(a)(1) interest); Estate of Stewart v. Comm’r, 617 F3d 148 (2d Cir. 2010) (an implied agreement...
a situation where a decedent has deeded a portion of a residence to a transferee, but has continued to reside in the residence until death. In determining whether to apply Section 2036(a)(1) to the transferred portion of the residence, the courts should apply the same tests that they apply when an entire residence is transferred.

[iii] Implied agreements in the context of family limited partnerships and limited liability companies. In recent years, the Commissioner has had a substantial amount of successes in disregarding entities in the form of family limited partnerships or family limited liability companies, thereby denying discounts in the value of the assets held by the entities. Initially, the Commissioner was successful in finding an implied agreement to retain the income from property in a situation where a transferor created a family limited partnership and transferred interests in the partnership to other family members and, under the partnership agreement, the partnership or other family members had the rights to partnership income, but the transferor diverted all the partnership income for the transferor’s personal use. That situation essentially opened the gates and the Commissioner has been successful in implying a Section 2036(a)(1) right of income or possession or enjoyment of the transferred property and denying discounts in other situations where: (1) the decedent transferred a majority of decedent’s assets to the entity leaving the decedent with insufficient resources to provide for decedent’s support; (2) the decedent...

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76 A more common transfer of a partial interest occurs where a decedent has transferred the residence to a personal residence trust while retaining the use of the residence for a term of years. See IRC § 2702(a)(3)(A)(ii); ¶ 19.03[3][d]. In that situation, if the decedent dies during the term of years, Section 2036(a)(1) applies. See supra ¶ 4.08[2], text accompanying notes 46–48; Reg. §§ 20.2036-1(c)(2)(i), 20.2036-1(c)(2)(iv), Ex. 6.

77 In situations where the courts have found an agreement under Section 2036(a)(1), they have also concluded that the bona fide sale exception is inapplicable, generally due to a mere recycling of value. See supra ¶ 4.08[1][a], text accompanying notes 20, 21.


79 Estate of Korby v. Comm’r, 471 F3d 848 (8th Cir. 2006); Estate of Thompson v. Comm’r, 382 F3d 367 (3d Cir. 2004); Strangi v. Comm’r, 417 F3d 468 (5th Cir. 2005). Cf. Estate of Jorgensen v. Comm’r, 97 TCM (CCH) 1328 (2009), aff’d, 107 AFTR2d 2069 (9th Cir. 2011) (insufficient assets retained to make planned gifts and pay taxes).
transferred a residence to the family limited partnership but continued to occupy the residence with inadequate payment of rent; (3) the formalities of the entity agreement were disregarded; (4) the decedent received disproportionate distributions of income from the entity in relation to the other partners; and (5) the decedent’s personal obligations could be satisfied by the entity. The above factors that the Service and courts have used to imply an agreement and to disregard the entity provide a list of what not to do when establishing and operating a family limited partnership or family limited liability company, because the courts will imply a Section 2036(a)(1) agreement and deny the bona fide sale exception to pull the transferred assets (not subject to discounts) into the decedent’s gross estate. One other factor to consider in these cases is that the courts seem more reluctant to imply an agreement where the assets in

82 Estate of Reichardt v. Comm’r, 114 TC 144 (2000) (no rent); Strangi v. Comm’r, 417 F3d 468 (5th Cir. 2005) (no rent); Disbrow v. Comm’r, 91 TCM (CCH) 794 (2006) (transfer and lease back of residence, but lease agreement not enforced as it would have been in a situation not involving family members).


84 Estate of Korby v. Comm’r, 471 F3d 848 (8th Cir. 2006); Estate of Abraham v. Comm’r, 408 F3d 26 (1st Cir. 2005),cert. denied, 547 US 1178 (2006); Estate of Rosen v. Comm’r, 91 TCM (CCH) 1220 (2006); Estate of Liljestrand v. Comm’r, 102 TCM (CCH) 440 (2011).

85 Estate of Korby v. Comm’r, 471 F3d 848 (8th Cir. 2006); Strangi v. Comm’r, 417 F3d 468 (5th Cir. 2005); Estate of Abraham v. Comm’r, 408 F3d 26 (1st Cir. 2005), cert. denied, 547 US 1178 (2006); Estate of Erickson v. Comm’r, 93 TCM (CCH) 1175 (2007); Estate of Malkin v. Comm’r, 98 TCM (CCH) 225 (2009); Estate of Turner v. Comm’r, 102 TCM (CCH) 214 (2011); Estate of Gore v. Comm’r, 93 TCM (CCH) 1436 (2007), modified, 94 TCM (CCH) 602 (2007), aff’d, 581 F3d 1267 (2009); Estate of Rector v. Comm’r, 94 TCM (CCH) 567 (2007); Estate of Hurford v. Comm’r, 96 TCM (CCH) 422 (2008).

86 See supra ¶ 4.08[1][a][i].

the family limited partnership constitute an active trade or business, although seemingly mere passive assets can be used if one avoids the above pitfalls.\textsuperscript{88}

\[\textbf{[iii] Independent trustee discretion.}\] An implied agreement arguably can arise if a decedent has transferred property to a trust with provision for the payment of income and ultimately corpus to others but has given the trustee, an individual other than the settlor decedent, complete discretion to make income payments to the decedent.\textsuperscript{89} Section 2036(a)(1) requires that the decedent retain either “possession or enjoyment” or “the right to the income.” If the decedent has no legal right to income, the “income” phrase would not support inclusion under Section 2036.\textsuperscript{90} Perhaps it may be said the decedent has retained “enjoyment.”\textsuperscript{91} However, if some meaning is to be accorded the word “retained,” some showing of an arrangement, more than the fact that income was paid to the decedent, should be required.\textsuperscript{92}

\begin{footnotesize}
\textsuperscript{88} See \[\S\ 4.02\][g], text accompanying notes 252–256. In addition to the direct attacks of the Service on the use of FLPs and FLLCs, Circular 230 (issued by the Department of Treasury prescribing standards governing those who practice before the Service) may provide a mechanism of indirect attack on the use of FLPs and FLLCs when used to obtain improper valuation discounts and no legitimate business purpose exists for creation of the entity. 31 CFR §§ 10.0–10.93 (2011). Through its imposition of disciplinary measures (31 CFR §§ 10.50–10.53(2011)), Circular 230 may make tax practitioners more cautious in advising the use of FLPs and FLLCs to advance marketability and minority discounts.

\textsuperscript{89} If the trustee were required under a standard such as support to make income payments to the transferor, then the corpus necessary to produce the support payments would be included in the decedent’s estate. IRC § 2036(a)(1).

\textsuperscript{90} Estate of Wyly v. Comm’r, 610 F2d 1282 (5th Cir. 1980); Priv. Ltr. Rul. 200120021 (Feb. 13, 2001) (no Section 2036 inclusion where independent trustee discretion to make payments for decedent’s obligations from a defective grantor trust). Where the question is whether a decedent has retained a “right” to income (as opposed to whether the decedent has in fact retained enjoyment), the connotation may be a legal right. But see United States v. O’Malley, 383 US 627 (1966) (which speaks in terms of “power” rather than “right”); United States v. Byrum, 408 US 125, reh’g denied, 409 US 898 (1972); Estate of Gilman v. Comm’r, 65 TC 296 (1975) (speaking of a legally enforceable power). See also White, J., dissenting in Byrum.

\textsuperscript{91} There might be a basis for saying that the term “enjoyment” in Section 2036(a)(1) should have reference only to physical possession or use of non-income-producing property, and that if an income interest is in question, mere retained “enjoyment” is not a substitute for the legal “right” to the income. However, precedent runs the other way. See, e.g., Estate of McNichol v. Comm’r, 265 F2d 667 (3d Cir.), cert. denied, 361 US 829 (1959); Estate of Skinner v. United States, 316 F2d 517 (3d Cir. 1963).

\textsuperscript{92} Estate of Wells v. Comm’r, 42 TCM (CCH) 1305 (1981); Estate of Uhl v. Comm’r, 241 F2d 867 (7th Cir. 1957); Comm’r v. Irving Trust Co., 147 F2d 946 (2d Cir. 1945); Estate of McCabe v. United States, 475 F2d 1142 (Cl. Ct. 1973); Estate of German v. United States, 85-1 USTC \[\S\ 13,610\] (Cl. Ct. 1985). Cf. Estate of Gutches v. Comm’r, 46 TC 554 (1966). Since such transfers are treated as complete when made for gift tax purposes (see Rev. Rul. 77-378, 1977-2 CB 347, discussed at \[\S\ 10.01\][9], text accompany-
[5] Control Over Others’ Interests

The foregoing comments concern a transferor decedent’s lifetime retention of beneficial interests in transferred property. The enjoyment of property or the right to income it produces are such substantial ownership attributes as clearly to support the inclusion in the gross estate required by Section 2036(a)(1). Paragraph (2) identifies far less significant ownership attributes that invoke the provisions of Section 2036. Most obviously, under Section 2036(a)(2), if a transferor retains the right for life (or for any similarly prescribed period) to say who may enjoy transferred property or the income therefrom, even if the transferor has put it beyond the power to claim enjoyment or income for the transferor’s own benefit, Section 2036 applies. If this seems fair enough, what are some of the further reaches of the provision?

[a] Right to Designate Retained Indirectly

The right to designate may be indirectly retained. If the decedent names a third party as trustee and gives the trustee the right to designate who shall enjoy the income, the decedent has not retained the proscribed control. But if, in such circumstances, the decedent has the right to discharge the trustee and

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93 By statute, amounts held in a Qualified Tuition Plan or an Education Savings Account are generally not includible in the contributor’s gross estate even though the contributor held the right to select new designated beneficiaries. IRC §§ 529(c)(4)(A), 530(d)(3). But see IRC §§ 529(c)(4)(B), 529(c)(4)(C); Prop. Reg. § 1.529-5(d)(2). See also ¶ 9.04[1][e], text accompanying notes 132, 133.

94 If a trustee has discretion regarding the disposition of trust income, this will not invoke Section 2036 unless the decedent is the trustee. Especially where the decedent has been trustee and has sought to resign as such, a difficult evidentiary question may arise. See, e.g., Estate of Ware v. Comm’r, 480 F2d 444 (7th Cir. 1973). Similarly, a question may arise whether the decedent actually had the right to designate. Estate of Edmonds v. Comm’r, 72 TC 970 (1979); Estate of Bowgren v. Comm’r, 105 F3d 1156 (7th Cir. 1997) (power held under local law). Cf. Rev. Rul. 79-177, 1979-1 CB 298.


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name the decedent as trustee with the same right, the decedent has indirectly retained the condemned control even if the decedent never becomes the trustee.\textsuperscript{96} Further, even if the decedent has the right to become the trustee with the same right only in the case of the trustee’s inability to serve, resignation, or removal by a proper court for cause, Section 2036(a)(2) still applies.\textsuperscript{97} Again, the section may apply even if the retained right is not currently operative.\textsuperscript{98}

The Service has reconsidered its position that the reservation of the right to replace one trustee with another, even absent the right to name oneself as trustee, constitutes a retention of the trustee’s powers for purposes of Section 2036(a)(2).\textsuperscript{99} The Service now pretty much agrees that the grantor’s reservation of the right or power to substitute one trustee for another will not result in an attribution of the trustee’s powers to the grantor, but only if the potential appointees do not include a trustee who is related or subordinate to the grantor under Section 672(c).\textsuperscript{100}

[b] Illusory “Control”

Seeming authority of the decedent to shift income or enjoyment may be quite illusory and still be within Section 2036(a)(2). If the decedent may direct income to others only with the consent of some other person, the decedent is

\textsuperscript{96} Reg. § 20.2036-1(b)(3).

\textsuperscript{97} Estate of Farrell v. United States, 553 F2d 637 (Ct. Cl. 1977); Rev. Rul. 73-21, 1973-1 CB 405. This identification of indirect control is clearly within the present statutory language. Where complete discretion is lodged in a trustee who cannot be removed, however, it is still likely the trustee may comply with the settlor’s wishes. See Estate of Goodwyn, 32 TCM (CCH) 740 (1973), holding, under the rationale of \textit{Byrum}, that the decedent has no “right” to control in such situations, making Section 2036(a)(2) inapplicable. See infra text accompanying notes 99, 100.

\textsuperscript{98} See supra ¶ 4.08[2], text accompanying note 45.


\textsuperscript{100} Rev. Rul. 95-58, 1995-2 CB 191. This effort to “legislate” Section 672(c) into Section 2036(a)(2) is inappropriate. See supra ¶ 4.08[4][b], note 60. See Priv. Ltr. Rul. 200531004 (Apr. 21, 2005) (firewalls and limitations prevented inclusion in shareholder trust grantor’s estate upon corporation’s appointment as trustee and its exercise of discretionary distribution powers).
still within the provision.\footnote{101} This is so even if the one who must join in the decedent’s action has an interest adverse to the exercise of the power. Thus, if, under a trust created by $D$, $B$ had the right to the income but with $B$’s consent $D$ could designate $C$ as income beneficiary, $D$ has the prescribed “right” to designate.\footnote{102} Here and in some other places Congress recognizes that concepts of enlightened self-interest do not work in a typical family setting. However, in some circumstances illusory control is recognized as such and Section 2036(a)(2) is not applied.\footnote{103}

[c] Right to Designate Who Benefits

The right to designate need not be authority to decide at large who shall enjoy the property or receive its income. Authority to choose only between two named beneficiaries is enough.\footnote{104} Moreover, the *O’Malley* case\footnote{105} holds

\footnote{101} The decedent has the proscribed right to designate even if it is expressly lodged in another but made subject to the decedent’s veto or consent. Cf. Estate of DuCharme v. Comm’r, 164 F2d 959 (6th Cir. 1947), aff’d on reh’g, 169 F2d 76 (6th Cir. 1948); Estate of Thorp v. Comm’r, 164 F2d 966 (3d Cir. 1947), cert. denied, 333 US 843 (1948); Rev. Rul. 70-513, 1970-2 CB 194. However, if the transfer was made before June 7, 1932, the power must be in the decedent alone. Reg. § 20.2036-1(a)(3)(ii).

\footnote{102} Reg. § 20.2036-1(b)(3). This may not be so, and should not be, if all persons with an interest in the property must join. Cf. Reg. § 20.2038-1(a)(2); Helvering v. Helmholtz, 296 US 93 (1935); Priv. Ltr. Ruls. 200247037 (Aug. 19, 2002), 200919008 (Jan. 12, 2009), 201233008 (Mar. 28, 2012); ¶ 4.10[6]. See Old Colony Trust Co. v. United States, 423 F2d 601, 602 n.2 (1st Cir. 1970).

\footnote{103} Priv. Ltr. Ruls. 200350009 (Aug. 25, 2003) and 200350010 (Aug. 25, 2003) (gift to private foundation in which donor is sole director but has no control over such funds); Priv. Ltr. Ruls. 200523003 (Mar. 8, 2005) and 200531004 (Apr. 21, 2005) (grantor no control even though shareholder of corporate trustee where firewall provisions precluded control); Priv. Ltr. Rul. 200548035 (Aug. 2, 2005) (firewall provisions in family trust precluded control). See also Notice 2008-63, 2008-2 CB 261 (private trust companies as trustee of family trusts without adverse Section 2036 consequences).

\footnote{104} Industrial Trust Co. v. Comm’r, 165 F2d 142 (1st Cir. 1947). See, however, the argument of Magruder, J., dissenting, that the right to designate under Section 2036 should be restricted to instances of broader control than under Section 2038, because the broader reach of Section 2036 argues for a narrower application of its principles. Appropriately, the Service has taken the position that a Section 2036(a)(2) power does not include changes of beneficial interests as a result of after-born or after-adopted children of the transferor becoming beneficiaries of a trust. Rev. Rul. 80-255, 1980-2 CB 272. Cf. Estate of Tully v. United States, 528 F2d 1401 (Cl. Ct. 1976).

\footnote{105} United States v. O’Malley, 383 US 627 (1966). In *O’Malley*, the Supreme Court did not state the actual terms of the trust in which the decedent grantor held a power as trustee to accumulate income. The briefs of the case indicate that the income beneficiary had a right to income for a term of years with a remainder to the income beneficiary after those years if living but if not, a remainder to a third party. Thus, accumulation might have resulted in the income’s eventually going to the third-party contingent remainderperson and that triggers Section 2036(a)(2).
squarely that a mere right to direct the accumulation of trust income that would otherwise be payable to named beneficiaries is a proscribed power to designate within paragraph (2), if the accumulation will eventually pass to a third-person remainderperson or even if it will only possibly pass to a third-person remainderperson.

What if, under a power to accumulate, income not paid to the current income beneficiary may later be paid to the beneficiary or will at least ultimately be paid to the beneficiary’s estate? Does this fall within the concept of a right to designate the persons who shall enjoy the income? Some courts have held that it does. In *Struthers v. Kelm*,\(^\text{106}\) the trust created by the decedent grantor provided for the payment of the income to the decedent’s daughter for the grantor’s life, then remainder to the daughter. The decedent held a power to accumulate income. Under the local law, the beneficiary had the right to dispose of her remainder interest by will in the event she predeceased her mother; if she made no will, the property would have passed as hers under Minnesota laws on descent and distribution. Smitten by the then-recent decision in *Lober v. United States*,\(^\text{107}\) a Section 2038 case,\(^\text{108}\) the court held that the property was included in the decedent’s gross estate under the predecessor of Section 2036(a)(2). The *Struthers* holding and the *O’Malley* dictum seem to suggest that under any circumstances, a retention of a power to accumulate income is the retention of the proscribed Section 2036 power to designate. But the authors believe that it is not, and that *Struthers* is wrong and *O’Malley* distinguishable, even though the Tax Court expressly disagrees, and its opinion has been affirmed by the Fourth Circuit.\(^\text{109}\)

Granting that Sections 2036 and 2038 have much in common, their tests for applicability are different and the effects of their application are not the same. On the latter point, if the power to accumulate is a power to alter—at least a power to alter as to time of enjoyment—as it should invariably be viewed, the application of Section 2038 would include only the income interest subject to such alteration. In contrast, if the power to accumulate is a right to designate the persons who will enjoy the property, as it should only sometimes be, then the entire trust corpus may be swept into a grantor’s gross estate. It is very well for the Treasury to say in its regulations that a mere power to alter the time of enjoyment is a Section 2038 power, “even though the identity of the beneficiary is not affected.”\(^\text{110}\) The Treasury wisely does not include any such “even though” clause in the Section 2036 regulations. After all, a power

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\(^{106}\) *Struthers v. Kelm*, 218 F2d 810 (8th Cir. 1955).


\(^{108}\) See ¶ 4.10[3], text accompanying note 17.


“to designate the persons who shall possess or enjoy” connotes some ability to choose between persons, however limited the circles of selection may be.\textsuperscript{111} Authority over the timing of a single individual’s enjoyment is simply not a power to designate under Section 2036(a)(2), and a rejection of the decisions to the contrary is urged.\textsuperscript{112}

Thus, a power to accumulate given facts, such as those in \textit{Struthers}, should invoke only Section 2038, menacing the income interest subject to the power.\textsuperscript{113} A power to accumulate under the facts (known from the briefs) in \textit{O’Malley}, in addition to being within Section 2038, though innocuous there because of the limited inclusion, is properly viewed as a power to designate under Section 2036, sweeping the trust corpus into the gross estate. This is because in \textit{O’Malley}, unlike \textit{Lober}, accumulated income might ultimately pass to third parties, not merely the named beneficiary or the beneficiary’s estate. This ability to shift income to others is clearly a power to designate who shall enjoy the income.

In an equally outrageous extension of the right to designate who benefits under Section 2036(a)(2), one Tax Court memorandum decision suggested that a decedent who transferred property to a family limited partnership but held a minority interest in the corporate general partner had a power to designate because of the power to combine with the other corporate shareholders to cause the partnership dissolution and liquidation.\textsuperscript{114} On appeal of the case, the Fifth Circuit declined to deal with this hot potato issue because the court had already applied Section 2036(a)(1) to disregard the entity and include the partnership assets in the decedent’s gross estate, and it did not need to resolve the Section 2036(a)(2) issue.\textsuperscript{115}

\begin{itemize}
  \item \textsuperscript{111} Cf. Industrial Trust Co. v. Comm’r, 165 F2d 142 (1st Cir. 1947).
  \item \textsuperscript{112} See supra text accompanying notes 106, 109. The authors’ thinking is reinforced by the Magruder dissent in Industrial Trust Co. v. Comm’r, 165 F2d 142 (1st Cir. 1947). See supra note 104.
  \item \textsuperscript{113} This would have involved a zero inclusion in \textit{Struthers}, because the income interest terminated on the decedent’s death; but that is appropriate.
  \item \textsuperscript{114} Estate of Strangi v. Comm’r, 85 TCM (CCH) 1331 (2003).
  \item \textsuperscript{115} Strangi v. Comm’r, 417 F3d 468 (5th Cir. 2005). But see Estate of Turner v. Comm’r, 102 TCM (CCH) 214 (2011) (decedent held a general partnership interest and could alter the persons who possessed or enjoyed the property, and Section 2036(a)(2) was applied even though the property was included under Section 2036(a)(1)). See also Kimbell v. United States, 371 F3d 257 (5th Cir. 2004) (50 percent general partner had no control, thus Section 2036(a)(2) inapplicable); Gans & Blattmachr, “Strangi: A Critical Analysis and Planning Suggestions,” 100 Tax Notes 1153 (Sept. 1, 2003).
\end{itemize}
[6] Indirect Interests or Controls

A pervasive problem in the estate tax area, which has an active counterpart in income tax and gift tax matters, is that circumstances, relationships, interests, rights, and obligations that bear importantly on questions of tax liability very often arise in something quite different from a marketplace setting. The cast of characters, seemingly distinct personal entities, often have subsurface personal, familial, fraternal, or business ties, which make them much more cronies than arm’s-length bargainers. Naturally, too, they are likely to be in league against that outsider, the tax gatherer. And perhaps the problems are the greatest when one of the players is wearing several hats. For example, the settlor of a trust may play the role of principal owner of the stock of the corporation forming the trust res and the roles of employee and director of the corporation as well. The settlor may also be the trustee and, as such, have substantial managerial powers. To talk in formal terms of rights and interests in such settings approaches sophistry; but, since the statute does so, the game must be played.

[a] Settlor Trustee

If a trust settlor names oneself as trustee, it now seems settled, although subject to a statutory exception,\(^{116}\) the settlor may as such retain the typical managerial powers of a fiduciary without running afoul of Section 2036. It will be conceded that such powers can affect the enjoyment of the trust property, because, if the settlor may control investments, the settlor’s decision to prefer high-yield bonds, for example, over growth stocks increases the rewards of income beneficiaries at the possible expense of remainderpersons, and vice versa. There is similar latitude regarding discretion as to the allocation of receipts or charges between principal and income. Nevertheless, both ancient\(^{117}\) and more recent\(^{118}\) precedents reject such powers as a basis for applying Sec-

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\(^{116}\) See the anti-Byrum amendment to Section 2036(a)(1), discussed infra ¶ 4.08[6][d].


tion 2036. For example, a nonfiduciary power retained by a grantor with the approval of a fiduciary trustee to acquire trust property by substituting property of an equal value will not trigger Section 2036 inclusion of the property in the grantor’s gross estate.\footnote{Rev. Rul. 2008-22, 2008-1 CB 796; Priv. Ltr. Ruls. 200842007 (June 24, 2008), 200944002 (July 15, 2009). Cf. IRC § 675(4)(c), which treats such a power as triggering the grantor trust provisions under the income tax. The rulings thus provide an effective method to create a “defective” grantor trust. See the discussion of “defective” grantor trusts at ¶ 10.01[10][e], text accompanying notes 275–280.}

Again, without incurring tax liability under Section 2036, somewhat more direct control over enjoyment may be retained by a settlor trustee if the settlor restricts the powers to compliance with an ascertainable standard. The trustee may, for example, have authority to distribute income otherwise to be accumulated (literally, “to designate” who “shall…enjoy…the income”) if the trustee may do so only to ensure a beneficiary’s accustomed manner of living, for the beneficiary’s educational needs, or in case of sickness.\footnote{Leopold v. United States, 510 F2d 617 (9th Cir. 1975); Estate of Wier v. Comm’r, 17 TC 409 (1951), acq. 1952-1 CB 4; Priv. Ltr. Rul. 199903025 (Oct. 27, 1998). Noninclusion here results only if the grantor is under no obligation of support that might require the grantor to meet such needs. See supra ¶ 4.08[4][b], text accompanying notes 67–69.}

The notion here is that the trustee is not permitted to be an innovator; the trustee simply carries out directions found in the trust instrument, and, being limited by a standard, does not have a power to designate.\footnote{Compare the effect of a standard under Section 2036(a)(1), supra ¶ 4.08[4][b], text accompanying notes 67–69.}

However, if the discretion is limited only by the trustee’s appraisal of what will make the beneficiary “happy” or “comfortable,” the trustee has gone too far; in the words of Judge Aldrich, the string the trustee has held on the property will produce “a rope burn.”\footnote{Old Colony Trust Co. v. United States, 423 F2d 601, 605 (1st Cir. 1970).}

Section 2036 applies.\footnote{Estate of Cutter v. Comm’r, 62 TC 351 (1974). For examples of standards here and under Section 2038, see ¶ 4.10[5].}

There may be a pernicious fallacy in all of this. After a certain amount of wealth is accumulated, all a trust settlor may wish to do is pass along to others at death as much as the settlor can, perhaps giving them some enjoyment of the trust property also while the settlor is living. A question, then, is whether the settlor can freeze the tax liability (to value at the time of gift) and yet work to enlarge the settlor’s estate for life without estate tax attrition at death. A power to control investments (merely fiduciary) coupled with a restricted

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Allocations by a trustee to adjust total return between principal and income under section 104 of the Uniform Principal and Income Act (1997) should not cause gross estate inclusion under Section 2036 where the settlor is trustee. See, e.g., Cal. Prob. Code § 16336 (West 2012); Fla. Stat. § 738.104 (2012). See also ¶ 4.10[4][c], text accompanying notes 37–39.
power over enjoyment (an adequate standard) may permit one to accomplish virtually all one’s lifetime wishes with respect to property and still escape estate tax. This is hostile to the general philosophy underlying Section 2036 but not to its language, as properly interpreted. Should anything be done about this? Can anything be done about it?\(^\text{124}\)

[b] Enjoyment Retained in Commercial Transactions

The term “enjoyment” of property under Section 2036(a)(1) connotes “substantial present economic benefit” from the property.\(^\text{125}\) Where a donor transfers land to another but they agree the donor will use the land rent-free for the donor’s lifetime, there is a retention of enjoyment of the property.\(^\text{126}\)

[c] Rent Paid by Transferor

An intriguing situation under the present statute is presented by a gratuitous transfer of real property coupled with a leaseback agreement under which the transferor pays rent for continued possession. Generally, when full market value is paid, the transfer is outside the estate tax under parenthetical exceptions to the lifetime transfer provisions, but those provisions relate to value received by the decedent for property interests transferred. A decedent’s agreement to pay full rental value for continued possession of property that the decedent transfers will work a further diminution (beyond the transfer of the property) in the decedent’s estate. Gratuitous transfers and leasebacks under which taxpayers have, often without success,\(^\text{127}\) sought income tax advantage should not be equally vulnerable to the estate tax. A series of cases have held that Section 2036(a)(1) is inapplicable where the property is business property that is leased back for its fair rental value.\(^\text{128}\) However, if enjoyment is exclu-

\(^{124}\) Cf. \(\S\) 19.01–19.05.

\(^{125}\) Cf. Comm’r v. Estate of Holmes, 326 US 480, 486 (1946). See Rev. Rul. 75-259, 1975-2 CB 361, holding that a “family estate” trust is includible in a grantor decedent’s estate under Section 2036(a)(1) because there is a retention of a substantial present economic benefit in the property transferred. See also Rev. Rul. 75-257, 1975-2 CB 251; Rev. Rul. 75-258, 1975-2 CB 503; Rev. Rul. 75-260, 1975-2 CB 376, dealing with the income and gift tax consequences of “family estate” trusts.


\(^{127}\) See, e.g., Van Zandt v. Comm’r, 341 F2d 440 (5th Cir.), cert. denied, 382 US 814 (1965); Mathews v. Comm’r, 520 F2d 323 (5th Cir. 1975). But see Brooke v. United States, 468 F2d 1155 (9th Cir. 1972). See also current Section 673, eliminating the ten-year reversionary safe harbor allowed when these cases were litigated.

sively retained and inadequate rent is paid or there is no agreement to pay rent, then Section 2036(a)(1) appropriately has been applied.

The government has asserted that if a residence is leased back at its fair market value, the business property rule should not be followed and Section 2036(a)(1) should apply. The government’s distinction between business and nonbusiness property is meaningless and the courts should not accept it. However, a somewhat distinguishable case involving a sale and leaseback gives cause for concern of the eventual outcome of the issue. In that case, two years before her death, the decedent “sold” her personal residence to her son and his wife for $270,000, with the applicable gift tax annual exclusion amounts forgiven simultaneously with the sale. A mortgage note was executed for the $250,000 balance. Following the “sale,” the decedent leased the house from her son and daughter-in-law for an amount that closely approximated the annual mortgage interest owed by them to her. The decedent resided in the house until her death. In each of the years following the sale, decedent forgave the mortgage debt equal to the then annual exclusion amounts of $20,000; and, in her will, which was executed two days after the sale, the decedent forgave the balance of the debt. The Second Circuit agreed with the Tax Court that the “sale” did not constitute a sale but, instead, a transfer within Section 2036 because it was anticipated that there would be no payment of any portion of the purchase price. Even though the decedent dotted every “i” and crossed every “t,” the court applied substance over form to apply Section 2036(a). The case casts a shadow over inclusions in the gross estate of inter vivos transfers well beyond the retained residential context in which it arose.

129 In Estate of Du Pont v. Comm’r, 63 TC 746 (1975), the rent to be paid was not commensurate with the value of the property and the arrangement seemed to involve an elaborate tax saving plan. The Tax Court viewed the arrangement as a kind of sham and simply treated the transfer as one with enjoyment retained within Section 2036(a)(1). “[W]e are firmly convinced,” said the court (id. at 764) “that the series of legal steps…comprised a single device, wholly lacking in substance, by which decedent attempted to divest himself of title to the property without relinquishing his possession or enjoyment thereof.” In these circumstances, the court said, “it is quite beside the point that decedent paid some, albeit inadequate ‘rent’.” Id. at 766. See also Estate of Disbrow v. Comm’r, 91 TCM (CCH) 794 (2006) (Section 2036(a)(1) applied where there was inadequate rent).

130 See supra ¶ 4.08[4][c][i].


132 A similar issue arises where a transferor of a personal residence trust leases the residence after the termination of the trust. See ¶ 19.03[3][d], text accompanying notes 249–251; Estate of Riese v. Comm’r, 101 TCM (CCH) 1269 (2011) (sufficient evidence of intent to pay rent).

133 Estate of Maxwell v. Comm’r, 3 F3d 591 (2d Cir. 1993), aff’g 98 TC 594 (1992).

134 See ¶ 9.04[1].
[d] Section 2036(b) Transfer of Stock

Gifts of corporate stock create a unique problem under Section 2036. If one makes an outright transfer to an independent trustee and retains no interest in or control over the trust, Section 2036 seems inapplicable. Of course, if it is corporate stock that is transferred and the transferor retains control over the corporation, the trust and its beneficiaries may continue to feel the transferor’s presence.

Generally, there is no overlap of the Section 2036(a)(1) statutory concepts of the “right to income” from property and the “possession and enjoyment” of property because the former applies to income-producing property and the latter to non-income-producing property. However, if during life a decedent had transferred voting stock of a “controlled” corporation to a trust, irrevocably naming a third party as the income beneficiary, but the decedent had retained the right to vote such stock, Section 2036(a)(1) includes the voting stock within the decedent’s gross estate. Even though the decedent did not retain the right to the income from the stock, Section 2036(b) provides nevertheless that there is a Section 2036(a)(1) retention of enjoyment of the stock. Under Section 2036(b), the direct or indirect retention of voting rights in a “controlled corporation” is “considered” a retention of the “enjoyment” of transferred property so as to trigger application of Section 2036(a)(1). The requirements for inclusion are essentially two-fold: first, there must be a “controlled corporation,” and, second, the decedent must have retained voting rights with respect to the corporation.

Section 2036(b)(2) defines “controlled corporation” as one in which the decedent owns, directly or by attribution under Section 318, stock possessing at least 20 percent of the combined voting power of all classes of stock of the corporation. Even in the absence of stock ownership, actual or attributed, a corporation is controlled if the decedent has a right to vote (either alone or in


137 IRC § 2036(b)(1). Although the Byrum case involved possible application of both Section 2036(a)(1) and Section 2036(a)(2), nevertheless the anti-Byrum provision relates only to retained enjoyment under Section 2036(a)(1). Congress clearly did not focus only on the effect voting rights might have on dividend payments and thus on the designation of who might enjoy the trust income.

138 Section 318 provides a set of rules for attribution of stock ownership under which stock actually owned by other persons or entities is treated as owned by the taxpayer involved. For a discussion of the intricacies of Section 318, see B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 9.02 (Thomson Reuters/Tax & Accounting, 7th ed. 2006).

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conjunction with any other person) at least 20 percent of the combined voting power. The ownership of stock or voting rights must have been at a time after the decedent’s transfer of the property to the trust and during the three-year period ending with the decedent’s death.

The second requirement, that a decedent have directly or indirectly retained the voting rights of the stock in question, is met if the decedent transferred stock to a trust naming the decedent as trustee, with the trustee having power to vote the stock. The requirement is also met if the decedent was a

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139 This power could be held by the decedent as a co-trustee or with an adverse party. See Prop. Reg. § 20.2036-2(c); supra ¶ 4.08[5][b]. However, if the transferor is a co-trustee and state law permits each trustee to vote a proportionate number of the shares held, the transferor should not be treated as having a right to vote the co-trustee’s shares because those shares are not held in conjunction with the co-trustee.

140 See Prop. Reg. § 20.2036-2(d)(2). Voting power is determined by the stock’s power to elect directors. Stock that may vote only on extraordinary matters such as mergers and liquidations is disregarded. Treasury stock and stock that is authorized but unissued is also disregarded. The statute allows Section 318 attribution only to determine actual ownership of stock, not to attribute voting rights as well. IRC § 2036(b)(2). Proposed Regulations Section 20.2036-2(c), fourth sentence, is consistent with the statute. However, Proposed Regulations Section 20.2036-2(d)(1) is drafted too broadly in also permitting use of Section 318 attribution to determine the portion of voting rights. Proposed Regulations Section 20.2036-2(d)(1) should be amended to permit attribution only to determine ownership, not to determine voting rights. Cf. Prop. Reg. § 20.2036-2(d)(2)(iii), Ex., which is vague as to the rationale for Section 318 attribution.

141 See IRC § 2036(b)(3). Thus, if a decedent who had held 50 percent of the stock or voting rights of a corporation transferred 70 percent of the stock or rights (reducing the decedent’s stock rights to 15 percent) to unrelated parties more than three years prior to the decedent’s death, there would be no “controlled corporation” and the decedent’s possession of voting rights over the retained 15 percent would not trigger the application of Section 2036(a)(1), although practically speaking, even with only 15 percent, the decedent might control the corporation. On the other hand, if the decedent transferred only 5 percent of the stock of a corporation to a trust and the decedent retained only voting rights (no right to income or power to designate) in the stock transferred to the trust, but the decedent was also an independent trustee of an unrelated trust with only third-party beneficiaries, and in that capacity held voting rights over another 16 percent of the stock, the 5 percent transferred to the first trust is included in the decedent’s gross estate.


143 An inter vivos relinquishment of such voting rights might prevent their being held for one of the disqualifying periods required by Section 2036. See supra ¶ 4.08[2]. However, Section 2036(b)(3) provides that if such rights are relinquished or cease within three years of death, the relinquishment will be treated as a transfer of property for Section 2035 purposes. Thus, if a decedent who holds voting rights in a “controlled corporation” releases them within three years of death, the release will be treated as a transfer of the property that, if held until death, would have been included in the decedent’s gross estate under Section 2036. Cf. IRC § 2035(a)(2); Prop. Reg. § 20.2036-2(b).
co-trustee,\[144\] or was not a trustee but had the power to name the decedent as trustee, if the trustee has the required voting rights.\[145\] If the provision is to have its intended effect, the requirement will have to be considered met in a situation where the decedent transfers cash to a trust on the understanding that the trust will purchase stock and the decedent will have the right to vote the stock.\[146\] Stated more clearly, if a decedent transfers cash to the trust and several years later, as trustee, the decedent invests in stock of a controlled corporation over which the decedent holds the voting rights, this also falls within the concept of indirect retention of voting rights and results in inclusion in the decedent’s estate.\[147\] Further, the subsection should also apply where the stock of one corporation is sold or exchanged for stock with voting rights of another controlled corporation.\[148\]

Thus, if a decedent “controls” a corporation and transfers its voting stock to a trust with decedent as trustee, providing the income is paid to A for A’s life, remainder to B, the decedent’s ability as trustee to vote the stock leaves the property in the decedent’s estate under Section 2036(a)(1) if the decedent dies before or less than three years after the death of A.\[149\] What results in this situation if the corporation has both voting and nonvoting stock and the decedent transfers only nonvoting stock to the trust? An initial thought is that the nature of the decedent’s control over the trust property is much the same as if the decedent had transferred the voting stock. However, under the statute, that may be a misleading thought. With regard to controlled corporations, Congress chose to attack retained “enjoyment” under paragraph (1) of Section 2036(a), not powers to “designate” enjoyment under paragraph (2). Consequently, solely as a matter of statutory interpretation (not as a matter of tax policy), it is not surprising to find a comment in the legislative history\[150\] placing a transfer of nonvoting stock outside the reach of Section 2036 in such an instance.

\[144\] Prop. Reg. § 20.2036-2(c). Cf. Gilman v. Comm’r, 547 F2d 32 (2d Cir. 1976); TAM 199938005 (June 7, 1999) (stock transferred to limited partnership, but decedent retained right to vote stock separately).

\[145\] See supra ¶ 4.08[5][a].


\[149\] See IRC §§ 2036(b)(3), 2035(a)(2); supra text accompanying note 141.

even though the decedent has and keeps control of sorts by way of retained voting stock. The proposed regulations adopt the same interpretation.\footnote{Prop. Reg. § 20.2036-2(a); Rev. Rul. 81-15, 1981-1 CB 457; Priv. Ltr. Rul. 9710021 (Dec. 6, 1996) (nonvoting stock transferred to a business trust that was treated as a partnership). The proposed regulations cited also contain the Service’s definition of “voting stock” for purposes of Section 2036(b) inclusion. Compare the definition of “voting power” for control purposes. See supra note 140.} This same line of reasoning supports an interpretation of the statute to make Section 2036 applicable only to the value of voting stock transferred, if a decedent transfers some voting and some nonvoting stock of a controlled corporation. The apparent sense of the statute is that the decedent has retained “enjoyment” only of the voting stock; again, control, if any, over the transferred nonvoting stock is irrelevant for purposes of Section 2036(b).

On a policy level, it may be questioned whether there is a kind of de facto power to designate enjoyment of the transferred interest when the decedent controls the valve freeing or restraining dividend payments.\footnote{Note that in \textit{Byrum}, a question was raised whether the decedent had such control.} An amendment could be framed to make that a relevant question under Section 2036. However, if that is done, Congress should at the same time address itself to other circumstances in which a decedent may have de facto control over enjoyment of others—the case of the friendly or at least nonadverse trustee, and so forth. Additionally, when Congress looks only to paragraph (1) enjoyment and disregards paragraph (2) control, it invites manipulation. Much of what could be done by transferring voting stock and retaining voting rights can be accomplished by a transfer only of nonvoting stock, even if a recapitalization is required to create the nonvoting stock. It is difficult, therefore, to feel that Congress has responded significantly to the problems brought into sharper focus by the \textit{Byrum} decision; however, with the repeal of the short-lived Section 2036(c) and the enactment of Chapter 14,\footnote{Chapter 14 is discussed at ¶¶ 19.01–19.05.} Section 2036(b) applies in very limited circumstances.\footnote{Perhaps that is why the Treasury, which promulgated proposed regulations under the subsection in 1983, has failed to finalize those regulations.}

\section*{[e] Other Legislative Possibilities}

Without attempting detailed legislative proposals, the following ideas might be advanced. Congress could provide that if a trust settlor names settlor trustee and retains that position until death (or relinquishes it within three years of death), the settlor’s gross estate will include the value of the property transferred to the trust. If this approach were taken, it would seem prudent to apply the same rule to a settlor who makes the settlor’s spouse trustee and of course to one who reserved the right to substitute oneself for the named trus-
The problem, however, if it really is one, is nearly as great where others are named trustees because of the high probability that they will simply comply with the settlor’s wishes. Congress could provide that if any “related or subordinate party” other than the grantor or his or her spouse is named trustee, the same result would follow. If this were thought to go too far, as indeed it seems to, then the result might be made to turn on whether such a related or subordinate party was given more than mere fiduciary powers.

[7] Transfer by the Decedent

Section 2036 is applicable only with regard to an interest in property that has been transferred by the decedent.\footnote{This requires an actual or imputed transfer by decedent. Estate of Brown v. Comm’r, 73 TCM (CCH) 2655 (1997) (transaction was not a transfer by decedent); Priv. Ltr. Rul. 200203045 (Oct. 19, 2001) (trustee was not the transferor to a trust where transfer made by trustee pursuant to court order). A mere computational election to split gifts under Section 2513 effects no transfer recognized by Section 2036. Priv. Ltr. Rul. 200130030 (Apr. 30, 2001). Cf. Rev. Rul. 74-556, 1974-2 CB 300. For examples of an imputed transfer by a decedent, see TAM 9043074 (July 12, 1990); TAM 9506004 (Nov. 1, 1994).}\footnote{See infra ¶ 4.08[7][d].} Transfers by others, which create rights in the decedent, do not invoke the provisions of this section, except for others’ transfers imputed to the decedent, such as by way of the reciprocal trust doctrine.\footnote{The trust may be subject to the tax on generation-skipping transfers because there would be a taxable termination at child’s death. See ¶ 13.02[2].} For example, a classic estate planning tool has been the grandfather trust, which is simply a transfer by an individual providing for the payment of income to a child for life, remainder to a grandchild. The interest received by the child terminates on the child’s death and nothing is includible in the child’s estate under Section 2036, as the child was not the transferor.\footnote{A contingent interest in property can be the subject of a Section 2036 transfer. Rev. Rul. 72-611, 1972-2 CB 256.} Moreover, the question of whether a decedent has made a transfer of an interest in property generally depends on whether under local property law the decedent had an interest that the decedent could transfer.\footnote{Heasty v. United States, 239 F. Supp. 345 (D. Kan. 1965), aff’d, 370 F2d 525 (10th Cir. 1966). See Estate of Anderson v. Comm’r, 32 TCM (CCH) 1164 (1973); American Nat’l Bank & Trust Co. v. Comm’r, 33 TCM (CCH) 1158 (1974), raising the issue whether there was ownership by a donee decedent of property held in trust or whether the donor made the transfer to the trust. Cf. infra ¶ 4.08[8][a], text accompanying notes 228–232.} There are some circum-

\footnote{\textsuperscript{155} Cf. IRC § 672(c)(1).} \footnote{\textsuperscript{156} See IRC § 672(c)(2). Such action, if taken, should be taken by Congress, not the Treasury. See supra ¶¶ 4.08[4][b], note 60, 4.08[5][a], note 100.}\footnote{\textsuperscript{157} This requires an actual or imputed transfer by decedent. Estate of Brown v. Comm’r, 73 TCM (CCH) 2655 (1997) (transaction was not a transfer by decedent); Priv. Ltr. Rul. 200203045 (Oct. 19, 2001) (trustee was not the transferor to a trust where transfer made by trustee pursuant to court order). A mere computational election to split gifts under Section 2513 effects no transfer recognized by Section 2036. Priv. Ltr. Rul. 200130030 (Apr. 30, 2001). Cf. Rev. Rul. 74-556, 1974-2 CB 300. For examples of an imputed transfer by a decedent, see TAM 9043074 (July 12, 1990); TAM 9506004 (Nov. 1, 1994).} \footnote{\textsuperscript{158} See infra ¶ 4.08[7][d].} \footnote{\textsuperscript{159} The trust may be subject to the tax on generation-skipping transfers because there would be a taxable termination at child’s death. See ¶ 13.02[2].} \footnote{\textsuperscript{160} A contingent interest in property can be the subject of a Section 2036 transfer. Rev. Rul. 72-611, 1972-2 CB 256.} \footnote{\textsuperscript{161} Heasty v. United States, 239 F. Supp. 345 (D. Kan. 1965), aff’d, 370 F2d 525 (10th Cir. 1966). See Estate of Anderson v. Comm’r, 32 TCM (CCH) 1164 (1973); American Nat’l Bank & Trust Co. v. Comm’r, 33 TCM (CCH) 1158 (1974), raising the issue whether there was ownership by a donee decedent of property held in trust or whether the donor made the transfer to the trust. Cf. infra ¶ 4.08[8][a], text accompanying notes 228–232.
stances, however, in which the courts have invented an estate tax concept of ownership to identify a property interest that has been the subject of a transfer, even though no interest in the transferor would be recognized under local law.\textsuperscript{162} This problem raises a question whether the requisite transfer has taken place to render Section 2036 applicable, and it may also bear on the amount to be included in the gross estate if Section 2036 is found applicable.\textsuperscript{163}

[a] Indirect Transfers

Under certain circumstances, another’s transfer of an interest in property is imputed to the decedent; the decedent may be treated as having made a transfer of property that the decedent, personally, never really transferred at all. In some instances, this is not difficult to understand; if the decedent pays another person $14,000 to transfer real estate of like value into a trust, it is not unrealistic to treat the decedent as the one who transferred such real estate to the trust, even though the decedent never owned it.\textsuperscript{164} Section 2036 is silent on this point, but the reality is discernible to the tax administrators and the courts in the application of this section and others that concern transfers by the decedent.\textsuperscript{165}

Indirect transfers have been found in other unusual circumstances. In the Vease case,\textsuperscript{166} for example, after a decedent’s death, all of the beneficiaries under his executed will agreed, as part of a family settlement, to substitute a distribution arrangement specified in an unexecuted will. The courts properly held that this agreement constituted a transfer by the beneficiaries under the executed will, just as if they had actually received their respective interests and had then made transfers of them. A similar result has been reached by treating as a transfer a beneficiary’s agreement to extend a trust when the beneficiary had the right, instead, to receive the trust corpus.\textsuperscript{167} When a husband, instead of repaying his wife for a loan she had made to him, transferred funds to a


\textsuperscript{163} See infra ¶ 4.08[8][b].


\textsuperscript{165} See the quote infra ¶ 4.08[7][d], note 198.

\textsuperscript{166} Comm’r v. Estate of Vease, 314 F2d 79 (9th Cir. 1963). See also Estate of Hoffman v. Comm’r, 78 TC 1069 (1982); National City Bank of Cleveland v. United States, 371 F2d 13 (6th Cir. 1966).

\textsuperscript{167} Sexton v. United States, 300 F2d 490 (7th Cir.), cert. denied, 371 US 820 (1962). See Estate of Miller v. Comm’r, 58 TC 699 (1972) (a surviving wife’s failure to assert her right to income from a portion of her husband’s estate was treated upon her death as a Section 2036 transfer). But see Estate of Tull v. United States, 1974-2 USTC ¶ 13,010 (ED Mich. 1974).
trust in which she received a life interest, he was held to have acted as her agent in transferring corpus in the amount of the loan, and she was properly treated as the transferor.\footnote{Estate of Marshall v. Comm’r, 51 TC 696 (1969), nonacq. 1969-2 CB xxvi. Cf. Rev. Rul. 81-166, 1981-1 CB 477.} A wife may be treated as transferring one half of the proceeds of a community property life insurance policy at the insured husband’s death\footnote{See ¶ 4.14[8], text accompanying notes 141, 142.}; and where she holds Section 2036 powers over the proceeds, they are included in her estate at her death.\footnote{Estate of Bothun v. Comm’r, 35 TCM (CCH) 1008 (1976).} 

[b] Transfers by Election

Transfers of an indirect nature may also arise out of some types of election situations. For example, if a beneficiary has a right to receive a fixed dollar amount of insurance proceeds upon another’s death, but the beneficiary elects instead to have the insurance company hold the proceeds and pay interest on them for one’s life with the proceeds passing at death to one’s children, the election constitutes an indirect transfer, and upon one’s death, the proceeds are included in one’s gross estate under Section 2036(a)(1).\footnote{Estate of Tuohy v. Comm’r, 14 TC 245 (1950); Estate of Morton v. Comm’r, 12 TC 380 (1949). Cf. Estate of Haggett v. Comm’r, 14 TC 325 (1950), acq. 1950-2 CB 2; Rev. Rul. 70-84, 1970-1 CB 188. Note that if the owner of the policy had simply provided in the policy that the decedent would receive the interest for life with a remainder to the decedent’s children, nothing would be included within the decedent’s estate, as the decedent would have made no transfer.}

[c] Spouse’s Election

The recognized transfer may be less apparent in other election-type situations. For instance, if a husband bequeaths to his wife a life interest in a trust created by his will on the condition that she transfer outright to an unrelated person property equal in value to the life interest, she would be looked upon as having received consideration for her transfer to the unrelated person if she elects to make it, and thus would not have made a taxable lifetime gift.\footnote{IRC § 2512. If her transfer were to a family member, Section 2702 would apply. See ¶ 19.03.} However, at her death she should be viewed as a settlor of the husband’s trust (as having made a transfer to it) to the extent that she procured an interest in it by way of her transfer to the unrelated person. Taking account of her “re-
tained” life interest, at her death Section 2036 would apply to the portion of
the trust of which she is treated as the transferor.173

The transaction just described has a familiar counterpart that historically
was employed in community property states and was commonly called a com-
munity property widow’s election.174 Under the counterpart and assuming the
husband predeceased the wife, the husband’s will would provide that the
widow would take none of the husband’s community property unless she
elected to transfer her interest in the community property to the decedent’s test-
amentary trust, to which his community property was also transferred. If she
did so, the corpus of the trust was made up of both spouses’ community prop-
erty, she received in return a life interest in the entire trust, and the remainder
was left to third persons, generally their children. The decedent husband’s
property was fully included in his estate at his death,176 and the wife, who
made the election at the time of her husband’s death, was deemed to have
made a gift in an amount equal to the excess of the value of the property inter-
est she gave to others (a remainder to the children in her community property)
over the consideration she received (a life interest in the husband’s community
property).177 The sought-after tax-saving aspect of the widow’s election oc-

173 Consideration received from her husband would reduce her gross estate inclusion.
See IRC § 2043(a), infra text accompanying notes 179–189. Such consequences should
also follow as a result of a widow’s electing a life estate in some of a deceased husband’s
property in exchange for relinquishing her dower or statutory rights in lieu thereof. See
Westfall, “Estate Planning and the Widow’s Election,” 71 Harv. L. Rev. 1269, 1284
(1968).

174 The term “widow’s” election is somewhat outdated. At the time the technique was
initially employed, a widow generally survived her spouse. However, most plans also pro-
vide for an alternate widower’s election if the wife predeceases.

175 The historically employed community property widow’s election is discussed in
the following articles: Wilson, “The Widow’s Election Viewed in the Light of the 1976
Tax Reform Act and the 1975 California Probate Code Revision,” 28 Hastings LJ 1435
Rev. 531 (1972); Lane, “The Widow’s Election as a Private Annuity: Boon or Bane for
Estate Planners?” 44 S. Cal. L. Rev. 74 (1971); Johanson, “Revocable Trusts, Widow’s
Election Wills, and Community Property: The Tax Problems,” 47 Tex. L. Rev. 1247
(1969); Halbach, “The Community Property Widow’s Election and Some of Its Counter-
parts,” 107 Tr. & Est. 108 (1968).

176 IRC § 2033.

177 Comm’r v. Siegel, 250 F2d 339 (9th Cir. 1957). See ¶ 10.01[3][b].

One common variation was to give the widow a special power of appointment over
the remainder to the children. This would avoid any gift by the wife at the time of her
election because her transfer would be incomplete for gift tax purposes. Estate of Sanford
v. Comm’r, 308 US 39 (1939). See ¶ 10.01[6]. However, providing the wife a special
power over the remainder could create other problems. The bargain or exchange aspect
of the widow’s election seems to disappear and the creation of the trust may involve only a
straight bequest by the husband and a concurrent transfer by the wife to the trust for no
consideration. Lack of consideration for her transfer would increase the amount included

Section 2036
curred at the time of the widow’s death. Although the widow transferred her property and retained a Section 2036(a)(1) life interest in it, she received consideration equal to the value of her life interest in her husband’s community property for her transfer and, consequently, only a portion, possibly none, of her community property that she previously owned outright would be included in her gross estate under Section 2036(a)(1).

Over the years, legislation and case law have created obstacles that have dramatically altered the possibility of benefiting from using the commu-

in her estate under Section 2036(a)(1). See Johanson, “Revocable Trusts, Widow’s Election Wills, and Community Property: The Tax Problems,” 47 Tex. L. Rev. 1247, 1295, 1309 (1969). In addition, with an eye to the income tax, if the wife never transferred anything of value in acquiring her life interest, it would not have been acquired by purchase and would not be amortizable (IRC § 273) and would have no cost basis on a separate sale (IRC § 1001(e)); but in addition there would seem to be no purchase or sale with possible adverse income tax consequences to the husband’s estate. See infra note 194.

178 Note, however, that income generated by all the trust property, including that transferred by the decedent husband, that was not consumed or given away by the widow, enlarged her wealth and would be included in her gross estate under Section 2033. It is this fact that supports the notion that the widow receives partial consideration for her transfer and, taken into account with gift tax that may be paid at the time of election, might substantially reduce the supposed tax savings.

179 See the hypothetical infra note 180.

180 Assume that husband (H) transferred his one half of the community property worth $20 million to a trust with income to his wife (W) for life with a remainder to their children at a time when W’s life estate and the remainder each had a 50 percent actuarial value. The results under the historically employed widow’s election were as follows:

\[
\begin{align*}
\text{H’s community property subject to estate tax: } & \text{§ 2033} \\
\text{inclusion and no } & \text{§ 2056 deduction} \\
\text{W’s community property gift: } & \text{§ 5 million remainder transferred minus } \text{§ 5 million life estate consideration received} \\
\text{W’s community property subject to estate tax: no } & \text{§ 2036 inclusion assuming a bona fide sale (but see infra text accompanying notes 182–189) for adequate and full consideration was received for the transferred remainder} \\
\text{Total of their } & \text{§ 20 million of community property subject to tax} \\
\text{transfer taxation} & \text{§ 10 million}
\end{align*}
\]

This hypothetical disregards any consideration of use of a Section 2010 credit shelter trust. See ¶ 5.06[6]. Use by both spouses of a shelter trust would not alter the end result: subjection of only one half of the community property in excess of any sheltered amount to transfer taxation.

181 The QTIP exception to the marital deduction terminable interest rule provides a likely alternate way to use a community property widow’s election. IRC § 2056(b)(7). See ¶ 5.06[8][d]. As a result of this provision, the husband’s estate can qualify a portion of the husband’s transfer to the community property trust for a marital deduction. However,
nity property widow’s election technique. However, as a result of more recent

the husband’s property qualifying for a marital deduction is generally then included in the
widow’s gross estate under Section 2044. See ¶ 4.16. This alternative does not impose an
obstacle to use of the widow’s election.

A hypothetical may be helpful to illustrate the consequences here. Assume, in facts
similar to those supra note 180, that H (husband) has community property worth $10 mil-
lion and that he creates a community property widow’s election with a grantor retained
annuity trust (GRAT) or a grantor retained unitrust (GRUT) for W (widow), which has an
actuarial value equal to 50 percent of the corpus. The hypothetical assumes that a GRAT
or GRUT is a “qualifying income interest” under Section 2056(b)(7)(B)(ii). See infra
¶ 4.08[8], text accompanying notes 215–223; ¶ 5.06[8][d], text accompanying notes 342–
344. The consequences are as follows:

No QTIP election (supra note 180 hypothetical):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>H’s community property subject to estate tax:</td>
<td>$10 million</td>
</tr>
<tr>
<td>W’s community property gift: $5 million transferred</td>
<td></td>
</tr>
<tr>
<td>remainder minus $5 million consideration received</td>
<td>0</td>
</tr>
<tr>
<td>W’s community property subject to estate tax — no § 2036</td>
<td></td>
</tr>
<tr>
<td>inclusion because adequate and full consideration was received for the remainder</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>$10 million</td>
</tr>
</tbody>
</table>

QTIP election:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>H’s community property subject to estate tax: $10 million less § 2056 marital deduction, $500,000 (the amount of $10 million subject to the § 2056(b)(7) election less consideration H received, $5 million, see United States v. Stapf, 375 US 118 (1963), ¶ 5.06[5][b])</td>
<td>$ 5 million</td>
</tr>
<tr>
<td>W’s community property gift: $5 million transferred remainder minus $5 million consideration received</td>
<td>0</td>
</tr>
<tr>
<td>W’s gross estate: none of her community property included under § 2036(a), but § 2044 would include $5 million (the portion of H’s property that qualified under § 2056(b)(7))</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>$10 million</td>
</tr>
</tbody>
</table>

The hypothetical illustrates that where there is no appreciation in the value of the
property subject to the QTIP election, the use of a QTIP election results in no difference
in tax liability. However, as a practical matter, failure to make a QTIP election will result
in a payment of estate tax dollars at the time of H’s death. This disadvantage in failing to
make a QTIP election must be weighed against the potential QTIP disadvantage of includ-
ing the appreciation in the portion of the property subject to the QTIP election in W’s
gross estate under Section 2044.
case law, there may be an opportunity to revitalize its use. For many years, the first obstacle was Estate of Gradow, which represented the prevailing view among both the courts and the Service of the manner in which Section 2036(a) applied to the widow’s gross estate. In Gradow, the Federal Circuit held that whether the Section 2036(a) exception for a bona fide sale for full and adequate consideration applied to a transfer of the widow’s community property interest was dependent upon the entire value of the widow’s community property transferred, not the value of the remainder interest she transferred. However, several other circuit courts of appeal later held (but not in the context of a community property widow’s election) that if there is a bona fide sale of the remainder interest for its fair market value (with a retained life estate), Section 2036(a) is inapplicable, because the transferor has received full and adequate consideration for the transferred remainder. This result is more sound than the result reached in Gradow. However, it may be argued that Gradow is still the applicable law in a community property widow’s election.

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182 Estate of D’Ambrosio v. Comm’r, 101 F3d 309 (3d Cir. 1996); Wheeler v. United States, 116 F3d 749 (5th Cir. 1997); Estate of Magnin v. Comm’r, 184 F3d 1074 (9th Cir. 1999). The cases are discussed in more detail supra ¶ 4.08[1][a], text accompanying notes 32–34.


184 See Estate of Vardell v. Comm’r, 307 F2d 688 (5th Cir. 1962) (recognizing Section 2043(a) consideration but not considering what is adequate and full consideration); Estate of Gregory v. Comm’r, 39 TC 1012 (1963) (Section 2036(a) applied where inadequate consideration was received for the remainder or the corpus). See Brown, “The Allen Case and the Widow’s Election,” 36 S. Cal. L. Rev. 229 (1963); Bomash v. Comm’r, 432 F2d 308 (9th Cir. 1970) (variation on the standard community property widow’s election); Estate of Sparling v. Comm’r, 552 F2d 1340 (9th Cir. 1977) (dealing with the Section 2013 credit in a community property widow’s election situation).

185 Thus, at the widow’s death the full value of the widow’s one half of the community property was included in her gross estate reduced only by the dollar value of the consideration she received from the husband. IRC §§ 2036(a)(1), 2043(a). Thus, under the Gradow case in the hypothetical, supra note 180, Section 2036(a)(1) would have applied with the result that the value of W’s one half of the community property at her death would be included in her gross estate reduced under Section 2043(a) by only the dollar amount ($5 million) of consideration she received.

186 Estate of D’Ambrosio v. Comm’r, 101 F3d 309 (3d Cir. 1996); Wheeler v. United States, 116 F3d 749 (5th Cir. 1997); Estate of Magnin v. Comm’r, 184 F3d 1074 (9th Cir. 1999). The cases are discussed in more detail supra ¶ 4.08[1][a], text accompanying notes 32–34.

187 In Gradow, the court likely inappropriately applied Section 2036(a). See supra ¶ 4.08[1][a][iii]. See also Estate of Christ v. Comm’r, 54 TC 493 (1970), aff’d, 480 F2d 171 (9th Cir. 1973) (seemingly disagreeing with Gradow); Parker v. United States, 75 AFTR2d 95-2509 (ND Ga. 1995) (where the court acknowledged that it had “some reservations about the correctness of Gradow”); supra ¶ 4.08[1][a], note 35.
context, because while full and adequate consideration may have been re-
ceived, the widow’s transfer was not a “bona fide sale.”

Another obstacle to the historically employed community property
widow’s election is the enactment of Section 2702. If the remainder transfer
is to a family member, Section 2702 generally values the wife’s retained in-
terest at zero for gift tax purposes, increasing the amount of the widow’s gift
transfer by the value of the retained income interest, unless Section 2702 is
avoided. Uncertain income consequences have also created a potential obsta-
cle to the use of the community property widow’s election. In summary, al-
though the line of cases disagreeing with the Gradow result may remove an
obstacle to the use of the community property widow’s election, other obsta-
cles continue to cast a shadow over employment of the election technique.

188 See supra text accompanying note 186. See also supra ¶ 4.08[1][a][iii].
189 Jordan, “Sales of Remainder Interests: Reconciling Gradow v. United States and
Section 2702,” 14 Va. Tax Rev. 671, 716–718 (1975); Jensen, “Estate and Gift Tax Ef-
efects of Selling a Remainder: Have D’Ambrosio, Wheeler, and Magnin Changed the
Rules?” 4 Fla. Tax Rev. 537, 585–589 (1999). However, note that a bona fide sale is rec-
ognized in community property widow’s election situations for income tax purposes. See
infra text accompanying note 194.
190 See ¶ 19.03.
192 Thus, in the hypothetical posed, supra note 180, W would make a gift at the time
of her election equal to $10 million, less $5 million, or $5 million. See ¶ 19.03[2][a], text
accompanying note 30.
193 The Section 2702 obstacle is seemingly avoided if the widow retains a “qualified
income interest” in the form of a GRAT or a GRUT or avoids the Section 2702 zero valu-
ation rule in some other manner. See IRC §§ 2702(a)(2)(A), 2702(b)(1), 2702(b)(2);
¶¶ 19.03[3][b], 19.03[3][b][i], and the hypothetical at supra note 181. See also Jordan,
“Sales of Remainder Interests: Reconciling Gradow v. United States and Section 2702,”
Tax’n for Law. 74 (1994).
194 Some cases have allowed the widow to amortize the cost of her income interest in
the husband’s property on the theory that she purchased the husband’s income interest in
a bona fide sale. Gist v. United States, 423 F2d 1118 (9th Cir. 1970); Estate of Christ v.
Comm’r, 480 F2d 171 (9th Cir. 1973). However, if she purchased the husband’s income
interest, then the husband would have sold that interest with potentially disastrous income
tax consequences under Section 1001(e)(1), unless the Section 1001(e)(3) exception is ap-
licable. See Freeland, Lind & Stephens, “What Are the Income Tax Effects of an
Estate’s Sale of a Life Interest?” 34 J. Tax’n 376 (1971); Wilson, “The Widow’s Election
Viewed in the Light of the 1976 Tax Reform Act and the 1975 California Probate Code
195 See supra text accompanying notes 190–194.
[d] Reciprocal Trusts

A transfer may be attributed to the decedent under a sophisticated judicial doctrine of “reciprocal” or “crossed” trusts.\textsuperscript{196} For example, assume A sets up a trust for the benefit of B and at the same time B creates a trust of equal value for A, and under the provisions of A’s trust, the income is to be paid to B for life with a remainder to B’s children; and the trust B created provides for income to A for life, remainder to A’s children. Literally, neither A nor B has made a transfer under which the transferor has retained a life interest; nevertheless, A and B are both in the same circumstances they would have been if they had done so. Consequently, the courts have developed the reciprocal trust doctrine, under which the grantors of the trusts are switched and each grantor is regarded as creating a trust under which the grantor retained a life interest, resulting in inclusion of the corpus in the grantor’s gross estate.\textsuperscript{197}

Although it is easy to state the theory underlying the reciprocal trust doctrine, it has been difficult to harness the theory so as to determine whether, on any particular facts, trusts will be treated as crossed. The Second Circuit, in first developing the doctrine, spoke in terms of one grantor paying a “quid pro quo” for the other grantor’s transfer and of the trusts being established in consideration for one another.\textsuperscript{198} For some time thereafter, the application of the reciprocal trust doctrine turned mainly on the crucial factor of consideration, which in turn depended in part on a determination of the subjective intent of the grantors.\textsuperscript{199} However, in its first encounter with the reciprocal trust doctrine,\textsuperscript{200} the Supreme Court in the \textit{Grace} case\textsuperscript{201} imposed a less stringent test to

\textsuperscript{196} The doctrine applies not only under Section 2036 but also under other provisions, such as Section 2038, which depend on transfers by the decedent. See \textit{In re Lueder’s Estate}, 164 F2d 128 (3d Cir. 1947); \textit{Lehman v. Comm’r}, 109 F2d 99 (2d Cir.), cert. denied, 310 US 637 (1940); \textit{Estate of Newberry v. Comm’r}, 6 TCM (CCH) 455 (1947), aff’d per curiam, 172 F2d 220 (3d Cir. 1948); \textit{Exchange Bank & Trust Co. of Fla. v. United States}, 694 F2d 1261 (Fed. Cir. 1982); \textit{Estate of Bischoff v. Comm’r}, 69 TC 32 (1977). But see \textit{Estate of Green v. United States}, 68 F3d 151 (6th Cir. 1995) (refusing to apply the doctrine where the transferors did not personally have retained economic interests in the trusts, a decision that is too narrow an application of the reciprocal trust doctrine).


\textsuperscript{198} The court quoted A. Scott, Law of Trusts § 156.3, for the proposition that “a person who furnishes the consideration for the creation of a trust is the settlor, even though in form the trust is created by another.” \textit{Lehman v. Comm’r}, 109 F2d 99, 100 (2d Cir.), cert. denied, 310 US 637 (1940).

\textsuperscript{199} \textit{McLain v. Jarecki}, 232 F2d 211 (7th Cir. 1956); \textit{In re Lueder’s Estate}, 164 F2d 128 (3d. Cir. 1947); \textit{Estate of Newberry v. Comm’r}, 201 F2d 874 (3d Cir. 1953).


\textsuperscript{201} It seems likely that given the broader \textit{Grace} test, the courts deciding some earlier cases would not have rejected application of the reciprocal trust doctrine. See, e.g., \textit{McLain v. Jarecki}, 232 F2d 211 (7th Cir. 1956); \textit{In re Lueder’s Estate}, 164 F2d 128 (3d Cir. 1947).
switch grantors, seemingly expanding the scope of the reciprocal trust doctrine. The Court said that application of the reciprocal trust doctrine is not dependent on questions of consideration, subjective intent, or a tax avoidance motive; instead, the Court said:

"Application of the reciprocal trust doctrine requires only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries."

While the Grace decision unquestionably broadens the scope of the reciprocal trust doctrine, its still-value test leaves some doubt regarding to what extent the Commissioner may attempt to extend the doctrine. In Grace, the Court applied the doctrine in circumstances in which the terms of the trusts were identical, there was no time differential in the creation of the trusts, and the trusts were of equal value. These were all factors that the lower courts had previously looked to in determining the subjective intent question under the consideration test, and it would appear that while the doctrine has been expanded, the Grace decision has mostly relieved the Commissioner of the bur-

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1947), although in Lueder the lapse of fifteen months between the creation of the trusts might mitigate its reciprocal aspects. However, the trusts involved in some earlier cases would still likely not constitute reciprocal trusts, even under the Grace test. See, e.g., Estate of Ruxton v. Comm'r, 20 TC 487 (1953), acq. 1953-2 CB 6. But see Note, "United States v. Estate of Grace: The Reincarnation of the Reciprocal Trust Doctrine," 17 UCLA L. Rev. 436 (1969).


203 In Estate of Bischoff v. Comm'r, 69 TC 32 (1977), the full Tax Court, in the first decision subsequent to United States v. Estate of Grace, 395 US 316, 324 (1969), was faced with applying the reciprocal trust doctrine. The majority apparently held that the mere similarity and the establishment of the trust produced the necessary interrelationship to apply the doctrine. Three judges concurred in the opinion, and four judges dissented. See also Exchange Bank & Trust Co. of Fla. v. United States, 694 F2d 1261 (Fed. Cir. 1982).

Presumably, the requirement that the trusts be "interrelated" would preclude, as it should if such a circumstance could ever be proved, an application of the doctrine in a case where two settlors quite unknowingly and coincidentally happened to create similar trusts for each other.

204 The following factors figured prominently in the earlier cases: (1) identity of trust terms (Estate of Moreno v. Comm'r, 260 F2d 389 (8th Cir. 1958); Estate of Hanauer v. Comm'r, 149 F2d 857 (2d Cir.), cert. denied, 326 US 770 (1945); Lehman v. Comm'r, 109 F2d 99 (2d Cir.), cert. denied, 310 US 637 (1940); Estate of Newberry v. Comm'r, 201 F2d 874 (3d Cir. 1953)); (2) simultaneous creation (Estate of Cole v. Comm'r, 140 F2d 636 (8th Cir. 1944); Estate of Eckhardt v. Comm'r, 5 TC 673 (1945); Estate of Fish v. Comm'r, 45 BTA 120 (1941), acq. 1942-1 CB 6; but see Priv. Ltr. Ruls. 9735025 (May 30, 1997), 9804012 (Oct. 22, 1997) (no reciprocal trusts where reciprocal powers created twenty-six years after creation of the trusts)); and (3) equivalency of value (Estate of Moreno, supra; Lehman v. Comm'r, 109 F2d 99 (2d Cir.), cert. denied, 310 US 637 (1940)).
den of proving subjective intent.\textsuperscript{205} If the trust terms are not substantially identical, the doctrine is inapplicable.\textsuperscript{206}

If trusts of unequal value are held to be reciprocal, the amount that can be included in either grantor’s estate under Section 2036 is no more than the value of the smaller trust at the applicable estate valuation date. For example, in \textit{Estate of Cole},\textsuperscript{207} a husband had transferred 700 shares of X Corporation stock in trust for his wife, the decedent, who at the same time transferred 300 shares of identical stock in trust for the husband. Each party was the income beneficiary for life under the trust set up by the other. The trusts were held to be reciprocal, and the gross estate of the decedent wife was held to include the value of 300 shares of the 700-share trust of which she was beneficiary; but the decedent was not treated as the transferor of the other 400 shares of the trust.\textsuperscript{208}

This consideration of the reciprocal trust problems and earlier consideration of other indirect transfer phenomena should not be permitted to obscure the basic proposition that the decedent must have made a transfer of the property in question, either actual or imputed, for Section 2036 to bring the value of the property into the decedent’s gross estate.

\[8\] \textbf{Amount to Be Included}

Under Section 2036, it is not the value of the interest retained by the decedent (such as a life interest) or controlled by the decedent (under a right to designate), but the date-of-death value of the property interest transferred in the prescribed manner, in general the trust corpus, that finds its way into the decedent’s gross estate.\textsuperscript{209} The idea here is that for tax purposes it is appropriate to treat the lifetime transfer as the equivalent of a testamentary disposition.


\textsuperscript{207} Estate of Cole v. Comm’r, 140 F2d 636 (8th Cir. 1944).


if the decedent postponed the real effect of the transfer until death (or for a related period)\textsuperscript{210} by retention of the income or use or control over who else should have the property.

Section 2036 can apply in such a way as to include only a portion of property transferred by the decedent. For example, if $D$ transferred a residence to $S$ and retained for life the use of two out of eight rooms (assuming equal value for all rooms), one fourth of the date-of-death value of the residence would be included in $D$’s gross estate.\textsuperscript{211} Similarly, if $D$ transferred property in trust and retained for $D$’s life the right to one half of the income from the trust property, one half of the value of the trust corpus would be included in $D$’s gross estate at death.\textsuperscript{212}

If, in making a transfer generally within the scope of Section 2036, an interest is created that is unaffected by the interest retained by $D$, the value of such an “outstanding interest” is excluded. This applies, for instance, to a secondary life estate in which $D$’s right to the income arises only upon the termination of a life interest in another person. In such circumstances, the amount to be included is the value of the property transferred, less the value of the outstanding life interest, as of the date of $D$’s death.\textsuperscript{213}

\textsuperscript{210} Section 2036 applies if the decedent retains such controls not only for life but either for a period not ascertainable without reference to the decedent’s death or which does not, in fact, end before decedent’s death. IRC § 2036(a). See supra ¶ 4.08[2]. If there is Section 2036 inclusion in a situation where the rights do not end before decedent’s death, but continue after the decedent’s death, the rights subsequent to the decedent’s death are not included in the decedent’s gross estate under Section 2033 because they are already included under Section 2036. Reg. § 20.2036-1(c)(1)(i). However, payments that become payable to the decedent prior to the decedent’s death, but are not paid until after the decedent’s death, are included in the decedent’s gross estate under Section 2033. Id.

In addition, Section 2035(a) also applies to result in Section 2036 inclusion when the decedent relinquishes the Section 2036 interest or power within three years of death. See ¶ 4.07[2][a], infra ¶ 4.08[8][b]; Reg. § 20.2036-1(c)(2), Ex. 1.

\textsuperscript{211} Reg. § 20.2036-1(a)(1)(i). See Rev. Rul. 79-109, 1979-1 CB 297 (retention of right to use a vacation home for a portion of each year); Estate of Stewart v. Comm’r, 617 F3d 148 (2d Cir. 2010) (remand to determine inclusion of a fractional share of building where commercial portion treated as owned by decedent under Section 2036(a)(1) and co-occupied residential portion not within Section 2036(a)(1)). See Jones & Mitchell, “A Divided Second Circuit Fractionalizes Section 2036 in Estate of Stewart,” 113 J. Tax’n 220 (Oct. 2010); Bogdanski, “Upstairs, Downstairs: Retained Interests and Estate of Stewart,” 130 Tax Notes 911 (Feb. 21, 2011).

\textsuperscript{212} See Reg. §§ 20.2036-1(c)(1)(i), Ex. 1, 20.2036-1(c)(2)(iv), Ex. 4; Comm’r v. Estate of Dwight, 205 F2d 298 (2d Cir.), cert. denied, 346 US 871 (1953). Cf. Reg. § 20.2036-1(c)(2)(iv), Ex. 8. If the decedent retained an income interest subject to a standard of support, then the amount of corpus necessary to produce the amount of income for support would be included in the decedent’s estate.

\textsuperscript{213} Reg. § 20.2036-1(b)(ii); Marks v. Higgins, 213 F2d 884 (2d Cir. 1954). See Reg. § 20.2036-1(c)(1)(ii), Ex. 1; supra ¶ 4.08[2], text accompanying note 45. Cf. Reg. §§ 20.2036-1(c)(2)(ii), 20.2036-1(c)(2)(iv), Ex. 8. The regulations improperly, or at least...
ing interests was clearer, perhaps, under earlier statutory language. When the question was whether the interest was “intended to take effect in possession or enjoyment only at or after the decedent’s death,” interests not deferred as to possession or enjoyment were clearly not included. The result must be reached under the present statute by identifying the several interests transferred and raising the question in each case whether the decedent has retained any interest or rights with respect to each transferred interest. As in the case of all the gross estate provisions concerning lifetime transfers, partial consideration received for the interest transferred reduces the amount to be included in the gross estate.214

The same principles apply but computation of the amount of inclusion is more difficult to compute where the decedent retains for one of the restricted periods215 an interest in a trust (other than a trust constituting an employee benefit) in the form of an annuity interest (either a GRAT or a charitable remainder annuity trust (CRAT)),216 a unitrust interest (either a GRUT or charitable remainder unitrust (CRUT)),217 an interest in a pooled income fund,218 or any similar interest.219 The amount of inclusion in these situations is the portion of the trust corpus valued at the date of the decedent’s death (or alternate valuation date) necessary to yield the payment or (use) using the appropriate Section 7520 interest rate in effect at the decedent’s death (or alternate valuation date).220 The computation becomes even more complicated if the annuity,
unitrust, or other payment is a graduated retained interest that increases over a period of time. A similar complicated computation occurs when the decedent’s retained interest follows that of another person. These rules on the amount of inclusion have a variety of effective dates.

As it is only the value of interests transferred by the decedent that is caught by Section 2036, the effect of its application to a trust may depend on whether persons other than the decedent have transferred property to the same trust. If A and B have both transferred property to a trust under which A has the right to the income for life and A dies, the amount includible in A’s estate is only the portion of the trust property that can properly be identified as transferred by A.

It has been questioned whether there is a retention of “the income” generated by the corpus in such circumstances. Because the transferred property generates the annuity or unitrust amount, the Treasury’s position is proper. Compare Estate of Becklenberg v. Comm’r, 273 F2d 297 (7th Cir. 1959); Estate of Bergan v. Comm’r, 1 TC 543 (1943), acq. 1943 CB 2; see supra ¶ 4.08[4].

The rules are illustrated in a variety of examples in Regulations Section 20.2036-1(c)(2)(iv) involving Section 2036(a)(1) inclusion of a CRAT paid annually (Ex. 1), a GRAT paid monthly (Ex. 2), a CRUT paid quarterly (Ex. 3), an interest in a pooled income fund (Ex. 5), and a retained interest in a QPRT (Ex. 6).

Accumulated Income

What about income accumulations added to corpus? If a decedent transferred property to a trust, retaining only the right to direct the accumulation of trust income, it is likely that Section 2036 applies to tax, as part of the decedent’s estate, the property that the decedent actually transferred. If income is in fact accumulated, is the accumulated income also to be included? It is now settled that it is.

The result depends on a judge-made estate tax concept of ownership. The accumulated income may become a part of the corpus and subject to the same provisions as income from the original trust property. However, it is not possible to find any actual property interest in the decedent in the income that the decedent may direct to be accumulated. Consequently, in conventional property terms, the decedent cannot possibly be said to have made a transfer of such income. It is therefore a question whether the decedent’s estate’s liability for tax on accumulated income should not be controlled only by Section 2041, which deals with property interest not transferred by the decedent but subject to the decedent’s power. The Supreme Court has decided otherwise, perhaps questionably, treating income accumulations as if owned and trans-

225 See supra ¶ 4.08[5][c], text accompanying note 105. But see supra ¶ 4.08[5][c], text accompanying notes 106–113.

226 United States v. O’Malley, 383 US 627 (1966). See also Horner v. United States, 485 F2d 596 (Ct. Cl. 1973). This principle does not apply to accumulated income that is transferred to a separate fund over which the decedent has no Section 2036 or Section 2038 controls. See Leopold v. United States, 510 F2d 617 (9th Cir. 1975), in which accumulated income did not become part of a Section 2036 trust corpus but was put into a separate account to be given to the income beneficiary at age 21.

227 See ¶ 4.13.
ferred by the decedent for purposes of measuring tax liability under Section 2036.

The accumulation situation is not the only instance in which a judge-made estate tax ownership concept might seem a useful device; but it is not uniformly invoked. For example, assume that a decedent and a child had owned property jointly that the decedent originally funded and they subsequently transferred to another, retaining joint-and-survivor income interests. The child predeceased the decedent, and the decedent was in receipt of all the income at death. Only one half of the value of the property is included in the decedent’s estate,²²⁸ the portion actually transferred by the decedent, even though the entire value of the property would have been included under Section 2040(a)²²⁹ if the lifetime transfer had not been made. An estate tax ownership concept, with collateral support from Section 2040, might have been invoked to treat the decedent as the transferor of the entire property.²³⁰ Despite judicial rebuff,²³¹ the Commissioner should not give up on this issue short of rejection by the Supreme Court.²³²

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²²⁹ See ¶ 4.12.

²³⁰ See also Glaser v. United States, 306 F2d 57 (7th Cir. 1962). It is curious that the Tenth Circuit, which decided Heasty v. United States, 239 F. Supp. 345 (D. Kan. 1965), aff’d, 370 F2d 525 (10th Cir. 1966), and which had accepted an estate by ownership concept in United States v. Allen, 293 F2d 916 (10th Cir. 1961), before the Supreme Court sanctioned such an approach in United States v. O’Malley, 383 US 627 (1966), rejected the concept in Heasty, seemingly the most compelling circumstance for involving the concept. On the other hand, a rejection of an estate tax ownership concept may favor the government. The Heasty rationale supports a tax on one half of the value of joint tenancy property transferred in a Section 2036 manner even in the estate of one who contributed nothing to the acquisition of the jointly held property. Miller v. United States, 325 F. Supp. 1287 (ED Pa. 1971). If full ownership were attributed to the potential Section 2040 estate tax owner, presumably the result would be otherwise, as the one who had contributed nothing would be seen as having no estate tax interest to transfer.

²³¹ Cf. Sullivan v. Comm’r, 175 F2d 657 (9th Cir. 1949).

²³² But see Rev. Rul. 69-577, 1969-2 CB 173, issued prior to the enactment of Section 2040(b), in which the Commissioner concedes the issue, saying in effect that the Service will follow Heasty v. United States, 239 F. Supp. 345 (D. Kan. 1965), aff’d, 370 F2d 525 (10th Cir. 1966). The ruling involved a tenancy by the entirety rather than a joint tenancy and concluded that one half of the value of the property was included in the decedent husband’s estate. See also Priv. Ltr. Rul. 8331005 (Apr. 22, 1983). However, if the husband’s interest was worth less than one half of the value of the property (cf. Reg. § 25.2515-2(b)(2)), only the value of his lesser proportionate interest should be included in his estate, even though the income from the property was split equally, if actual legal interests are to control.
[b] Lifetime Relinquishment of Prescribed Interests

Section 2036 raises only the question whether the decedent has made a lifetime gratuitous transfer of property retaining certain interests for a specified period. Accordingly, it could be argued that a later lifetime relinquishment of the retained interest or right does not alter the fact that a prescribed transfer was made and that, however such relinquishment is made, the value of the transferred property should be included in the transferor’s estate.\footnote{Section 2036 states that the section applies if “at any time” the prescribed transfer was made. See Breitenstein, J., concurring in United States v. Allen, 293 F2d 916, 918 (10th Cir. 1961). This result has some theoretical justification. It is possible that a young person could transfer property to a trust, retaining a life estate and giving a remainder with a small actuarial value to a third person. At a later date, close to but more than three years prior to the transferor’s death (when the value of the income interest is small), the transferor could give the remaining income interest to a third person. The effect of such a transfer, even if the income interest is transferred for adequate and full consideration, may be to remove most of the value of the corpus from transfer tax consequences (but see IRC § 2702, discussed at ¶ 19.03), although such a result is theoretically inappropriate.} Nonetheless, the lifetime relinquishment of the retained interest may render Section 2036 inapplicable, provided the relinquishment is not made within three years of death.\footnote{Cf. IRC § 2035(a). Although perhaps theoretically inappropriate, it is the authors’ opinion that United States v. Allen, 293 F2d 916 (10th Cir. 1961), in the context of Section 2036(a)(1), should be limited to its facts, that is, a situation in which the transfer of a retained life estate occurs within three years of the transferor’s death. If such transfers beyond three years of the decedent’s death are to be pulled into the decedent’s gross estate, Congress should provide for such a result. But see supra note 233. The Allen case should be applied where there is a commutation of a trust within three years of the death of the transferor who held a retained life estate if the transferor was instrumental in the commutation action (cf. Priv. Ltr. Rul. 9815023 (Apr. 10, 1998)) (no ruling on Allen issue) or there was an implied agreement with the commuting trustee (cf. Priv. Ltr. Rul. 9935003 (May 18, 1999)) (ruling treated original transferor as commuting the trust implying an implied agreement).} Such a two-step transaction should not be differentiated from a one-step transaction by which the decedent divests all interest in the property at the time of the initial transfer.

On the other hand, as a policy matter, few would argue that a “death bed” relinquishment of a life interest should be a recognized escape hatch from Section 2036. Section 2036 is deficient in this respect; it is silent on the issue. However, Section 2035(a) is applicable.\footnote{See ¶ 4.07[2][a].} Section 2035 mandates inclusion where an interest that would have generated inclusion under Section 2036 if retained by the decedent until death is relinquished within three years of death. In effect, Section 2036 is exhumed by the application of Section 2035(a).

The problem is aggravated if the tainting life interest is sold for its full value. Retention of the interest until death might, for instance, make a...
$100,000 trust fully includible in the decedent’s gross estate; but the value of the life interest (if the individual who has it is old) might be $1,000. Can the life interest be sold for its full value, $1,000, to defeat an inclusion of $100,000?236 To avoid this absurdity, the convenient device of an estate tax ownership concept has been judicially applied here with seemingly good reason.237 The transaction is seen to involve the value of the property that would have been included absent the transfer. Thus, the $1,000 received represents only partial consideration, and the date-of-death value of the trust property (maybe $100,000), less the consideration received ($1,000), is included.238 Congress did not tighten up Section 2035 as we have urged, but, even so, the courts should continue to interpret it in this manner to reach an appropriate result.239

Further problems arise if a transferor retains a Section 2036(a)(2) power to designate the beneficiary, which is relinquished by the transferor within three years of death. For example, if a transferor provides an income interest to A or B, whomsoever the transferor selects, for the transferor’s life and a remainder to C, and the transferor relinquishes the power within three years of death, the property would be included in its entirety in the transferor’s gross estate; note that Section 2035(a), which triggers such inclusion under Section 2035(a), applies expressly to a transfer of an “interest in property,” or a “relinquished power.”240

[9] Background of the Section

A limitation on the application of Section 2036 is set forth in subsection (c), which is of diminishing importance because it relates only to transfers made a long time ago. The section is expressly made inapplicable to transfers made before March 4, 1931, and in some cases to transfers made before June 7, 1932.241 The origin of this limitation provision is found in a strange bit of legislative and judicial history. In the Revenue Act of 1916, the first enactment of the federal estate tax, and in subsequent acts, the statute required that there be included in the gross estate the value of property “to the extent of any interest

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236 Generally, a transfer for full consideration is outside the special provisions on lifetime transfers. IRC §§ 2035, 2036, 2037, 2038.
237 United States v. Allen, 293 F2d 916 (10th Cir. 1961). Perhaps this case can be looked upon as not satisfying the bona fide sale requirement of the exception. See supra ¶ 4.08[1][a][i].
238 United States v. Allen, 293 F2d 916 (10th Cir. 1961).
239 See ¶ 4.07[2][b][i]. In some situations the results may have been altered. See discussion of Section 2702 at ¶ 19.03[2].
240 See ¶ 4.07[2][a].
241 See also supra ¶ 4.08[6][d], note 135, for the effective dates of Section 2036(b).
therein of which the decedent has at any time made a transfer...intended to take effect in possession or enjoyment at or after his death." No language such as is now found in Section 2036 was included, but it might appear obvious that the original provision was meant to catch a lifetime gratuitous transfer under which a decedent retained for life the enjoyment of the transferred property. Under such circumstances, certainly, enjoyment by the transferee is deliberately postponed until the decedent's death. Surprisingly, however, in 1930, the Supreme Court held that although a decedent had reserved a secondary life interest in the property transferred to a trust, no part of the value of the trust property was includible in the decedent's gross estate. In 1931, the Court held that the presence of an intervening life interest in the earlier case was not the basis for that decision and that a reservation of an immediate life interest in the settlor with the remainder to named beneficiaries did not result in the trust's inclusion in the gross estate. These decisions apparently rested on the ground that the decedent retained no interest that passed to another at death; the retained life interest simply expired at that time. Congress immediately enacted a joint resolution overruling the Supreme Court decisions. The language now appearing in Section 2036(a) arrived there in part by way of the joint resolution and in part by way of an amendment made June 6, 1932.

In 1938, the Supreme Court ruled that the forerunner of Section 2036 did not apply retroactively to affect transfers effected prior to its enactment. This decision reflects the law in its present form. There was an interim flurry, however, which is no longer of much importance. In 1949, the Supreme Court

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246 46 Stat. 1516 (1931). This joint resolution was enacted the very next day following the decisions by the Court.
247 46 Stat. 1516 (1931). The two periods stated in the joint resolution were “for his life” and “for any period which does not in fact end before his death.”
248 Revenue Act of 1932, Pub. L. No. 72-154, § 803(a), 47 Stat. 169, 279 (1932), adding the third time period “for any period not ascertainable without reference to his death.” Despite the abundance of legislative history, only one court of appeals has accepted the clearly sound proposition that transfers after March 3, 1931, and before June 7, 1932, are includible in the gross estate only if they are within the scope of the joint resolution. Estate of Hubbard v. Comm’r, 250 F2d 492 (5th Cir. 1957). Two courts of appeals have taken the position that a transfer includible only under the 1932 amendment (namely, a transfer where the period was merely not ascertainable without reference to the decedent’s death) was nevertheless includible even though the transfer took place before June 7, 1932. Comm’r v. Estate of Arents, 297 F2d 894 (2d Cir.), cert. denied, 369 US 848 (1962); Bayliss v. United States, 326 F2d 458 (4th Cir. 1964), analyzed in Maxfield, “Federal Estate and Gift Taxation,” 1964 Annual Survey of American Law 199–200.
249 Hassett v. Welch, 303 US 303 (1938).
overruled *May v. Heiner* and held that a transfer with the right to enjoyment retained by the decedent until death was a transfer intended to take effect in enjoyment at death,\(^{250}\) under the original “possession or enjoyment” clause of the statute, in effect nullifying its earlier decisions that the 1931 and 1932 amendments did not apply retroactively.\(^{251}\) Congress was dissatisfied with this result,\(^{252}\) and so, under Section 2036(c), the statute is expressly made inapplicable to transfers made before the critical dates in 1931 and, in some cases, 1932.\(^{253}\) Clearly, this is not a general estate tax amnesty with respect to early transfers; other sections of the Code must still be considered in determining whether the value of property transferred prior to 1931 or 1932 must be included in the gross estate.\(^{254}\)

**¶ 4.09 SECTION 2037. TRANSFERS TAKING EFFECT AT DEATH**

**[1] Introduction**

From the inception of the estate tax, Congress has been concerned that lifetime transfers essentially testamentary in nature might be used as a means to avoid the tax.\(^1\) The earliest statutory obstacle to such avoidance was a provision that included in the gross estate the value of any property interest that was the subject of a lifetime transfer by the decedent “in contemplation of or intended to take effect in possession or enjoyment only at or after his death.”\(^2\) It does not take much imagination to see that the deferred possession or enjoyment aspect


\(^{251}\) Hassett v. Welch, 303 US 303 (1938).


\(^{254}\) See Estate of Thomson v. Comm’r, 495 F2d 246 (2d Cir. 1974), involving the interrelationship between United States v. O’Malley, 383 US 627 (1966), and the effective dates.

\(^1\) See ¶¶ 4.07[1], 4.08[1], 4.10[1].

\(^2\) Sections 2035 through 2038 all have common parentage in this original statutory language. Revenue Act of 1916, Pub. L. No. 64-271, § 202(b), 39 Stat. 756, 777 (1916). A third dimension to the estate and gift tax area should be mentioned: the tax on generation-skipping transfers. See Chapters 12–18.
of this clause is the basic concept expressed in Section 2036. It is also expressive of the philosophy underlying Section 2038, and it is closely akin to Section 2037, here under discussion. Somewhat narrow judicial interpretation of the original possession or enjoyment language prompted Congress to proliferate the concept, creating three substantially more explicit provisions that convey, but in much more detail, essentially the same thought. Of course, the greater detail in the statute reduces judicial flexibility; however, it is not inappropriate to hark back to the original language and its fundamental concept as an aid to interpretation. Section 2037 draws into the gross estate the value of some interests in property that the decedent has transferred conditionally during life. In its present form, the section applies only if:

1. The possession or enjoyment of the property is conditional upon surviving the decedent, and
2. The decedent has retained an interest in the property that may bring the property back to the decedent or to the decedent’s estate or back into the decedent’s power of disposition.

This double test is discussed later in this section, but two statutory exceptions should first be noted.

[2] Excluded Transfers

In common with Sections 2035, 2036, and 2038, all of which concern lifetime transfers by the decedent, Section 2037 is expressly not applicable to a bona fide sale for an adequate and full consideration in money or money’s worth. In addition, but of ever diminishing importance, Section 2037 does not apply to a transfer made on or before September 7, 1916, a rule that excludes transfers made before the first enactment of the federal estate tax. If the decedent has made a transfer that is not covered by one of these exclusionary rules, the general applicability of Section 2037 depends on whether the tests of survivorship and of retention of an interest by the decedent are satisfied. Both tests must be met in order for the section to be applied.

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3 See ¶ 4.08[1][a]. See also ¶¶ 4.07[2][b][i], 4.10[2].

4 As is true under other sections, a transfer not actually made by the decedent may be imputed to the decedent. Estate of Fried v. Comm’r, 445 F2d 979 (2d Cir. 1971), cert. denied, 404 US 1016 (1972); Estate of Bogley v. United States, 514 F2d 1027 (1975); Rev. Rul. 78-15, 1978-1 CB 289 (all involving contractual death benefits payable by a corporation to decedent employee’s surviving widow or to employee’s estate); Estate of Hill v. Comm’r, 229 F2d 237 (2d Cir. 1956). See ¶ 4.08[7].


A characteristic of any testamentary disposition of property is that the testator is dead before the possession or enjoyment of the property by the devisee or legatee begins. This characteristic is adopted as the primary test for attaching estate tax liability to a lifetime transfer under Section 2037. If the transferee of a property interest can get possession or enjoyment (through ownership of the interest transferred) while the decedent transferor is living, Section 2037 does not apply to the transfer. For example, assume that D, more than three years prior to death, transfers property to a trust under the following terms and conditions:

1. The income is to be paid to A for A’s life.
2. Upon A’s death, the corpus is to be distributed to B, if living.
3. If B predeceases A, the corpus is to revert to D, if living.
4. If both B and D predecease A, remainder is to go to R.

Assume, further, that D dies, survived by A and B. Is the property or some part of it includible in D’s gross estate under Section 2037? The answer depends on an analysis of each interest transferred to others—the life interest in A, the contingent remainder in B, and the contingent remainder in R.

It is apparent that A’s life interest, which takes effect in enjoyment immediately, is outside the section; A enjoys that interest without regard to whether D is living or dead. Although slightly less apparent, the same is true of the interest transferred to B. B will get the property upon A’s death if B is then living; and B can get such possession even if D is living. As B need not survive D to get possession, R’s interest fails the primary test for inclusion under Section 2037. R’s interest is in a different posture. R (and anyone taking by virtue of R’s interest) cannot acquire the property until both B and D are dead. As R’s interest cannot take effect in possession until D dies, R’s interest meets the first test of Section 2037.

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5 It is obvious that if B and then A should die before D, the property will return to D and simply be a part of D’s Section 2033 estate unless, before death, D makes some other disposition of it.

6 Note that Section 2033 will include nothing, as D’s reversion is cut off by D’s death. Section 2036 is probably also inapplicable; however, an argument can be made that if D retained a reversionary interest in property, other than one that could only arise after D’s death, during D’s life the property might have reverted to D and D would have retained the right to the income from it under Section 2036(a)(1). Compare the secondary life estate situation under Section 2036(a)(1), discussed at ¶ 4.08[2], text accompanying note 45. Since the transfer was not revocable or otherwise alterable, Section 2038 will not apply; and, even if made within three years of D’s death, Section 2035 would not apply to the interests of A and B. IRC § 2035(a)(2).

7 A further test for taxability is discussed infra ¶ 4.09[4].
Careful congressional use of the terms “interest” and “property” supports the above analysis. It is interests in property transferred by the decedent, under which possession or enjoyment of the property is deferred until the decedent’s death, that are included in the decedent’s gross estate under Section 2037. R’s interest is of that type but the other transferred interests are not; thus, the value of R’s contingent remainder at the time of D’s death is included in D’s gross estate, because the second test is obviously met too.  

It is almost frivolous to mention that R, in this example, could get immediate enjoyment of the property, with D still living, if A transferred A’s immediate income right to R. Is the analysis in error then? Not at all; Congress thought of this, too. Whether an interest escapes the clutches of Section 2037 depends on whether the transferee of an interest can get possession or enjoyment of the property “through ownership of such interest” without surviving the decedent transferor. The fact that R may secure early possession or enjoyment in some other way is immaterial.  

There is one situation in which a transferred interest that cannot itself produce possession or enjoyment until the decedent transferor’s death is placed outside Section 2037, even if the other statutory tests for inclusion are met. If possession or enjoyment could be obtained while the decedent was living by way of the exercise of a general power of appointment over the interest that was exercisable immediately before the decedent’s death, all bets are off under Section 2037.  

The one to whom an interest in question has been transferred need not have the power. In the preceding example, if B had the requisite general power, it would remove R’s contingent remainder from the reach of the section. And it seems equally clear that the general power need not be held by one who has an interest in the transferred property; by adding a general power in E in the example, the section can be avoided.

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8 It would make no difference if A died survived by B the day after D’s death, cutting off R’s contingent remainder unless, for valuation purposes, Section 2032 was elected. See ¶ 4.03[3][b].
9 It is likewise immaterial that the transfer under consideration will, except for the value of D’s retained contingent reversion, be fully subject to gift tax when made. Smith v. Shaughnessy, 318 US 176 (1943). See ¶ 10.01[3][d]. But the gift tax paid will be a Section 2001(b)(2) subtraction in the computation of the estate tax or, if the gift was made before 1977, a credit for gift tax paid may be allowed against the estate tax. Cf. IRC § 2012(e); ¶ 3.04.
10 IRC § 2037(b) (last sentence).
11 Cf. Reg. § 20.2037-1(e), Ex. 6.
12 It should be noted, however, that the statutory exception raises the question whether “any beneficiary” could obtain possession by the exercise of a general power. The quoted phrase is puzzling, because neither the section nor the excepting sentence is limited to trusts, and the term “beneficiary” is not aptly used to indicate owners of successive or contingent legal interests. If the exception is intended to require that someone who has at least some interest in the property might be able to get possession through exercise...
The first test of Section 2037 is precisely phrased to raise the question: Can possession be obtained without surviving the decedent? The question is clearly not whether possession was obtained before the decedent’s death. Thus, a transfer to a trust with provision for accumulation of the income for ten years and then distribution of corpus and accumulated income to a beneficiary seems well outside the section; possession can be obtained (when ten years expire) before the decedent’s death. The decedent’s death within the ten-year period does not make the section applicable.

The same may be said in general of alternative contingencies under which possession may be obtained. For example, if an accumulation trust was to terminate after ten years or upon the settlor’s death, whichever occurred first, the primary test of Section 2037 would again not be met. Possession could be obtained after ten years, even if the settlor is still living. Suppose, however, termination were to occur upon the death of the settlor A, or twenty years after the death of X (life expectancy forty years at the time of transfer), whichever came first. If A is ninety years of age at the time of the transfer, the termination contingency that is an alternative to A’s death could hardly be taken seriously. The Treasury expressly refuses to take it seriously, indicating in the regulations that if an alternative contingency is “unreal” and if the decedent’s death does precede it, the transfer will be considered one taking effect only at

of a power, not just any general power over the property will defeat the section. For example, if E in this illustration could appoint only to E’s estate, E’s power would be a general power (IRC § 2041(b)); but no one with an interest in the property (no “beneficiary”) could obtain possession by way of an exercise of the power. This seems too narrow a view of the exception, and perhaps, the phrase “any beneficiary” should be ignored. See HR Rep. No. 1412, 81st Cong., 1st Sess. 9 (1949), reprinted in 1949-2 CB 295, 299, which omits the phrase. If Congress abhors estate tax ownership in the transferor here, where under Section 2041 another is simultaneously the estate tax owner of the entire property, why is this policy not more generally expressed in the statute?

It is quite possible that a decedent will have made a transfer generally within the scope of Section 2037 but will have given a third party a general power, not to appoint the entire property, but only to appoint the property after termination of another’s interest, such as a power to appoint the remainder of a trust after termination of an interest for a term. This should be viewed as a power to appoint “the property,” and, if it is exercisable immediately before the decedent’s death and extends to the very interest otherwise included under Section 2037, it should render the section inapplicable. “Property” is sometimes used in the Code to mean an interest in property. Cf. IRC § 2503(c); Comm’r v. Herr, 303 F2d 780 (3d Cir. 1962).

The concept of Section 2036, regarding a “period which does not in fact end before” the decedent’s death, is not adopted in Section 2037.

Since enactment of the Tax Reform Act of 1969, it may be less realistic to talk of accumulation trusts. See IRC §§ 665, 666, 667, 668, concerning income tax consequences of accumulation distributions. See also IRC § 2601, taxing generation-skipping transfers, discussed at Chapter 12.

Reg. § 20.2037-1(b).
the death of the decedent. With regard to this illustration, however, the regulations do not purport to deal with a situation in which possession or enjoyment is not geared at all to the decedent’s death. Suppose, in the above example, the trust was simply to terminate twenty years after the death of X, whether A, the settlor, died earlier or not. The transfer still should be considered within Section 2037; the case is not realistically distinguishable from the alternative contingency situation, although in that situation possession or enjoyment will be accelerated to the date of A’s death.

Although it may seem contrary to the statutory language, Section 2037 can apply to a case in which the transferee gets both possession and enjoyment of the property at the time of the transfer. If A transfers property to B for life, reversion to A, but provides that if A predeceases B, B shall take the property in fee simple at A’s death, Section 2037(a)(1) is satisfied. Here it is necessary to recognize that B receives two interests, the life estate and a contingent remainder. The life estate does not depend on A’s death for enjoyment and is outside Section 2037. But possession and enjoyment of the property under the remainder interest cannot be obtained except “by surviving the decedent.”

The same result follows if B in the example is given a remainder subject to a condition subsequent (B’s death prior to that of A) that would defeat the remainder. Under the present statute at least, these principles are sound, but

16 See also Reg. § 20.2037-1(e), Ex. 5.
17 To meet the second test of the statute, it may be assumed that upon termination the corpus is to be distributed to Y, if living, and, if not, to A or A’s estate.
18 This is where the original language, “intended to take effect...at or after...death” should be remembered. Although “intended” has been interpreted to raise no question of subjective intent (Estate of Spiegel v. Comm’r, 335 US 701 (1949)), the natural consequence of the transfer considered is to defer enjoyment until after A’s death. If, until death, A has retained the requisite reversionary interest (IRC § 2037(a)(2), discussed infra ¶ 4.09[4]), Section 2037 should apply. Possession or enjoyment is attainable only by surviving the decedent, and then some. Shukert v. Allen, 273 US 545 (1927), deciding against inclusion under the early “possession or enjoyment” clause where there was a similar postponement of enjoyment, is not contrary authority, as the decision seems to turn on the lack of any retained interest by the decedent transferor. Nor would it seem relevant under the present statute that the transfer is “unaffected by whether the grantor lives or dies.” See Estate of Spiegel, supra, at 705, if it is clear that “possession or enjoyment...can...be obtained only by surviving the decedent.”
20 Helvering v. Hallock, 309 US 106 (1940). For a time the law was otherwise (Helvering v. St. Louis Union Trust Co., 296 US 39 (1935); Becker v. St. Louis Union Trust Co., 296 US 48 (1935)), seemingly on the theory that in such circumstances no interest passed from the decedent at death; the decedent’s possibility of reversion simply expired. This was also the reasoning supporting the surprise decision in May v. Heiner, 281 US 238 (1930), subsequently overruled by statute. See Roberts, J., dissenting in Helvering v. Hallock, 309 US 106, 123 (1940); Reinecke v. Northern Trust Co., 278 US 339 (1929) (questioned in Estate of Spiegel v. Comm’r, 335 US 701 (1949)). See also ¶ 4.08[9].
they may be subject to misapplication. In *Estate of Thacher v. Commissioner*, D created a trust with income payable to his wife for her life, with remainder over to others. However, the trust instrument also provided that if his wife pre-deceased him, or in case of their legal separation or divorce, the corpus was to be returned to D. It also provided that upon the wife’s remarriage after the death of D, her life interest would terminate and the corpus would be distributed to the remainderperson. It is clear, on these facts, that the transferred interests that followed the wife’s life interest meet the test of Section 2037(a)(1), because as long as D was alive, the property would revert to him upon the wife’s death. When D died survived by his wife, however, the litigated issue concerned includability of the wife’s income interest. Contrary to the court’s decision in *Thacher*, her enjoyment of that interest is no way dependent upon her surviving the decedent. Its full enjoyment can be secured by her not divorcing the decedent while he is living and by not remarrying after his death. His death merely eliminates the divorce condition. If it is suggested that he might divorce her while living, it still must be said that she can fully enjoy the interest if he does not do so. Thus, while it is true that one who has immediate enjoyment of property may also have an interest within the scope of Section 2037(a)(1), *Thacher* is not such a case. The decision is wrong.

**[4] Retention of Reversionary Interest**

Even if the survivorship requirement is met, nothing will be included in the decedent’s gross estate unless the decedent retained a reversionary interest in the property transferred as required by paragraph (2) of Section 2037(a).

Questions of how the interest was retained and of what the value of the inter-

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22 In Estate of Thacher v. Comm’r, 20 TC 474 (1953), acq. 1954-1 CB 7, the wife’s interest could be said to be enjoyable only by surviving the decedent if he could terminate it any time in his absolute discretion. He could, of course, have terminated it by obtaining a divorce. At the time of *Thacher*, however, no-fault divorce did not exist, and consequently, she would have had to provide him with grounds for obtaining a divorce. Hence, her full enjoyment would be assured by not giving him grounds for divorce. If *Thacher* had occurred today, under a no-fault divorce jurisdiction, the result should still be the same. As a practical matter, a life interest should not be considered conditional if a transferor would have to give up his wife to reacquire the property.

23 In Estate of Thacher v. Comm’r, 20 TC 474 (1953), acq. 1954-1 CB 7, the Tax Court puts misplaced reliance on Helvering v. Hallock, 309 US 106 (1940). None of the three cases litigated nor the three others principally discussed there dealt with the *Thacher* problem. Instead, in each instance, the life interest transferred was assured, but whether the life beneficiary obtained a larger interest was conditional upon her surviving the decedent.

24 The Tax Reform Act of 1986 Act imposed a similar 5 percent reversionary test for purposes of the *Clifford* trust income tax reversionary rule. IRC § 673(a). Tax Reform Act
est was, both of which may bear on the final decision whether the section applies, are discussed next. The first problem is determining what constitutes a "reversionary interest," as the term is used in the statute.

[a] Definition of "Reversionary Interest"

Under Section 2037(b), the term is defined to include the possibility that the property may return to the decedent transferor, as well as the possibility that it may return to the decedent’s estate. It should be noted that this requirement is satisfied by the existence of the possibility; it is not necessary to show the property will return. Even if the possibility ends with the decedent’s death, the decedent has retained the requisite interest long enough within the statutory concept. For example, if D transferred property to a trust providing that the income be paid to B for life and that upon B’s death the corpus be distributed to D if living and, if not, to C or C’s estate, D has the requisite reversion even though it is cut off by D’s death if D is survived by B. Moreover, the term is further defined to include the possibility that the property may become subject to a power of disposition by the decedent, even though the property could not return to the decedent or the decedent’s estate as beneficial owner. The decedent has been held to have retained a reversionary interest if, after the decedent’s death, the property might go into a trust set up under the decedent’s will. The Commissioner’s contention that a contingent power that could not be exercised to benefit the decedent or the decedent’s creditors constitutes a reversionary interest has been judicially approved.

26 Costin v. Cripe, 235 F2d 162 (7th Cir. 1956); Estate of Klauber v. Comm’r, 34 TC 968 (1960), nonacq. 1964-2 CB 8. These cases have the potential of vastly increasing the scope of Section 2037, although there is a broad overlap with the other grantor provisions. In Costin v. Cripe, the decedent created a trust under which he retained the right to the income for his life, after which provision was made for payment of the income to A and B for their joint lives, with a remainder to C or C’s estate. Because the transfer was made in 1923, Section 2036 did not apply. See IRC § 2036(c). The decedent also retained a special power of appointment over the remainder, exercisable if he survived A and B. The court included the value of C’s interest in the decedent’s estate under Section 2037 when the decedent predeceased A and B. Note that Section 2038, as well as Section 2036, would be inapplicable as, at the time of his death, the decedent had no power to change interests. See ¶ 4.10[8], text accompanying note 81. However, Section 2036(a)(2), if applicable, would arguably include C’s remainder interest. If the trust provided income to A and B for their joint lives with a special power in the decedent at any time to appoint the remainder and, on failure of appointment, remainder to C, Sections 2037, 2038, and likely Section 2036(a)(2), would all apply to include the remainder interest. In Klauber, supra, the decedent created a trust with income to A and a remainder to B, with the decedent indirectly retaining the cumulative power to invade corpus up to $4,000 per year for A’s Section 2037
In any event, at the time the decedent made the transfer, the decedent must have retained the interest or right that may bring the property or power of disposition back. If a decedent provided in a lifetime trust instrument that upon termination of the trust, the property was to go to the decedent’s spouse or the spouse’s estate, should the decedent be held to have a reversionary interest in the property on the ground that the decedent might be entitled to share in the spouse’s estate? Viewed superficially, there is a possibility that the decedent will get the property or part of it at the spouse’s death, which may seem to satisfy the statutory requirement. However, the possibility should not be regarded as “retained” by the decedent any more than one might be said to “retain” a reversionary interest in property transferred outright to any near relative on the ground that upon the transferee’s death, the transferor might be entitled to or hope to share in the estate. In other words, the statutory requirements should not be regarded as being satisfied unless the condemned possibility arises directly out of action by the decedent. The Treasury has now accepted this line of reasoning.

In contrast to the foregoing situation, a decedent might properly be regarded as having retained a reversionary interest, by operation of law, if the decedent provided for distribution of the trust corpus “to such person or persons who would be entitled thereto under the intestate laws of the State” as if the life beneficiary owned the trust property outright at death, if the decedent was among such persons. Under such circumstances, however, if the decedent ever got the property, the decedent would receive it because of rights re-

benefit. It was held that Section 2037 applied to the value of $4,000 multiplied by the number of years of the decedent’s life expectancy immediately prior to his death. In contrast, in Estate of Valentine v. Comm’r, 54 TC 200 (1970), the trustees were required to pay the decedent settlor $150,000 annually from the corpus. In applying Section 2037, the court included the entire value of the trust in the decedent’s gross estate, since the possession or enjoyment of the corpus could be obtained by the remainderperson only by surviving the decedent. Klauber was distinguished on the ground that the decedent’s power of invasion in Valentine embraced the entire corpus, because the large amounts that were required to be paid out annually could have depleted the trust.


These interests [reversionary interests], whether expressed in the instrument or arising by operation of law, must be distinguished from expectancies. See Restatement, Property c. 24 (1936). Where the settlor is a blood relative of the remainderman, he may conceivably re-acquire the trust property as an heir of the remainderman. But the settlor will not take under the terms of the trust instrument; he will receive the trust property not from the trustees, but from the executor or administrator of the remainderman’s estate, subject, for example, to prior payment of the remainderman’s debts.

28 See Comm’r v. Estate of Marshall, 203 F2d 534, 535 (3d Cir. 1953), decided in favor of the estate on other grounds.
served by inference in the trust instrument; the decedent would receive it from the trustees, and it would not be subject to the debts of the deceased life beneficiary; nor could the decedent’s rights be defeated by some other dispositive provision in the life beneficiary’s will.

Subsection (b) of Section 2037 specifies that the term “reversionary interest” does not include a possibility merely that the income from property or the power to designate who shall have the income may return to the decedent. The consequences of retention of such possibilities must be considered under Section 2036.29

[b] How the Interest Is Retained

Regarding the manner in which the reversionary interest arises, the statute differentiates transfers on or after October 8, 1949, from those made earlier. In the case of earlier transfers, only reversionary interests that arise “out of the express terms of the instrument of transfer” are to be taken into account. The effect and purpose of this parenthetical provision is to disregard any such interest that arises only by operation of law.30

Incomplete provision for distribution of the corpus of a trust, which fails to take into account all contingencies, might, by operation of local law, leave the decedent with a possibility of reverter.31 With respect to pre-1949 transfers, this reversionary interest arising by operation of law does not satisfy the retained interest requirement. With regard to transfers made on or after October 8, 1949, however, the requisite reversionary interest need not be expressly retained; it is enough if it arises by operation of law. Accordingly, the “express” requirement is not a factor in present-day drafting.

[c] Negligible Reversionary Interests

The value of the reversionary interest is not the amount to be included in the gross estate. The statute requires valuation of that interest only to determine whether Section 2037 applies at all. If it does, the amount to be included has no connection with the value of the reversionary interest.

A reversionary interest retained by the decedent does not meet the requirement of paragraph (2) of Section 2037(a) unless its value, immediately before the decedent’s death, exceeds 5 percent of the value of the transferred

29 A complementary Section 2036 rule appears at Regulations Section 20.2036-1(b)(3).
30 Section 811(c)(2) (1939) expressly excluded such interests arising “by operation of law.”
31 Cf. Reg. § 20.2037-1(e), Ex. 5.
property. This is congressional acceptance of the de minimis principle rejected by the Supreme Court in a case that did much to shape the present statutory language; if the reversionary interest retained is inconsequential, it is ignored.

[d] Mortality Tables and Actuarial Principles

Section 2037(b) provides that in undertaking to value the decedent’s reversionary interest for the purpose of determining the applicability of the section, the fact of the decedent’s death is to be disregarded and usual valuation methods are to be employed, including the use of gender-neutral mortality tables and actuarial principles. Under these tables and principles, the state of a decedent’s health immediately prior to death is disregarded. Controversy has developed around the question whether mortality tables and actuarial principles may be used as the sole determinants of value or whether the decedent’s physical condition before death should also be taken into account.

e] Decedent’s Physical Condition

The Tax Court and the Treasury have recognized that to take account of physical condition just before death, whether or not the physical condition involves a terminal illness, would largely nullify the statute. Yet, one court has allowed the decedent’s physical condition immediately prior to death to be

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32 As explained earlier (see supra ¶ 4.09[3], text accompanying note 10), a general power over property otherwise taxable under Section 2037 may render the section inapplicable. It would seem that even an outstanding nongeneral power could have that effect if it bore on the possibility of the property’s returning to the decedent or his estate in such a way as to reduce the value of that possibility to less than 5 percent of the value of the property. Cf. Rev. Rul. 67–370, 1967–2 CB 324.


34 Reg. § 20.7520–3(b)(3)(ii) (last sentence).

35 See Estate of Roy v. Comm’r, 54 TC 1317, 1322–1323 (1970), citing the second edition of this treatise, wherein the court stated: “A drastically foreshortened actual life expectancy would bring any retained reversion below the 5 percent level. Section 2037 would then be applicable only in cases of sudden death.” Reg. § 20.7520–3(b)(3)(ii) (last sentence). See also Robinson v. United States, 632 F2d 822 (9th Cir. 1980); Estate of Jones, Jr. v. Comm’r, 36 TCM (CCH) 380 (1977); Rev. Rul. 80–80, 1980–1 CB 194, and Rev. Rul. 66–307, 1966–2 CB 429 (last paragraph) (both rulings taking this position but declared obsolete for the estates of decedents dying after December 13, 1995, in Rev. Rul. 96–3, 1996–1 CB 348, in view of the promulgation of Regulations Section 20.7520–3(b)(3)(ii) (last sentence)).

36 Hall v. United States, 353 F2d 500 (7th Cir. 1965). Arguably, the statutory provision authorizes the Treasury by regulation to specify usual methods of valuation, including mortality tables and actuarial principles, and, under the provision in question, it could be
considered in valuing her reversion, on the basis that Section 2037(b), providing for valuation “by usual methods of valuation, including the use of gender-neutral tables of mortality and actuarial principles,” does not require valuation to be determined in all cases solely by reference to mortality and actuarial tables. The Tax Court and Treasury approach have such strong policy support that even though it stretches the statute, it should prevail.

[F] Application of the 5 Percent Test

If physical condition is ignored, in general, application of the 5 percent rule becomes primarily a determination of the decedent’s mathematical chances, on the basis of age just prior to death, of surviving some contingency or contingencies. An extreme set of facts may illustrate the problem. Suppose the decedent transferred property in trust to pay the income to the decedent’s children for the decedent’s life and, in the case of death of any child prior to the decedent’s death, to pay that share to the child’s children or, if the child has none, to the decedent’s other children, and with the further provision that upon the decedent’s death, the corpus be distributed in the same manner but that if no child or grandchild survived the decedent, the trust corpus be paid over to the decedent’s estate. This is a transfer taking effect at death under which the decedent has retained a reversionary interest. However, if the decedent was survived by numerous children and grandchildren, the decedent’s chances, as of the moment before death, of surviving all of them would be negligible. In substantially similar circumstances, the Supreme Court has recognized that a reversionary interest of the decedent in a $1 million trust might at death be worth as little as $70. As $70 is only a small fraction of one percent of $1 million, the 5 percent test would not be met.

Complexities in a trust instrument that may make it very difficult to value a reversionary interest do not foreclose application of the section. The legislative history of the 1954 Code indicates that a reversionary interest is not to be regarded necessarily as having no value because the value cannot be measured precisely. However, there is a point at which a reversionary interest becomes so remote that it will simply be accorded a zero value.

37 Hall v. United States, 353 F2d 500, 503 (7th Cir. 1965).
39 If a special factor is required to ascertain the value of a reversionary interest, the personal representative of the decedent’s estate may get it from the Service. See Reg. §§ 20.2037-1(c)(3), 20.2031-7(d)(4).
Base for the 5 Percent Test

It is clear from the forerunner of Section 2037 that “in determining whether the value of the reversionary interest exceeds 5 percent, it is to be compared with the entire value of the transferred property, including interests that are not dependent upon survivorship of the decedent.”

Accordingly, in the foregoing example, the value of the life estate is not subtracted from the value of the corpus for the purpose of the 5 percent test, even though its value is ultimately excluded from the gross estate as a separate interest not subject to survivorship and not taxable.

If a decedent retains a reversionary interest in only one half of the trust corpus, the value of his or her reversionary interest will be compared with the value of one half of the trust corpus.

Recall that the possibility the transferred property may become subject to a power of disposition by the decedent, even though such a disposition cannot operate to the decedent’s financial benefit, is included within the definition of the term “reversionary interest.” Valuation of such an interest is to be made just as if that possibility were in fact a possibility that the property may return to the decedent.

Pre-Death Termination of Reversion

A transfer made by the decedent during life, which would at the time of transfer meet the general tests for liability under this section, nevertheless will not result in tax includability unless the tests are also met at death. The requirement that the decedent’s reversionary interest “immediately before death” exceed 5 percent of the value of the property suggests that if the decedent’s reversionary interest was extinguished prior to death, nothing would be includible in the decedent’s estate under Section 2037. This conclusion was reached under prior law, under less compelling circumstances, where the decedent’s reversionary interest was cut off before the decedent’s death by an event over which the decedent had no control. However, if the transferor relinquished the transferor’s prescribed reversionary interest within three years of death,

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43 Reg. § 20.2037-1(c)(4). It should be noted that the value of the reversionary interest and the corpus are determined an instant before the decedent’s death. Therefore, the fact that the decedent’s executor elects the alternate valuation date is of no significance in applying the 5 percent test. Reg. § 20.2037-1(c)(3).
44 IRC § 2037(b) (third sentence). See Costin v. Cripe, 235 F2d 162 (7th Cir. 1956).
45 Estate of Matthews v. Comm’r, 3 TC 525, 539 (1944), acq. 1944 CB 19.
The problem is similar to that discussed earlier in connection with Section 2036. The discussion is not extended here, except to suggest that numerous such problems seem to call for congressional attention.

[6] Amount to Be Included

To recapitulate briefly, Section 2037 will apply if, after September 7, 1916, the decedent has made a transfer of property to take effect only at or after the decedent’s death and has retained a reversionary interest in such property (perhaps expressly) that has a value just before the decedent’s death in excess of 5 percent of the value of the property transferred. The remaining question is: What is to be included in the gross estate when Section 2037 is applicable? As previously explained, reference to the value of the decedent’s reversionary interest can be wholly misleading; valuation of that interest is undertaken only to determine the applicability of the section and bears no relation to the value to be included in the gross estate if the section is applicable. It is not the value of the decedent’s reversionary interest that is to be included in the gross estate under Section 2037.

Somewhat obscured by detail, the rule of Section 2037 is that the gross estate shall include the value at the date of death (or as determined under the alternate valuation provisions of Section 2032) of any interest in property that has been transferred in such a way as to take effect in possession or enjoyment at or after the decedent’s death, subject, of course, to all the qualifications discussed here. Thus, in order to ascertain the amount to include in the gross estate it is necessary to identify the taxable interests and then to value them. Two examples will illustrate this. Suppose the decedent, D, transferred prop-

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46 IRC § 2035(a). The relinquished reversionary interest would have to be reconstructed and artificially valued at death for purposes of applying the 5 percent test, which must be met immediately prior to death for Section 2035 to be applicable. Rev. Rul. 79-62, 1979-1 CB 295. Cf. United States v. Allen, 293 F2d 916 (10th Cir. 1961).

47 See ¶ 4.08[8][b].

48 In Estate of Klauber v. Comm’r, 34 TC 968 (1960), nonacq. 1964-2 CB 8, the decedent settlor acting with another nonadverse party could only direct $4,000 annual payments of principal to those who were the income beneficiaries. The value of such prospective distributions exceeded 5 percent of the value of the trust corpus at the decedent’s death. Only $31,280, the value of the portion of the trust deemed subject to the power, was included; the balance of the trust property was held not to have been transferred conditionally. Compare Estate of Valentine v. Comm’r, 54 TC 200 (1970), where a similar power to invade for the decedent was deemed substantial enough to encompass the entire corpus, and Klauber was distinguished. Cf. Rev. Rul. 66-87, 1966-1 CB 217, construing Section 2041(b)(2)(B) (powers of appointment), discussed at ¶ 4.13[7][f], text accompanying note 111.

Section 2037
A trust property in trust providing that the income from the trust be paid to D's spouse during D's life and upon D's death the corpus be paid over to D's spouse, if living, and if not, to D's estate. D's spouse survives D. Assuming that D's chance of surviving the spouse just before D's death was such that the value of D's reversionary interest exceeded 5 percent of the trust corpus, the amount to be included in D's estate is the entire value of the trust property, for that is the value of the interest that has been transferred by D that is to take effect in possession or enjoyment at D's death.\(^{49}\)

However, as just suggested, if one inter vivos transaction involves the transfer of more than one interest in the same property, each such interest must be viewed separately to determine the amount to include in the gross estate under Section 2037. Suppose D transferred property to a trust providing for the payment of the income from the trust to D's spouse, S, for S's life and upon S's death for distribution of the corpus to D, if living, and if not, to child, C, or C's estate. Assume C and S survive D. Here, it will be observed, the income interest passing to S is in no way dependent upon D's death, for S gets immediate enjoyment to continue for S's life, whether D lives or dies. The value of S's interest, accordingly, is not included in D's gross estate under Section 2037.\(^{50}\) However, neither C nor the beneficiaries of C's estate can get possession or enjoyment through ownership of the remainder interest except by surviving D. Therefore, the value of the remainder interest will have to be included in D's gross estate upon D's death. Stated differently, Section 2037 requires in this situation that the entire value of the trust corpus, less the value of S's outstanding life estate, be included in D's gross estate.

If, instead, the trust had provided for income to S for S's life and, upon S's death, distribution of one half of the corpus to D if living and, if not, to C or C's estate and for the other half of the corpus to pass at S's death to grandchild, GC, or GC's estate, then only one half of the value of the corpus less one half of the value of S's outstanding life estate would be included within D's gross estate under Section 2037.\(^{51}\)

The Supreme Court has expressed the rule now found in Section 2037 in this way: “The value of the property subject to the contingency, rather than the actuarial or theoretical value of the possibility of the occurrence of the contingency, is the measure of the tax.”\(^{52}\)

\(^{49}\) Costin v. Cripe, 235 F2d 162 (7th Cir. 1956).


\(^{51}\) Cf. Reg. § 20.2037-1(c)(4), and note that the 5 percent reversionary interest test is based on the value of the decedent’s reversionary interest in relation to the value of one half of the corpus. See supra ¶ 4.09[4][g], text accompanying note 43.

\(^{52}\) Fidelity-Philadelphia Trust Co. v. Rothensies, 324 US 108, 112 (1945).
[7] Background of the Section

As indicated at the outset of this discussion, the first federal estate tax statute contained a provision that included in the gross estate the value of any interest in property that had been the subject of a gratuitous lifetime transfer by the decedent “intended to take effect in possession or enjoyment at or after his death.” The administrative, judicial, and legislative proliferation of this language involves a story too long and complex to be presented here even in broad outline, but mention of a few high points may aid in understanding the present section.

The current survivorship requirement is discernible in the original language, in the preceding quote. If “intended” was ever supposed to be important in the sense of actual motive, the Supreme Court obliterated that word in 1949 by holding that the subjective intent of the decedent was irrelevant. So, in retrospect at least, the basic test for liability under the “possession or enjoyment” provision has always been approximately the same as the present explicit survivorship test. No other test appeared expressly in the statute until 1949, but in 1929 the Supreme Court had found that a second test was implicit: Did the decedent retain an interest in the property until death?

From this it can be seen that the twofold test, explicit in Section 2037, developed out of the original language concerning transfers “intended to take effect in possession or enjoyment at or after...death.” Recent developments have largely centered around the retained-interest requirement. In 1949, the Supreme Court indicated, though it did not squarely hold, the statute did not require that an interest be retained by the decedent, and thus suggested abandonment of a rule that had been accepted for twenty years. The same year, Congress adopted that judicial pronouncement as the statutory rule for future transfers, keeping and embellishing the old retained-interest rule for transfers.

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56 Reinecke v. Northern Trust Co., 278 US 339 (1929). The notion at that time was that the estate tax was not intended to apply to property unless some interest in it passed from the decedent to others at the time of his death. Cf. May v. Heiner, 281 US 238 (1930). See Roberts, J., dissenting, in Helvering v. Hallock, 309 US 106 (1940).
before October 8, 1949. The present section reflects a full return to the retained-interest requirement and a “value” test, added at first only with respect to pre-1949 transfers in the 1949 legislation. With regard to the earlier transfers, a reversionary interest continues to be significant only if expressly retained.

To summarize, differentiation of transfers on or after October 8, 1949, from those made earlier on the basis of express reservation of a reversionary interest is traceable to the 1949 legislation, which first established the express reservation requirement regarding earlier transfers.

As a practical matter, Section 2037 currently rarely applies to a decedent’s estate. Prior to 1987, Section 673 of the income tax allowed an assignment of income if a grantor retained a reversionary interest only after a ten-year period. Such ten-year trusts were a commonly employed assignment of income vehicle; but if the decedent died within the ten-year period, Section 2037 was frequently triggered. However in 1987, Section 673(a) of the grantor trust provisions was amended to largely parallel Section 2037 of the estate tax. Under current Section 673(a), if a grantor retains a reversionary interest in a trust whose value is greater than 5 percent of the interest in which a reversion is retained, the trust income is generally taxed to the grantor of the trust. Thus, if a grantor is intending to assign income to another person, a 5 percent reversion cannot be retained. As a result, Section 673(a) is rarely used to attempt to assign income from a trust, and consequently Section 2037 is rarely triggered.

¶ 4.10 SECTION 2038. REVOCABLE TRANSFERS

[1] Introduction

If, as Webster’s tells us, to “revoke” means to “recall,” Section 2038 is very badly named. It is by no means limited in its reach to a decedent’s lifetime transfers that may be recalled; transfers that are “revocable.” It might better be named “alterable transfers”; for a decedent’s power to change the enjoyment of

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60 See IRC §§ 671–679.

61 But see IRC § 673(b).
transferred interests may invoke the section, even though the power cannot be exercised for the decedent’s own benefit. Here again, however, it may be misleading to speak in terms of a power in the decedent, because the section sometimes applies when, although there is a nominal power in the decedent to change transferred interests, as a practical matter the decedent has no power at all. It is hoped these mysteries are dispelled in the pages that follow, but a further introductory word about the section is in order.

As Sections 2035 through 2038 all have common parentage, all share certain characteristics. Each applies only to interests in property that have been transferred by the decedent. However, in each instance another’s transfer may be imputed to the decedent. In fact, although the problem is included in the previous discussion of Section 2036, it was a revocable transfer case under the forerunner of Section 2038 that first introduced the concept of reciprocal or crossed trusts. Moreover, the common parentage of the transfer sections causes them to overlap substantially, and this is especially true with respect to Sections 2036 and 2038. Indeed, a close analysis will show that it is difficult to find circumstances in which Section 2038 applies that are not also covered by Section 2036, sometimes with more onerous consequences. When two or more of the transfer sections are applicable, obviously the Commissioner quite properly will apply that section or combination of sections requiring the maximum inclusion in the decedent’s gross estate. Although the transfer sections are discussed seriatim in this book, it is always necessary to keep an eye on the other sections that are not the subject of immediate consideration as well as those on the generation-skipping transfer tax.

**[2] Excluded Transfers**

All the transfer sections, including Section 2038, are made inapplicable to “a bona fide sale for an adequate and full consideration in money or money’s

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1 All are traceable to the original statutory language concerning transfers “in contemplation of or intended to take effect in possession or enjoyment at or after death.” Revenue Act of 1916, Pub. L. No. 64-271, § 202(b), 39 Stat. 756, 777 (1916).

2 See, e.g., Comm’r v. Estate of Hagar, 173 F2d 613 (3d Cir. 1949) (taxing one half of the value of a trust to which decedent and wife had each made like contributions); Estate of Levin v. Comm’r, 90 TC 723 (1988) (transfer by decedent’s controlled corporation was imputed to decedent). But see Rev. Rul. 74-556, 1974-2 CB 300 (holding that an elective transfer under Section 2513 does not constitute a transfer for purposes of Section 2038); Estate of Folks v. Comm’r, 43 TCM (CCH) 427 (1982) (holding Section 2038 inapplicable because the decedent did not make a transfer of the property over which he held custodial powers).

3 Lehman v. Comm’r, 109 F2d 99 (2d Cir.), cert. denied, 310 US 637 (1940). See ¶ 4.08[7][d].

4 See the comparison of the provisions infra ¶ 4.10[10].
worth." On the other hand, since Section 2038 involves transfers that are subject to change, it is unlikely in transactions within its scope that a transferee will have paid consideration for the transferred interest.

In effect, the last sentence of Section 2038(a)(2) excludes from the provisions of Section 2038(a)(1) transfers made before June 22, 1936. There are four differences between paragraphs (1) and (2) that are traceable to amendments made in 1936 to the revocable transfer provision, but even so, the differences in the two paragraphs are more apparent than real. First of all, the pre-1936 language “alter, amend, or revoke” was changed to read “alter, amend, revoke, or terminate.” This has been held to be merely declaratory of prior law and not a substantive change in the statute. Similarly, the addition of the parenthetical phrase “in whatever capacity exercisable” has been deemed a mere clarifying amendment, and therefore these two formal differences in the two paragraphs may be disregarded. However, to overcome the result of a Supreme Court decision, Congress added the further parenthetical phrase, “without regard to when or from what source the decedent acquired such power.” Congress also made a change regarding the consequences of the relinquishment of some proscribed powers. These two substantive changes are taken into account in the discussion that follows, but it is unnecessary to present a full, separate discussion of the two paragraphs.

### [3] Any Change in Enjoyment

A key to the section is the question whether the enjoyment of an interest in property transferred by the decedent during life is subject to “any change” at the decedent’s death. A further question is whether the possible change may be brought about by the decedent through the decedent’s exercise of “a power.” First, a word about the kind of possible change that taints a lifetime transfer.

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5 See ¶ 4.08[1][a].
9 See Reg. § 20.2038-1(e)(2). Cf. IRC §§ 2035(a)(2), 2035(e); infra ¶ 4.10[8], text accompanying notes 89–93. Of course, the transfer in issue must occur prior to the relinquishment of the decedent’s power (or decedent’s death), otherwise the transfer will be outside the scope of Section 2038. Estate of Halpren v. Comm’r, 70 TCM (CCH) 229 (1995) (Sections 2038 and 2041 are mutually exclusive; Section 2038 relates to the powers of a grantor while Section 2041 relates to the powers of the grantee).
It is obvious that if the decedent could until death take back property that the decedent has transferred, the interests given to others would be dramatically subject to change, that is, to elimination. A similarly dramatic potential change can exist even if the decedent cannot take the property back. For example, if $D$ transfers property in trust, income to $A$ for life and remainder to $B$ or $B$'s estate, but reserves the right to invade corpus for the benefit of either $A$ or $B$, invasion for the benefit of either tends to defeat the enjoyment of the interest of the other; and so both interests are subject to change within the meaning of the section.

In other circumstances, the question becomes more subtle. Suppose instead that $D$ may invade corpus only for the benefit of $A$. $B$'s interest is clearly threatened by such a power of invasion and may indeed be cut off. The question is whether $A$'s interest is likewise subject to change. The Treasury's position is that if the "time or manner" of enjoyment of an interest may be altered, the interest is subject to change. It might appear that $A$'s interest is within that concept, but it is not. In all events, $A$ has a present right to the income from the property that will continue for $A$'s life. It may be said that if $D$ turns the entire corpus over to $A$, the "manner" of $A$'s enjoyment of $A$'s interest will be changed (from life beneficiary to outright owner); but if the regulation was intended to suggest that this is a tainting potential change, it would be in error.

It is necessary to consider closely the nature of the interests involved. In effect, the entire ownership of the property is divided in a time sense between $A$ and $B$. $A$ has a present interest enjoyable from the outset; $B$ has a future interest. If $D$ could shift the future interest of $B$ only to $C$, no one would argue that $A$'s interest was subject to change. The situation is no different with regard to $A$’s lifetime income interest if the future interest can be shifted to $A$. $A$ will still have the right to the income for life, albeit as outright owner rather than as life beneficiary. Actually, this analysis is in accord with a judicial decision and current administrative practice. Indeed, the example in the regulations following the "time or manner" expression is not at variance with the conclusion suggested.

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10 Reg. § 20.2038-1(a).
11 Cf. IRC § 2503(b)(1) (last sentence).
12 Walter v. United States, 341 F2d 182 (6th Cir. 1965). See Estate of DuCharme v. Comm'r, 164 F2d 959, 963 (6th Cir. 1947), aff'd on reh'g, 169 F2d 76 (6th Cir. 1948).
14 See the example at Regulations Section 20.2038-1(a), in which $A$'s income interest is additionally subject to change because the grantor reserved the right to accumulate income.
On the other hand, a possibility of mere acceleration of enjoyment is a potential change that is within the section. Thus, if a trust gave A the right to the income for ten years and the remainder at the end of that time, but the settlor could terminate the trust earlier and turn the corpus over to A or A’s estate, it might seem that A was in effect the sole owner of the property, as A had all the interests in it. Still, except for A’s ten-year income interest, the time and manner of enjoyment of A’s other interest in the property remains within the settlor’s control and thus remains subject to “change.” It may be said that any change will merely benefit A, because at worst A will become the outright owner of the property sooner than expected. But there is nothing in Section 2038 stating that the threatened change in an interest must be adverse for the section to apply. The thought is that if the decedent kept a hand on the property until death, even by a right to accelerate the enjoyment of an interest, the transfer is so much akin to testamentary disposition that the affected interest should be subject to estate tax. Some further facets of the question of potential change emerge in the next segment of this discussion, which considers whether the decedent has the prescribed power to effect a change.


The scope of this section can best be understood by a recognition of the fact that almost any authority in the transferor to tamper with the enjoyment of interests transferred during life constitutes a proscribed power to “alter, amend, revoke, or terminate.” Because the statute is framed in terms of the disjunctive “or,” any one of the enumerated powers will invoke the provisions of Section 2038. However, a power recognizable under Section 2038 must be demonstrable, real, apparent, and evident, not merely speculative.

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15 Section 2038 is compared with other sections infra ¶ 4.10[10]. It may be noted here that a mere power of acceleration is proscribed by Section 2038 but should not be by Section 2036. See ¶ 4.08[5][c]. Appropriate? Probably so. Section 2038 will tax only the interest subject to the minor change. If Section 2036 applied, it would tax the entire property in which the changeable interest existed.

16 Thus, in the example, while the actuarial value of A’s term of years would be excluded from the value of the trust included in the settlor’s estate, the value of the remainder is includible.


[a] Power to Revoke

The broadest type of power that a decedent might hold over an interest in property is a power to revoke (take back) that interest. A gratuitous lifetime transfer subject to revocation by the decedent has always been subject to the estate tax, even before there was an express provision on revocable transfers.\(^{19}\) The more general language of the first estate tax statute that caught such transfers is not of much present importance, but logically, if the decedent retains the right to get the property back, it is appropriate to tax the property “given” as a part of the decedent’s estate. Since 1924, the statute has specifically done so. If state law provides that a particular transfer is revocable if not specifically made irrevocable,\(^{20}\) the resulting power of revocation, even though not expressly retained,\(^{21}\) results in inclusion under Section 2038.\(^{22}\) Whether inter vivos transfers are revocable by the decedent depends on the decedent’s powers as determined under state law. For example, if a transferor makes an inter vivos transfer to a trust for the benefit of third parties, names a third-party trustee, and grants the trustee absolute discretion to invade corpus for the transferor, if under local law the creditors of the transferor can reach the trust corpus, the transferor has retained an indirect power to revoke the trust.\(^{23}\) However, a power in the grantor of a trust, even in a nonfiduciary capacity, to transfer substitute property of an equivalent value to the trust is not a power to revoke the trust.\(^{24}\)

Substantial litigation has occurred with respect to the issue whether a transfer made by a person holding a power of attorney over an individual’s property or who is a conservator or guardian for an individual has made a completed gift that escapes the individual’s gross estate\(^{25}\) or has made an in-

\(^{21}\) In contrast to Section 2036, there is no “retained” requirement at all under Section 2038 regarding post-1936 transfers. The question is simply whether the decedent had the power at death. But see White v. Poor, 296 US 98 (1935). See also infra ¶ 4.10[7].
\(^{22}\) Vaccaro v. United States, 149 F2d 1014 (5th Cir. 1945); Howard v. United States, 125 F2d 986 (5th Cir. 1942); Estate of Casey v. Comm’r, 55 TC 737 (1971); Estate of Davis v. Comm’r, 51 TC 361 (1968); Priv. Ltr. Rul. 8623004 (Feb. 18, 1986).

Seemingly, any retained power to revoke a trust directly or indirectly that is held at death also triggers Section 2036(a)(1) because it is a retained right to income that does not terminate prior to the decedent’s death. See Estate of Paxton v. Comm’r, 86 TC 785 (1986); ¶ 4.08[4][c], note 70.

\(^{24}\) Rev. Rul. 2008-22, 2008-11 CB 796. See infra ¶ 4.10[4][d], text accompanying notes 46, 47.

\(^{25}\) The following transfers were held to be complete and not included in the decedent’s gross estate under Section 2038: Estate of Ridenour v. Comm’r, 36 F3d 332 (4th
complete revocable transfer subsequently includible in the decedent’s gross estate under Section 2038. Where a transfer is made on a decedent’s behalf pursuant to a power of attorney, or by a court-appointed fiduciary, its effectiveness is also determined by local law.

Despite the fact that revocable transfers are pulled into a decedent’s gross estate, the use of inter vivos revocable trusts has become increasingly popular. While revocable trusts are not used to save gift or estate taxes, a variety of nontax considerations have increased the incidence of establishment and use of revocable trusts.

The following transfers were held to be incomplete and included in the decedent’s gross estate under Section 2038: Estate of Casey v. Comm’r, 948 F2d 895 (4th Cir. 1991) (gift made under power of attorney under Virginia law, distinguishing Casey v. Comm’r, 948 F2d 895 (4th Cir. 1991)); Neff v. Comm’r, 73 TCM (CCH) 2606 (1997) (complete gift made under power of attorney under Oklahoma law, which was orally directed and ratified); Estate of Pruitt v. Comm’r 80 TCM (CCH) 790 (2000) (complete gifts under power of attorney under Oregon law); TAM 9708004 (Oct. 31, 1996) (complete gift under broad power of attorney under New York law in conjunction with supplemental letter from decedent); Priv. Ltr. Rul. 9839018 (June 25, 1998) (conservator gifts complete under amended state law allowing consideration of estate planning issues); TAM 199944005 (July 19, 1999) (gifts under power of attorney that were not specifically authorized but were complete based on decedent’s intent and gift-giving history).

26 The following transfers were held to be incomplete and included in the decedent’s gross estate under Section 2038: Estate of Casey v. Comm’r, 948 F2d 895 (4th Cir. 1991) (gift made under power of attorney under Virginia law beyond the attorney’s power to make gifts); Estate of Swanson v. United States, 46 Fed. Cl. 388 (2000), aff’d, 2001-1 USTC 60,408 (gifts made under power of attorney under California law beyond scope of authority even though decedent orally ratified gifts); Townsend v. United States, 889 F. Supp. 369 (D. Neb. 1995) (gifts made under power of attorney under Nebraska law beyond express authority); Estate of Goldman v. Comm’r, 71 TCM (CCH) 1896 (1996) (gifts made under power of attorney under New York law beyond scope of accountant’s authority); Estate of Gaynor v. Comm’r, 82 TCM (CCH) 379 (2001) (gifts made under power of attorney under Connecticut law beyond scope of authority); TAM 9601002 (Sept. 22, 1995) (gifts made under power of attorney under Oregon law beyond scope of authority); TAM 9731003 (Mar. 31, 1997) (gifts by guardian approved by Maryland court under substitution of judgment doctrine held invalid). Cf. Estate of Christensen v. Comm’r, 80 TCM (CCH) 790 (2000) (gifts from decedent by another joint tenant of a joint bank account funded by decedent were revocable by decedent under Washington law).

27 Most of such transfers involve gifts of cash or near-death transfers. Under the unified transfer tax system, the issue of whether they are revocable has little fiscal significance (see ¶ 2.01[3]) because most involve transfers that, if complete, qualify for a gift tax exclusion and totally escape the clutches of the unified transfer tax base. See IRC §§ 2503(b), 2503(c); ¶¶ 9.04[1][a], 9.04[1][f].

28 See ¶ 10.01[5]. The principal reasons for use of revocable trusts are (1) avoiding the administrative hassles of probate; (2) avoiding ancillary probate; (3) maintaining privacy; and (4) providing for simplified property management during the grantor’s lifetime especially if the grantor becomes incapacitated. Saving probate costs can be a factor, but at least in jurisdictions where probate fees may be charged on an hourly basis, such cost savings are usually not a significant factor. The reasons for using revocable trusts are discussed in more detail at K. Henkel, Estate Planning and Wealth Preservation ¶¶ 7.02, 7.03
[b] Power to Alter or Amend

It has long been recognized that Section 2038 is not limited to powers that can be exercised to benefit the decedent.\(^{29}\) The power to “alter” or “amend” under the section encompasses a power generally to name new beneficiaries of a trust; and a mere power to change beneficial interests among a limited group of persons, such as the power to shift proportionate interests among persons already enjoying rights as beneficiaries, is also within the section.\(^{30}\) In such circumstances, the decedent “has not divested himself of that degree of control which [Section 2038] requires in order to avoid the tax.”\(^{31}\) The power to alter the interests of beneficiaries is sufficient to bring the alterable interests into the decedent’s gross estate, even though the decedent could exercise the power only by will and had no right during life to make adjustments.\(^{32}\)

[c] Administrative Powers

It is probably now a settled principle that mere administrative or managerial powers over trust assets do not constitute powers to alter beneficial interests in the trust within Section 2038.\(^{33}\) However, such a statement of principle invites the inquiry: What powers are merely administrative or managerial? For

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\(^{30}\) But see Rev. Rul. 80-255, 1980-2 CB 272 (decedent’s ability to have more children and thereby add new beneficiaries to a trust created by him was not a power to change beneficial interests).


\(^{32}\) Lober v. United States, 346 US 335, 337 (1953).


\(^{34}\) See Old Colony Trust Co. v. United States, 423 F2d 601 (1st Cir. 1970), overruling State St. Trust Co. v. United States, 263 F2d 635 (1st Cir. 1959), in which the court stated (perhaps too broadly): “No aggregation of purely administrative powers can meet the government’s amorphous test of ‘sufficient dominion and control’ so as to be equated with ownership.” Old Colony Trust Co., supra, at 601, 603. Cf. United States v. Byrum, 408 US 125, reh’g denied, 409 US 898 (1972).
openers, if an individual has the power to allocate receipts and disbursements between principal and income, does one have merely administrative powers? It must be admitted that the exercise of such powers may very well affect the enjoyment of interests in a trust. On the other hand, there is an obvious need for some flexibility in a trustee’s performance of fiduciary duties. For example, a trust settlor might very well wish to reject the rigidity of statutory rules such as those of the Revised Uniform Principal and Income Act, which allocates to principal dividends paid in the form of stock of the issuing corporation. This might be so whether a trust settlor or a bank is trustee. The trustee’s discretion to allocate stock dividends to principal or income should not be regarded as a Section 2038 power. This is because the exercise of such a fiduciary power is required to be undertaken evenhandedly for the benefit of all interests in a trust and is subject to control in this respect by a court of equity. Thus, principal and income allocation decisions by a trustee generally cannot be made for the purpose of changing beneficial interests, even if they have some such effect.

Discretionary authority to make those allocations clearly may go too far. For example, if a nontrustee grantor reserved complete allocation discretion and if such discretion was subject to no judicial restraint, the grantor should be viewed as holding a proscribed power. Consider in such circumstances the status of the income beneficiary if the grantor allocates all receipts to principal, or of the remainderperson if all receipts are allocated to income. However, the hypothetical may not be very realistic; in such circumstances, the grantor may

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35 See Comm’r v. Estate of Hagar, 173 F2d 613 (3d Cir. 1949); Ritter v. United States, 297 F. Supp. 1259 (SD W. Va. 1968) (decided under Section 2036(a)(2)).
36 See Estate of Pardee v. Comm’r, 49 TC 140, 147 (1967).
38 See Old Colony Trust v. United States, 423 F2d 601 (1st Cir. 1970); Estate of Ford v. Comm’r, 53 TC 114 (1969), nonacq. 1978-2 CB 3, aff’d per curiam, 450 F2d 878 (2d Cir. 1971); Estate of Budd v. Comm’r, 49 TC 468 (1968); Estate of Pardee v. Comm’r, 49 TC 140 (1967); Estate of Peters v. Comm’r, 23 TCM (CCH) 994 (1964); Estate of Werts v. Comm’r, 19 TCM (CCH) 544 (1960); Estate of Fiske v. Comm’r, 5 TCM (CCH) 42 (1946).
be a kind of quasi-fiduciary, restrained in actions by equitable principles.\textsuperscript{40} If the grantor is unbridled, however, and trust agreements can be drafted to meet the parties’ wishes, the allocation power should be regarded as being within Section 2038.

Similarly, even if an individual has allocation powers as trustee, if they are validly expressed in such a way as to foreclose restraint by a court of equity,\textsuperscript{41} they go beyond needed flexibility, involve affirmative authority to tamper with beneficial interests, and should be regarded as Section 2038 powers. Thus, if an individual has the unrestrained power to allocate capital gains either to principal or to income, the status of the remainderperson is rendered so tenuous as to be regarded as “subject to change.” For if, in fairly active trading, the trustee allocated all gains to income and charged all losses to principal,\textsuperscript{42} most of the trust property might soon be placed in the pockets of the income beneficiaries at the expense of the remainderperson even if, on the whole, the investment practices were quite successful.\textsuperscript{43} It is clear, therefore, that the broad principle removing managerial and administrative powers from the scope of Section 2038 does little more than require attention to be focused on any power to determine whether, under its terms and applicable local law, it is properly considered a fiduciary power or whether it really amounts to a power to change beneficial interests.

[d] Powers of Investment

While the foregoing discussion is centered around a power of allocation, the same principles should apply to powers of investment. It is obvious that a trust’s terms cannot anticipate and provide the answer for all investment decisions. Some fiduciary flexibility in investing is usually needed to protect the interests of the beneficial owners of the trust property. And investment discretion that is subject to judicial restraint should again be classified as a mere administrative or managerial power.\textsuperscript{44} However, if an individual has uncontrolled

\textsuperscript{40} Cf. Estate of Chalmers v. Comm’r, 31 TCM (CCH) 792 (1972) (decedent grantor’s powers could be exercised only with the trustees; consequently, although the court does not rest its decision on it, the fiduciary restraints on the trustees spilled over to the decedent); Estate of King v. Comm’r, 37 TC 973 (1962), nonacq. 1963-1 CB 5 (court found that a nontrustee grantor’s investment powers were reserved in a fiduciary capacity).

\textsuperscript{41} Ritter v. United States, 297 F. Supp. 1259 (SD W. Va. 1968); Comm’r v. Estate of Hagar, 173 F2d 613 (3d Cir. 1949).

\textsuperscript{42} See Unif. Principal and Income Act § 3(b) (Rev. 1962); Unif. Principal and Income Act § 401 (Rev. 1997).

\textsuperscript{43} See Comm’r v. Estate of Hagar, 173 F2d 613 (3d Cir. 1949).

\textsuperscript{44} Old Colony Trust Co. v. United States, 423 F2d 601 (1st Cir. 1970); United States v. Powell, 307 F2d 821 (10th Cir. 1962); Estate of Jordahl v. Comm’r, 65 TC 92 (1975), acq. 1977-1 CB 1; Estate of Chalmers v. Comm’r, 31 TCM (CCH) 792 (1972); Estate of King v. Comm’r, 37 TC 973 (1962), nonacq. 1963-1 CB 5; Estate of Wilson v. Comm’r,
power over trust investments, it is obvious that the remainderperson’s interest is threatened if the power holder invests in speculative high-yield mortgages and that the income beneficiary’s interest may be virtually eliminated if the power holder opts for non-dividend-paying growth stocks. Therefore, in these circumstances, the interests may be subject to change through the investment power. However, a nonfiduciary power retained by a grantor with the approval of a fiduciary trustee to acquire trust property by substituting property of an equal value will not result in Section 2038 inclusion. The somewhat unhappy conclusion is that no final answers are reached by noting that a power goes only to principal and income allocation or only to investment; in each instance, the exact nature and scope of the power must be considered.

[c] Power to Terminate

A power to terminate a trust is an expressly proscribed Section 2038 power. If a grantor can terminate a trust, does this bring the entire corpus into the grantor’s gross estate? Not necessarily; there is a risk of focusing so hard on the phrase “power...to alter, amend, revoke or terminate” as to forget that the only interests taxed are those the enjoyment of which was subject to “change” through the exercise of such powers. Nevertheless, the termination of a trust generally will change beneficial interests. For example, if D creates a

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13 TC 869 (1949), acq. in part, 1950-1 CB 5, nonacq. in part, 1950-1 CB 8, aff’d per curiam, 187 F2d 145 (3d Cir. 1951). Some earlier cases seem to reach this conclusion uncritically without examining the actual extent of the decedent’s control: Estate of Neal v. Comm’r, 8 TC 237 (1947), acc. 1947-1 CB 3; Estate of Hall v. Comm’r, 6 TC 933 (1946), acc. 1946-2 CB 3; Fifth Ave. Bank of NY v. Nunan, 59 F. Supp. 753 (EDNY 1945) (involving a grantor’s power to amend trustee’s investment powers under a trust); Estate of Downe v. Comm’r, 2 TC 967 (1943), nonacq. 1944 CB 37.


46 Cf. IRC § 675(4)(C), which treats such a power as a power triggering the grantor trust provisions under the income tax. Cf. ¶ 10.01[10][e].

47 Rev. Rul. 2008-22, 2008-1 CB 796. See Priv. Ltr. Rul. 200842007 (June 24, 2008). The rulings provide an effective method to create a “defective” grantor trust. See the discussion of “defective” grantor trusts at ¶ 10.01[10][e], text accompanying notes 275–279.

48 The principles expressed here are equally applicable under Section 2036(a)(2). See ¶ 4.08[6][a]. For a discussion of this general area, see Gray & Covey, “State Street—A Case Study of Sections 2036(a)(2) and 2038,” 15 Tax L. Rev. 75 (1959); Van Vechten, “The Grantor’s Retention of Powers as Trustee or Otherwise; Income and Estate Tax Consequences,” 25 NYU Inst. on Fed. Tax’n 943 (1967).

49 Despite the omission of the term “terminate” from Section 2038(a)(2), the two paragraphs (IRC §§ 2038(a)(1), 2038(a)(2)) do not differ in this respect, because the U.S. Supreme Court has held that authority to terminate a trust is within the meaning of the term “alter,” which appears in both paragraphs. Lober v. United States, 346 US 335 (1953); Comm’r v. Estate of Holmes, 326 US 480 (1946).
trust under which the income is to be paid to B for life, remainder to C or C’s estate, but reserves the right at any time to terminate the trust, effecting an immediate corpus distribution to C, the entire trust corpus is includible in D’s gross estate. B’s interest is clearly subject to change, as it can be terminated. C’s interest is likewise subject to change, as it can be accelerated and that change, even though favorable to C, is within the scope of the section.

The situation is different if D has only the power to direct a distribution of the trust corpus to the life beneficiary, B in this example. In these circumstances, although the remainder interest is clearly subject to change within Section 2038, the income beneficiary’s right to the income for life merely continues, albeit as outright owner of the property. Consequently, B’s life interest is excluded if D dies possessing the power.\[50\]

[f] Gifts to Minors

The fact that acceleration of enjoyment is a “change” within Section 2038 has implications outside the area of formal trusts. For example, under state statutes such as the Uniform Gifts to Minors Act and the Model Gifts of Securities to Minors Act, the custodian may apply income or principal for the minor’s benefit in the custodian’s sole discretion, if it seems advisable for the support and maintenance of the minor. The Service has ruled that under these statutes, property transferred by a decedent naming oneself as custodian is includible in the decedent’s gross estate if the decedent dies before the minor attains majority.\[51\] The Service’s position has been sustained in several judicial decisions.\[52\] There is an easy escape from estate tax liability in this situation; generally, the objectives of a gift tax exclusion\[53\] and the benefit to the minor can be achieved as well by naming someone other than the decedent as custodian.\[54\]

\[50\] Walter v. United States, 341 F2d 182 (6th Cir. 1965); Rev. Rul. 70-513, 1970-2 CB 194. See Estate of DuCharme v. Comm’r, 164 F2d 959 (6th Cir. 1947), aff’d on reh’g, 169 F2d 76 (6th Cir. 1948). This question is analyzed more fully supra ¶ 4.10[3].
\[52\] Suits v. Comm’r, 452 F2d 190 (7th Cir. 1971) (Illinois law); Estate of Eichstelt v. Comm’r, 354 F. Supp. 484 (ND Cal. 1972) (California law); Estate of Prudowski v. Comm’r, 55 TC 890 (1971), aff’d per curiam, 465 F2d 62 (7th Cir. 1972) (Wisconsin law); Estate of Jacoby v. Comm’r, 29 TCM (CCH) 737 (1970) (Missouri law).
\[53\] See discussion of Section 2503(c) at ¶ 9.04[1][f].
\[54\] Section 2038 will not apply if one other than the decedent has a power, and Section 2036 will not be invoked if only a third-party custodian has discretion to use income and principal for support of the transferor’s dependent. See ¶ 4.08[4][b], note 60. But see Exchange Bank & Trust Co. of Fla. v. United States, 694 F2d 1261 (Fed. Cir. 1982), discussed at ¶ 4.08[7][d], note 196. However, Section 677(b) may leave the transferor subject to income tax liability on income actually used for support.
[g] Power in “Whatever Capacity”

Section 2038 applies to a power “in whatever capacity exercisable” by the decedent.\(^{55}\) However, if the decedent has no connection with an outstanding power over property the decedent has transferred, the statute, of course, does not apply. For example, if the decedent has made a lifetime transfer creating a power in some third party (such as one’s spouse) to alter or amend, Section 2038 does not require the value of the transferred property to be included in the decedent’s gross estate.\(^{56}\) However, if the decedent has the unrestricted power to remove or discharge a trustee at any time and to appoint the decedent as trustee, the decedent is considered to have all the powers of the trustee.\(^{57}\) The decedent’s reservation of the power to substitute a trustee with someone other than oneself will not, by itself, result in inclusion under Section 2038.\(^{58}\) As a practical matter, the exemption from tax where only a third party has a power over property clearly leaves substantial room for tax-free control by the decedent through careful selection of the person or persons who alone will have the power.\(^{59}\)

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\(^{55}\) IRC § 2038(a)(1). Despite the 1936 addition in paragraph (1) of the clause “in whatever capacity exercisable,” it seems settled that the capacity in which the decedent can exercise a power has never made any difference. Reg. § 20.2038-1(a). See Estate of Levin v. Comm’r, 90 TC 723 (1988) (power held as controlling shareholder of corporation). On the other hand, if the power is held in a fiduciary capacity, a power that might otherwise invoke Section 2038 may, by reason of potential judicial restraint, be held not a power to change enjoyment. See discussion supra ¶ 4.10[3].

\(^{56}\) Reg. § 20.2038-1(a)(3). See, e.g., Estate of Hofheimer v. Comm’r, 2 TC 773, 783 (1943), nonacq. 1944 CB 40, rev’d on other issues, 149 F2d 733 (2d Cir. 1945). For income tax purposes the rule is otherwise. IRC §§ 672(e), 674, 676, 677.

\(^{57}\) Reg. § 20.2038-1(a)(3); Mathey v. United States, 491 F2d 481 (3d Cir. 1974); Estate of Edmonds v. Comm’r, 72 TC 970 (1979). Cf. Rev. Rul. 73-21, 1973-1 CB 405 (Section 2036(a)(2) case). Of course, if the trustee does not hold sufficient powers to require inclusion under Section 2038, a decedent’s power to name himself trustee will not cause Section 2038 inclusion. Miller v. United States, 325 F. Supp. 1287 (ED Pa. 1971).

\(^{58}\) Rev. Rul. 95-58, 1995-2 CB 1, discussed at ¶ 4.08[4][b], note 60; ¶ 4.08[5][a], text accompanying notes 99–100. Similarly, the Service has proposed a revenue ruling that would allow families to use private trust companies as trustees of family trusts without triggering Section 2038 inclusion. Notice 2008-63, 2008-2 CB 261. See Priv. Ltr. Ruls. 200548035 (Aug. 2, 2005), 200523003 (Mar. 8, 2005), 200531004 (Apr. 21, 2005). See also Priv. Ltr. Rul. 200350010 (Aug. 25, 2003) (grantor, sole director of charitable foundation; no Section 2038 power where no discretion over contributed amounts).

\(^{59}\) The results are impossible to justify. For example, if the decedent makes a transfer retaining the power to accumulate income only if the life beneficiary agrees, Section 2038 applies. On the other hand, if the decedent’s spouse has the power to revoke the transfer, Section 2038 is inapplicable. Nevertheless, the construction placed on the section requires these questionable results.
[5] Powers Restricted by Standards

It has been suggested here that judicial restraint on the exercise of fiduciary powers may neutralize apparent control in a decedent for purposes of Section 2038. The same neutralization may arise out of limitations expressed in the governing instrument itself. If the trust instrument directs the decedent as trustee in identifiable circumstances to shift interests between trust beneficiaries, a person entitled to the benefit of such a shift may have the rights enforced by a court of equity. In such circumstances, the decedent is merely a lieutenant, not a general, and a power to change enjoyment only in stated circumstances does not invoke Section 2038. If the decedent’s discretion whether to exercise a power is subject to independent review by a court of equity under an objective standard, the power is ignored because the decedent really holds no “power.” The leading case establishing this principle is *Jennings v. Smith*. In the *Jennings* case, the decedent’s power as trustee to pay out income to the son or his children if necessary in order to enable the beneficiary to keep himself and his family in comfort, “in accordance with the station in life to which he belongs,” was held not to be a Section 2038 power. On the other hand, if the decedent’s power to invade is exercisable simply if “the circumstances so require,” the property will be includible in the decedent’s gross estate. If the results of these two examples seem inconsistent, the differentiating factor is that in the first instance, the decedent is carrying out terms of the trust, although with some discretion, whereas in the second instance, the trust leaves it up to the decedent to make up the terms or conditions for invasions of the corpus.

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60 See supra ¶ 4.10[4][d].
61 Note that Section 2036(a)(2) would also be inapplicable in such circumstances. See ¶ 4.08[6][a]. See also Note, “The Doctrine of External Standards Under Sections 2036(a)(2) and 2038,” 52 Minn. L. Rev. 1071 (1968); Harris, “Ascertainable Standard Restrictions on Trust Powers Under the Estate, Gift and Income Tax,” 50 Tax Law. 489 (1997).
62 Jennings v. Smith, 161 F2d 74 (2d Cir. 1947).
63 Jennings v. Smith, 161 F2d 74, 76 (2d Cir. 1947).
64 Hurd v. Comm’r, 160 F2d 610 (1st Cir. 1947). See Rev. Rul. 73-143, 1973-1 CB 407. A power to “accelerate payments...in case of need for educational purposes or because of illness or for any other good reason” has been held subject to an ascertainable standard. Estate of Wilson v. Comm’r, 13 TC 869 (1949), acq. in part, 1950-1 CB 5, nonacq. in part, 1950-1 CB 8, aff’d per curiam, 187 F2d 145 (3d Cir. 1951).
65 In the early New Deal period, the proliferation of federal administration agencies was attacked on the ground of improper delegation of legislative power. The maxim “Delegata potestas non potest delegari” was invoked to challenge legislative abdication of power in favor of administrators. A question, however, was whether the authority conferred was to be carried out pursuant to an “adequate standard” or some “intelligible principle” legislatively prescribed. This now seems long ago; nevertheless, the problem as then viewed is analogous to that under discussion here. Some of the U.S. Supreme Court’s

The broad proposition here, as stated in the opinions, is that a power that is restricted by an objective standard is not a power within the meaning of Section 2038. The rationale is not always clearly stated, but such a power involves authority to *execute* rather than to *determine or to change* the terms of the transfer. Thus, if D creates a trust with the income payable to A and the remainder to B, but the trust terms require D to give A such corpus as is necessary for A’s support and maintenance, D must merely comply with a requirement of the trust, and D holds no independent power. However, if, in D’s discretion, D may distribute to A such amounts of corpus as D feels A should have, then D has a power to change the terms of the original transfer, and the value of the remainder interest is included in D’s estate. Whether and to what extent seeming discretion is restricted depends on the terms of the transfer instrument as interpreted under state law, which makes it impossible to frame a flat rule for neutral trust terms. Of course, whether any restriction found to exist defeats the application of Section 2038 is a purely federal question.66

66 The effect of state law is discussed broadly at ¶ 4.05[2][a]. Although interpretations of trust terms may vary widely from state to state, nevertheless here is a group of cases in which neutralizing standards for powers have been found to exist: United States v. Powell, 307 F2d 821 (10th Cir. 1962) (“maintenance, welfare, comfort, or happiness”); Leopold v. United States, 510 F2d 617 (9th Cir. 1975) (“support, education, maintenance and general welfare…solely in the uncontrolled discretion of the Trustees”); Estate of Klafter v. Comm’r, 32 TCM (CCH) 1088 (1973) (“support, maintenance, health, education and comfortable living”); Estate of Ford v. Comm’r, 53 TC 114 (1969), nonacq. 1978-2 CB 3, aff’d per curiam, 450 F2d 878 (2d Cir. 1971) (“need of funds…for the purpose of defraying expenses occasioned by illness, infirmity or disability…or for his support, maintenance, education, welfare and happiness”; court concluded that “need” limited “happiness”); Estate of Pardee v. Comm’r, 49 TC 140 (1967) (“education, maintenance, medical expenses, or other needs…occasional by emergency”; case contains a collection of cases on what constitutes an ascertainable standard).

The following cases found no ascertainable standard: Stuit v. Comm’r, 452 F2d 190 (7th Cir. 1971) (for minor’s “benefit” under the Illinois Uniform Gifts to Minors Act); Estate of Nettleton v. Comm’r, 4 TC 987 (1945), acq. 1946-1 CB 3 (trustees’ uncontrolled discretion “as they may consider suitable and necessary in the interest and for the welfare of such beneficiary”); Estate of Perrin v. Comm’r, 3 TCM (CCH) 225 (1944) (“may in his discretion deem necessary or proper for the comfort, support and/or happiness”); Estate of Bell v. Comm’r, 66 TC 729 (1976) (“funds for a home, business, or for any other purpose believed…to be for her benefit”). Many of these cases involved both Sections 2036(a)(2) and 2038, and what constitutes a standard for one also constitutes a standard for the other.
[6] Power Exercisable Only With Another

Even if a mere power that may be exercised only subject to an ascertainable standard is not a power for Section 2038 purposes, this does not mean that a decedent must have a cogent power to be caught by Section 2038. In general, a requirement that the decedent obtain the concurrence or consent of another person in the exercise of a power does not defeat the section; and, again in general, the status of the other person or person’s interest in the property subject to the power is not a relevant consideration. The statute applies to a power exercisable by the decedent alone or by the decedent in conjunction with any other person. Section 2038 applies even though the person with whom the power is held has an interest that would be adversely affected by the exercise of the power and would be unlikely to concur in its exercise. Thus, Section 2038 applies to the remainder interest of a trust in which the income is payable to A, remainder to B, but that gives the decedent a power to invade the corpus for A’s benefit with B’s approval. Even though the power is held conjunctively with B, whose remainder interest would be diminished by its exercise, and the decedent can be looked upon as powerless, Section 2038 nevertheless applies to include the remainder interest in the decedent’s gross estate.

Prior to the enactment of the forerunner of Section 2038 in 1924, the value of transferred property was not includible in the decedent’s estate if the decedent’s power over the property could be exercised only in conjunction with beneficiaries whose rights would be adversely affected by such exercise. And that rule has continuing vitality with respect to pre-1924 transfers otherwise within the scope of the section. However, the present provision has been interpreted strictly in this regard and sustained against constitutional attack on the ground that, under any other rule, the decedent could easily avoid the tax by joining in the exercise of the power an interested party who is reasonably certain to comply with the decedent’s wishes.


69 Reg. § 20.2038-1(d). But see New England Merchant’s Nat’l Bank of Boston v. United States, 384 F2d 176 (1st Cir. 1967) (involving a pre-1924 transfer in which, however, the institutional trustee had no adverse interest, so Section 2038 was applicable); Rev. Rul. 78-16, 1978-2 CB 289 (a substantial adverse interest in a pre-1924 transfer was created in 1940; the ruling held that since the decedent was not subject to an adverse interest that existed in 1924, subsequent adverse interests were subject to the post-1924 rule, and, therefore, Regulations Section 20.2038-1(d) was not applicable).

The Treasury and the courts do not differentiate between a power in the decedent to act with the consent of another and a power in another to act only with the decedent’s consent.\footnote{Rev. Rul. 55-683, 1955-2 CB 603; Estate of DuCharme v. Comm’r, 164 F2d 959 (6th Cir. 1947), aff’d on reh’g, 169 F2d 76 (6th Cir. 1948).} Each is treated as a power in the decedent, which may result in tax liability under Section 2038. Obviously, as an interpretation of the statute, this is a realistic approach; in either case, both must join in the exercise of the power, and verbalistic differences should be ignored.

One exceptional case in which a decedent transferor may hold a power with others will be disregarded under Section 2038. If the decedent holds a power that can be exercised only with the consent of all persons having an interest, vested or contingent, in the property subject to the power and if the power adds nothing to the rights of the parties under local law, the power is ignored.\footnote{Reg. § 20.2038-1(a)(2), echoing the result reached in Helvering v. Helmholtz, 296 US 93 (1935). See Priv. Ltr. Ruls. 200247037 (Aug. 19, 2002), 200919008 (Jan. 12, 2009), 201233008 (Mar. 28, 2012).} This exception rests upon two factors: (1) the required consent of all interested persons, and (2) a provision of local law that would allow such persons to alter the terms of the trust in any event. Neither factor standing alone is enough to defeat Section 2038. Apart from this exception, the term “any other person” in Section 2038 is held to mean literally any other person.\footnote{Helvering v. City Bank Farmer’s Trust Co., 296 US 85 (1935).}

[7] Source of the Power

As previously discussed, Section 2036 expressly raises the question whether, with respect to a lifetime transfer, the decedent has “retained” enjoyment or continuing rights. In contrast, the Section 2038 transfer provision has always raised only the question whether interests were subject to change by way of a power in the decedent at the time of death. Nevertheless, the 1935 Supreme Court decision in White v. Poor\footnote{White v. Poor, 296 US 98 (1935), discussed in Van Beuren v. McLoughlin, 262 F2d 315, 320 (1st Cir. 1958), cert. denied, 359 US 991 (1959).} gave the revocable transfer provision as it then existed a restrictive interpretation along the lines of the “retained” requirement of Section 2036. In that case, the decedent had created a trust naming herself and others as trustees and giving the trustees the power to revoke. Later she resigned, only to be appointed trustee by a vote of the then trustees upon the occurrence of another resignation. At death, as a trustee, she had the power with the others to revoke the trust. Her estate successfully argued that the estate tax provision concerning revocable transfers was inapplicable because the decedent had acquired the power by virtue of the action of the other
trustees and not because she had *retained* any power to control the enjoyment of the property.

This argument is of no avail regarding transfers made after June 22, 1936. When Congress enacted what is now paragraph (1) of Section 2038(a), it expressly provided that it makes no difference “when or from what source” the decedent acquired the proscribed power. However, there should be some linkage between the required transfer by the decedent and the decedent’s power. Section 2038 should be held inapplicable in situations where the decedent makes a complete, absolute transfer and, by a totally unrelated reconveyance, the decedent has some fiduciary power or control at death.

A power arising by operation of law is very likely within both Sections 2038(a)(1) and Section 2038(a)(2). For example, if a state statute gives a parent the right to revoke any lifetime transfer to a minor child, the parent may properly be regarded as having “retained” the power to revoke, even though the retention rests on the statutory provision rather than on language expressed in the transfer instrument. The *White* case restricts the scope of Section 2038(a)(2) with regard to powers conferred on the decedent by some independent outside force. Revenue Ruling 70-348 reflects the difference between pre-1936 and later transfers. In that ruling, a decedent had transferred property to another as custodian for a minor. Under relevant local law, the custodian had powers over the property that, if held by the decedent, would invoke Section 2038. Later, the original custodian transferred the property to the decedent as custodian, and in that way the decedent acquired the tainted power over the property that the decedent had originally transferred. *White v. Poor* places this case outside Section 2038(a)(2) for lack of *retention* of a power by the decedent but the Treasury properly ruled that the property was includible in the decedent’s estate under Section 2038(a)(1). It will be observed that in the case governed by the ruling, the decedent’s transfer created the power that the decedent ultimately acquired.

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77 Cf. IRC § 2037(a)(2).
79 For the same reason, Section 2036 is inapplicable.
80 See Reed Estate v. United States, 1975-1 USTC ¶ 13,073 (MD Fla. 1975).
[8] When Power Must Exist

In general, of course, the power must exist at the date of the decedent’s death. However, Section 2038(b) lays down specific rules regarding the existence of the power in order to prevent artful drafting from frustrating Section 2038. The statute provides that the power shall be treated as existing at the date of death, even though the exercise of the power is subject to a precedent giving of notice or even though the amendment, revocation, or termination takes effect only upon the expiration of a stated period after the exercise of the power. For example, if, under a trust instrument, the decedent could not exercise a power to revoke until thirty days after giving notice of revocation, enjoyment of the interest affected by the power would not be subject to change at date of death if no such notice had been given. Section 2038(b) provides that a power such as this, which requires a notice before exercise, shall be considered to be a power that the decedent possesses on the date of death, despite the necessity of giving notice. This principle has been applied to a related situation without the benefit of the precise statutory rule. In a case in which the trustee had a power to amend and the decedent had the right to discharge the trustee and appoint himself trustee, but only after giving notice, the decedent was held to have the prescribed power at death even though no such notice had been given.

On the other hand, the inference can properly be drawn from Section 2038(b) that if there are other contingencies (other than giving notice or a deferred effective date for the decedent’s action), Section 2038 does not apply.

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81 Reg. § 20.2038-1(b); Estate of Webster v. Comm’r, 65 TC 968 (1976). See Estate of Yawkey v. Comm’r, 12 TC 1164 (1949), acq. 1949-2 CB 3. Thus, property subject to a power exercisable only upon circumstances beyond the decedent’s control, which had not occurred by the time of the decedent’s death, is not within the section. Jennings v. Smith, 161 F2d 74 (2d Cir. 1947). For example, if the settlor has a power to appoint the settlor as a successor trustee only if the existing trustee should resign and at the settlor’s death such resignation has not occurred, the settlor will not be deemed to have the powers of the trustee at death. See also Round v. Comm’r, 332 F2d 590 (1st Cir. 1964).


83 But see Rev. Rul. 68-538, 1968-2 CB 406, which appears to be at odds with the above conclusion. In the ruling, the decedent had created a revocable trust and later executed amendments to the trust by which she waived her right of revocation for a period of several years. This restriction was in effect at the date of her death. The Service recognized that the decedent did not have the power to revoke at her death, but found that she did have at that time the power to revoke in the future, namely, when the duration of the waiver expired, and ruled that the existence of such a power was sufficient to bring the trust within Section 2038. The value of the trust, however, was discounted for the period from the date of the decedent’s death until the date when the waiver would have lapsed. Note that inclusion would occur under Section 2036 even when subject to a contingency beyond the decedent’s control, and the ruling, very questionable under Section 2038,
The inference merely confirms the apparent general requirement that the power exist at death. For example, assume D transfers property in trust providing that the income is to be paid to A for life, then to B and C for their lives as D may direct, with remainder payable to E. If D dies while A is alive, Section 2038 is inapplicable because D does not have the power to alter or amend the interests of B and C at the time of D’s death.84

The decedent, of course, can avoid Section 2038 by relinquishing the power prior to death. However, both paragraphs (1) and (2) of Section 2038(a) deal adversely with relinquishments made within three years of death.85 In general, and in contrast to the omission in Section 2036,86 Congress has expressly provided that the relinquishment of a power within three years of death does not defeat the section.87 Here again, however, there are substantive differences in Sections 2038(a)(1) and 2038(a)(2). The provision applicable to earlier transfers nails only relinquishments made by the decedent within three years of death. Under Section 2038(a)(2), if the decedent had a power exercisable only with A and A relinquished the power within three years of the decedent’s death, which under local law nullified the decedent’s power, Section 2038 will not apply. However, as to later transfers subject to Section 2038(a)(1), the question is only whether the power was relinquished within three years of the decedent’s death; under that provision, A’s relinquishment of A’s power within three years of the decedent’s death would not defeat the section.88 However,
both provisions are partially overridden by Section 2035(e). Section 2035(e) provides that for purposes of Sections 2035 and 2038, any transfer of any portion of a trust (while the trust was treated under Section 676 as owned by decedent by reason of a power of revocation in the grantor)\(^89\) will be treated as a transfer made directly by the decedent.\(^90\) Thus, transfers from a revocable trust or the relinquishment of a power to revoke part or all of a revocable trust\(^91\) within three years of a decedent’s death are treated as outright gifts by the decedent and are no longer within the grasp of either Section 2038 or Section 2035. However, this does not make the three-year language of paragraphs (1) and (2) of Section 2038(a) a dead letter. The provisions continue to apply to powers other than a Section 676 power of revocation that are held under Section 2038\(^92\) and are relinquished within three years of a decedent’s death. For example, if a decedent created an irrevocable trust with lifetime income and remainder interests but retained the power to change the designated beneficiaries or to alter the timing of a beneficiary’s enjoyment and the decedent relinquished the power within three years of death, the affected interests would be pulled into the decedent’s gross estate under Sections 2035 and 2038.\(^93\)

[9] Amount to Be Included

In arriving at the proper figure for the gross estate, all the sections defining it require (1) an identification of included interests\(^94\); (2) a determination as to the time for valuing the interests\(^95\); and (3) the valuation of the included interests in accordance with an accepted method.\(^96\) Regarding identification, Section 2038 includes in the gross estate the value of any interest in property transferred by the decedent if the enjoyment of such interest was subject at the date of the decedent’s death to change through one of the proscribed powers.\(^97\) The fact that the decedent had no beneficial rights in the property is irrelevant. The

\(^{89}\) Section 676 is the revocable grantor trust provision. Section 2035(e) disregards Section 672(e), under which, for income tax purposes, the grantor is deemed to hold a power to revoke because the grantor’s spouse holds such a power.


\(^{91}\) See ¶ 4.07[2][b][ii].

\(^{92}\) See generally supra ¶¶ 4.10[4]–4.10[7].

\(^{93}\) IRC §§ 2035(a), 2038(a).

\(^{94}\) See infra ¶ 4.10[10][l].

\(^{95}\) This presents a date-of-death (IRC § 2031) or alternate date (IRC § 2032) option.


\(^{97}\) Reg. § 20.2038-1(a) (first sentence).
question is: What is the value of the interest in property, the enjoyment of which is subject to a power held by the decedent, either alone or with others? The answer to this question is the amount to be included in the gross estate.

Assume, for example, that decedent, \( D \), made a transfer of property in trust under which beneficiary, \( B \), was entitled to the income until \( B \) attained age 30, at which time \( B \) was to receive one half of the corpus. Thereafter, \( B \) was entitled to receive the income from the balance of the trust until \( B \) attained age 35, at which time \( B \) was to receive the balance of the corpus. \( D \), having retained the power to terminate the trust at any time with the corpus to be distributed to \( B \), died without exercising the power when \( B \) was age 27. As \( D \) retained the right to terminate the trust, the corpus is includible in \( D \)’s gross estate, except for the value (determined actuarially at the time of \( D \)’s death) of \( B \)’s right to receive the income from the trust until age 30 and from half the trust from that time until age 35.\(^98\) In effect, in a case such as this, death terminates \( D \)’s control over the enjoyment of the trust property, identifying a kind of transmission reasonably subjected to tax, but not with regard to the assured income interests for which an exception is noted.

**[a] Interests Subject to Change**

Sometimes it is easy to identify the includible interests that are subject to change. If the power possessed by the decedent at the time of the decedent’s death affects only certain interests, only those interests will be included in the decedent’s gross estate. For example, if the decedent has power to change only an income interest, Section 2038 requires that there be included in the gross estate only the value of that income interest.\(^99\) If the income interest of a particular beneficiary of a trust is not subject to change, only the value of the other interests that are subject to change is included in the decedent’s gross estate. Thus, if a fixed amount of the income from a trust is to be paid to a named beneficiary and no power exists to change the amount, the value of the beneficiary’s interest cannot be included in the decedent’s gross estate under Section 2038, even though other income interests may be within the section.\(^100\)

Similarly, if a power in the decedent could not effectively be exercised at death because of a requirement of giving notice, the power is recognized under Section 2038(b), but the amount to be included in the gross estate is subject to adjustment. The adjustment excludes the value of the interest that could not have been affected by an exercise of the power if the decedent had lived. For example, suppose that a trust could be revoked only one year after the dece-


\(^99\) Industrial Trust Co. v. Comm’r, 165 F2d 142 (1st Cir. 1947).

\(^100\) Industrial Trust Co. v. Comm’r, 165 F2d 142 (1st Cir. 1947).
dent had given notice. If the decedent had not given notice at death, a beneficiary who had an income interest in the property would, at the date of death, be assured of the continuance of that interest for one more year. In such circumstances, Section 2038(b) provides that the amount otherwise includible in the gross estate shall be reduced by the value of the assured interest. For this purpose, the statute says that the notice shall be considered given on the date of the decedent’s death. A similar adjustment is to be made if the exercise of a power will take effect only after the expiration of a stated period.

[b] Sections 2036 and 2038 Compared

Although Sections 2036 and 2038 have a considerable overlap, one of the principal differences between them is the amount to be included in a decedent’s gross estate when one or the other of the sections applies. Here is a comparative illustration of the operation of the two sections. If the decedent retained a power to designate who should have the income from the property transferred for one of the prescribed periods, the value of the entire property is includible in the decedent’s gross estate under Section 2036(a)(2). However, under Section 2038 such a transfer would be includible only to the extent of the value of the alterable income interest. On the other hand, in some situations the same result will be reached whichever section is applied. For example, if the decedent transferred property to A for life, remainder to B, and retained the power to revoke, clearly both sections would apply and the value of the entire property would be includible under either. Both sections also apply to tax the entire property, if the decedent creates a trust with income to A for life, remainder to B, and the decedent in the decedent’s discretion retains the unlimited power to invade the corpus for the benefit of the remainderperson. In other circumstances, of course, the Commissioner will assert that provision of the statute that results in the greatest inclusion in the gross estate.

[10] A Reprise of the Lifetime Transfer Sections

At the end of this discussion of Sections 2035 through 2038, all of which are addressed to the estate taxation of a decedent’s lifetime transfers, some general comments may be advanced on two types of problems generated by these sections. One type, which will be seen to be largely academic, arises out of the substantial overlap of the several statutory rules. The other is that of identifying the taxed interest, regardless of what section may be applicable. As no new concepts are advanced here and the principles discussed are all presented else-

101 See infra ¶ 4.10[10].
102 IRC § 2036(a)(2); Lober v. United States, 346 US 335 (1953).
where with proper documentation, these comments are framed in general terms.

[a] Overlap: Sections 2036 and 2038 Applicable

Suppose that \( D \) transfers 1,000 shares of \( XYZ \) stock in trust with provision for payment of the income to \( A \) for life and then to \( D \) for life and with further provision for the payment of the remainder after the death of \( D \) and \( A \) to whomever \( D \) appoints by will but, in default of the exercise of \( D \)'s power, remainder to \( B \) if living and, if not, to \( D \)'s estate. In this situation, Sections 2036, 2037, and 2038 are applicable because \( D \) has made a transfer retaining an income interest in the property (Section 2036), but the transfer of the remainder interest is conditional upon \( D \)'s death and \( D \)'s testamentary power gives \( D \) a reversionary interest (Section 2037), and the remainder remains subject to a power to change at the time of \( D \)'s death (Section 2038). If these three sections apply, is it necessary to examine the scope of each? It usually is, unless one section pulls in the entire corpus. If \( D \) is survived by \( A \), each of the sections, whichever is applied, includes the value of the property reduced by the value of \( A \)'s outstanding life interest. If \( D \) survives \( A \), each of the sections includes the entire value of the trust property upon \( D \)'s death; but of course the trust property will be taken into account only once in any event.

[b] Overlap: Only Section 2037 Applicable

In the case of a transfer whose only taint is that it is conditional and the decedent has retained no more than a reversionary interest and no recognized right to affect the interests of others, only Section 2037 can cause inclusion of the value of the transferred property in the decedent’s gross estate. Although it is true, therefore, that any given transfer can invoke the inclusionary rules of Sections 2036, 2037, and 2038, in many instances only Section 2037 will apply. This is because that section supplies a unique test (relating to conditional reversions) that, even if met, will not invoke the application of the other transfer sections.

[c] Only Section 2036 Applicable

It is also true that Section 2036 can be the sole section applicable to a lifetime transfer. Examples are a decedent’s transfer in trust in which the decedent simply retains the right to the income from the trust for life and a decedent’s direct transfer retaining a legal life estate.
Only Section 2038 Applicable

It is more difficult to present a situation in which only Section 2038 will apply. This is because tax liability under Section 2038 rests on control or imputed control over transferred property by the decedent; and Section 2036(a)(2) is also brought into play by a retention of control over income or enjoyment. Of course, Section 2037 may also be brought into play by a retention of a conditional power to dispose of the transferred property. The questions then, admittedly largely academic, are: When does Section 2038 have a significant role to play? When is it something more than a second reason for including the value of a property interest in the gross estate? Phrased this way, the questions are largely academic because, when Section 2036 applies, its power to pull interests into the gross estate generally exceeds that of Section 2038.

Section 2036(a)(2) is couched in terms of powers “retained” by the decedent, while Section 2038 merely requires that the transferred interest be subject to the decedent’s power at the time of death. Thus, Section 2038 may be applicable, but Section 2036(a)(2) will be inapplicable, if the decedent does not retain a power in connection with a lifetime transfer. For example, assume that D creates an inter vivos trust with income to A for life and a remainder to B or B’s estate, giving an independent trustee the power to pay the income to C during A’s life. Assume further that although D retains no power to name D trustee, the independent trustee resigns and the court appoints D as trustee. If D then dies during A’s life, Section 2038 applies to pull the income interest

103 Beyond the common requirement that, to be included, a property interest must be one that the decedent transferred during life, some of the similarities of Sections 2036(a)(2) and 2038 include the following:

1. Both sections are subject to the full and adequate consideration exception and to the Section 2043(b) partial consideration rule;
2. Neither section applies if the decedent’s power is limited by an adequate external standard, and a standard adequate for one provision is also a standard adequate for the other;
3. Both sections treat the decedent as holding any powers the trustee holds if the decedent could appoint the decedent as trustee;
4. Both sections apply whether the decedent’s power was held alone or in conjunction with any other person (seemingly the Helmholtz exception, Helvering v. Helmholtz, 296 US 93 (1935), extends to Section 2036(a)(2) as well as to Section 2038);
5. Neither section applies if powers are held only by a third, albeit friendly, party;
6. The O’Malley doctrine is applicable to both sections; and
7. Regarding relinquishments by the decedent, both sections invoke the principles of Section 2035 including Section 2035(e), even though only Section 2038 contains specific statutory language to that effect. See Reg. § 20.2035-1(b).
into $D$’s estate. Section 2036(a)(2), which if applicable would tax the entire trust, does not apply because $D$’s power at death is not a retained power.104

There is another situation in which Section 2038 may have a longer reach than Section 2036(a)(2). If the decedent’s power, whether retained or otherwise, affects only the remainder and not the income interest, Section 2038 may be in exclusive control. Suppose, for example, that $D$ creates an inter vivos trust with income to $A$ for $D$’s life, remainder to $B$ or $B$’s estate, and $D$ retains the power to give the remainder to $C$ or $C$’s estate. $D$ dies survived by $A$. Section 2038 is clearly applicable to the remainder interest as it is subject to change through the exercise of a power by $D$. Although the literal wording of the statute would seem to require inclusion under Section 2036(a)(2) as well, as the power would seem to be a “right…to designate the persons who shall possess or enjoy the property or the income therefrom,” the regulations treat Section 2036(a)(2) as inapplicable.105 According to the regulations, Section 2036(a)(2) powers do “not include a power over the transferred property itself which does not affect the enjoyment of the income received or earned during the decedent’s life.”106 On the other hand, a perceptive reader will see that this supposed transfer is taxable under Section 2037 in the same manner as under Section 2038 and that the value of the remainder interest at $D$’s death is equal to the value of the corpus.

The scope of the foregoing regulation is uncertain. For example, it is questionable whether Section 2036(a)(2) applies in the hypothetical if $A$’s income interest is for $A$’s life rather than $D$’s life and $D$ dies survived by $A$. Given these facts, during $D$’s life it was possible that $A$ might have predeceased $D$, and if so, by naming the remainderperson $D$ could have determined whether $B$ or $C$ received the income while $D$ was still alive, and $D$ would have had a power that could have affected the enjoyment of the income from the property during $D$’s life. This problem is again largely academic because,

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104 Section 2037 similarly requires that $D$’s reversionary interest be “retained.” Although instances in which Section 2038 has exclusive significance are stressed here, a second subtle difference in the two provisions sometimes leaves the field to Section 2036. If $D$ has retained a power, but it is subject to a contingency beyond $D$’s control that has not occurred prior to $D$’s death, Section 2038 will not apply because the enjoyment of the transferred property will not be “subject at the date of the decedent’s death to any change.” Section 2038(b), of course, contains a limited exception to this rule. In contrast, however, Section 2036(a)(2) simply requires that a power of designation be retained for a proscribed period, which can be a period to begin at a future time. Thus, Section 2036 can apply even if the power was not exercisable at $D$’s death but was, instead, subject to a contingency beyond $D$’s control.

105 Reg. § 20.2036-1(b)(3).

106 Reg. § 20.2036-1(b)(3). See also the discussion at ¶ 4.08[5][c] for another situation in which Section 2038 may be applicable and Section 2036(a)(2) inapplicable. But see Alexander v. Comm’r, 81 TC 757 (1983), aff’d in unpub. op. (4th Cir. 1985).

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except in very narrow circumstances,\textsuperscript{107} even if Section 2036(a)(2) is applicable, the amount of the inclusion under that section is equal to the amount of the Section 2038 inclusion.\textsuperscript{108}

[c] Only Section 2035 Applicable

Prior to the 1981 changes in the Code, Section 2035 had a substantially broader scope encompassing all transfers made within three years of death. It now encompasses only transfers within three years of death of interests that would have been included under Sections 2036, 2037, 2038, and 2042 if no subsequent transfer had been made. Generally, there is no longer any statutory overlap between Section 2035 and Sections 2036 through 2038\textsuperscript{109} but, instead, statutory combination, with Section 2035 acting in conjunction with Sections 2036 through 2038 to require inclusion in the same manner as if they were directly applicable. With one exception, there is inclusion only under Section 2035.\textsuperscript{110}

[f] Identification of Taxed Interest

The discussion of the various lifetime transfer sections in this chapter reflects a dual inquiry under each section. One question is whether the section is applicable at all. When the first question is answered affirmatively, the other is: What transferred interest is taxed? This second identification question is the subject of some general observations here.

\textsuperscript{107} There is not a total overlap of the two sections here because if \(D\)’s power had been subject to a contingency beyond \(D\)’s control that had not occurred prior to \(D\)’s death, Section 2038 would be inapplicable, whereas Section 2036(a)(2) would apply. For example, assume \(D\) creates an inter vivos trust with income to \(A\) for \(A\)’s life and a remainder to \(B\) or \(B\)’s estate, but \(D\) retains a power to give the remainder to \(C\) if \(B\) becomes divorced. If \(D\) dies during \(A\)’s life at a time when \(B\) is still married, Section 2038 is inapplicable; but if the exception recognized in Regulations Section 20.2036-1(b)(3) is narrowly interpreted, Section 2036(a)(2) will include the remainder in \(D\)’s estate.

\textsuperscript{108} Section 2036(a)(2) would include the value of the corpus less the unaffected income interest (or an amount equal to the remainder interest), which would likewise be the amount included under Section 2038.

\textsuperscript{109} One instance in which there would be such overlap is a situation where within three years of death an insured transfers a life insurance policy on the insured’s life to a trust in which the insured retains a life estate. Both Sections 2035(a) and 2036(a)(1) would be applicable on the insured’s death.

\textsuperscript{110} There is overlap between Sections 2035 and 2038 caused by the express provisions of the last clause of Section 2038(a)(1) and the three-year provision of Section 2038(a)(2). But see IRC § 2035(e), which narrows the overlap and is discussed supra ¶ 4.10[8], text accompanying notes 89–93; ¶ 4.07[2][b][ii].
All the transfer sections share a characteristic that is troublesome at best. Each requires an identification of an included property interest on the basis of an occurrence at one time, the time of the transfer, but the valuation of the included interest at another time, the applicable valuation date. Thus, the included interest must be again identified at the later valuation date. The same difficulty arises even with respect to property included under Section 2033 if the executor elects the alternate valuation date under Section 2032. That section has its own expressed rules for post-identification date dispositions of property prior to the usual valuation date, easing some but not all\textsuperscript{111} of the problems otherwise inherent in the split dates.

With regard to transfers taxed because they were made within three years of death, it is fairly well established that the value of the very property involved at the time of the near-death transfer is the measure for the tax.\textsuperscript{112} What about interests transferred during life but included in the gross estate other than by reason of the near-death three-year rule? Where the property originally transferred is sold and the proceeds are reinvested, is the appropriate result to pull in the interests in the property originally transferred or to include the other property (or money, if no investment is made)? All the other lifetime transfer sections rest on some actual or imputed relationship of the decedent to the property, loosely the decedent’s retention of some enjoyment, a reversionary interest, or control. It seems sensible to say that the included property must be that to which the decedent bears the required relationship at death, and although the statute falls far short of saying so expressly, this seems a reasonable inference.

Suppose, for example, that A gives B A’s residence but reserves a legal life estate. If A and B subsequently agree to a sale of that residence and a reinvestment of the proceeds in another in which their present and future interests are the same, it is sound to value the second residence for inclusion in A’s estate.\textsuperscript{113} Perhaps, a fortiori, the same rule should apply if A transfers securities to a trust retaining the right to the trust income for life, remainder to B. If, under common trust powers, the trustee changes the investments, the value of B’s remainder interest, which is the value of the trust assets as altered by the time of A’s death, is what should be included in A’s estate.\textsuperscript{114} In all probability, in these cases the settlor’s wishes will largely govern the trustee’s investment decisions. Thus, a better result may be reached than if an attempt was made to value the property that was actually transferred. Suppose, for example, A placed $100,000 cash in the trust initially. If this is invested in se-

\textsuperscript{111} See discussion of Section 2032 at ¶ 4.03[3].
\textsuperscript{112} See ¶ 4.07[2][c].
\textsuperscript{113} A reinvestment of more or less than the proceeds would seem to be a manageable problem.
\textsuperscript{114} In point of fact, United States v. O’Malley, 383 US 627 (1966), even extends this approach to income retained in the trust.
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Securities by the trustee (maybe at A’s suggestion) and the securities are worth $200,000 when A dies, the statutory plan seems better implemented by including the larger death value of the trust in A’s estate, and the same rationale supports a smaller inclusion if the trust investments prove to be unwise.

Although the foregoing thoughts are expressed in terms of Section 2036 examples, they seem equally applicable to the other transfer sections, except Section 2035. On the other hand, they leave open the question of identification and value in a situation in which A makes a taxable transfer to a trust and others, either simultaneously or at different times, make transfers to the same trust.\textsuperscript{115}

4.11 SECTION 2039. ANNUITIES

It has been said that people are unique among the animals in the possession of the knowledge that they will die. This, coupled with a person’s familial instinct and capacity for affection, which are not unique, causes one to devise numerous direct and indirect means for the transmission of wealth to others. A person’s efforts in this respect often have a purely personal motivation quite detached from tax considerations. However, informed persons are aware that tax consequences have an impact on the accomplishment of their personal objectives. In any event, whether the means of conferring financial benefits on another are prompted purely by personal wishes or partly by tax thinking, Congress must examine the means to determine how a particular mode of wealth transmission fits into the federal taxing scheme. Section 2039, addressed to annuity arrangements, is another result of such examination and determination.\textsuperscript{1}

Annuity contracts take a variety of forms. The simplest is a single-life annuity without any refund feature. Under this type of contract, an amount is paid to the annuitant for life, and at death, all rights under the contract terminate. If a decedent purchases such an annuity for life, it will have no effect on the decedent’s gross estate at death; this is an instance of the decedent’s consumption of wealth during life, and it results in no transmission of anything to others either during life or at death.\textsuperscript{2} Logically, nothing in Section 2039 seeks to alter this conclusion.

\textsuperscript{115} A suggested approach to this problem is advanced in the discussion of Section 2036 at \textsuperscript{4.08[8].}

\textsuperscript{1} The gift tax consequences of annuity transactions are determined largely by the application of general principles. See Chapter 10.

\textsuperscript{2} Of course, amounts received under the annuity prior to death may enlarge the decedent’s actual estate subject to tax under Section 2033.
Other annuity contracts provide definitely or contingently for something to be paid to others upon the death of the primary annuitant. For example, a contract may contain provisions under which, if the amount paid the annuitant during life does not equal the cost of the contract (or sometimes, in the case of annuity contracts arising out of employment relationships, the contributions of the employee), the difference will be paid either to the primary annuitant’s estate or to named persons upon the annuitant’s death. Under other contracts, upon the death of one annuitant, the payment that the annuitant has been receiving may be paid to another for the other’s life; this is a self-and-survivor annuity or a survivorship-or-longer-life annuity. Still another common type of annuity is a joint-and-survivor annuity, under which a specified sum may be payable to two annuitants jointly during their lives and the same or a reduced amount paid to the survivor for life. It is agreements of these types, all of which involve some survivorship feature, that may have estate tax consequences under either Section 2039 or other general provisions, and properly so to the extent that they achieve a transmission of some of a decedent’s wealth to others.

Section 2039 covers many annuity contracts, but it is important to note that it does not purport to be exclusive. Generally, if the application of some other section would result in amounts being included in the gross estate beyond what would be included under Section 2039, the other section will be applied.3

[1] General Rule

Regarding annuity contracts with survivorship features, the general rule under Section 2039 is that the value of amounts receivable by beneficiaries by reason of their surviving the decedent is to be included in the decedent’s gross estate. A modification is expressed in Section 2039(b). First, however, it should be noted that Section 2039(a), which states the general rule, makes two explicit exceptions and several important qualifications.

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3 S. Rep. No. 1622, 83d Cong., 2d Sess. 472 (1954); Reg. § 20.2039-1(a). An example would be a purchase for another of an annuity for a term of years extending beyond the decedent’s life with the decedent retaining the power during life to alter the beneficiary between two persons other than the decedent, taxable under Section 2038. See Estate of Siegel v. Comm’r, 74 TC 613 (1980). The amounts of inclusion under both Section 2038 and Section 2039 would be equal. But if Section 2039 includes a greater amount than some other section, it generally will be applied. However, Section 2039 will not be applicable if Section 2036 applies because a decedent created a trust (other than a trust constituting an employee benefit) and retained the right to use trust property or retained an annuity, unitrust or other income interest in the trust. Reg. § 20.2039-1(e). See generally ¶ 4.08[8], text accompanying notes 215–223.
4.11[2] Exceptions Expressed in Section 2039(a)

[a] Life Insurance Policies

Section 2039(a) is expressly inapplicable to “insurance under policies on the life of the decedent.” Therefore, amounts receivable under such policies, although often payable in the form of annuities and even though received by reason of surviving the decedent, are unaffected by Section 2039(a) regardless of whether other requirements of the section are met. This exception makes it easy to place outside the scope of Section 2039 the ordinary straight-life, term, or limited payment insurance policies. It is clear that the proceeds of these policies are includible in the decedent’s gross estate in accordance with the provisions of Section 2042, which is discussed later in this chapter.4 It is equally clear that annuity contracts without insurance features, if includible in the gross estate, will be governed by Section 2039 or general provisions other than Section 2042. However, the common current practice of issuing combination policies having an insurance and an endowment aspect, such as retirement policies with death benefits, raises a question whether the estate tax consequences of such policies are determined under Section 2039 or Section 2042. According to the legislative history of Section 20395 and the regulations,6 if a policy is properly classified as life insurance, Section 2042 controls. The remaining question, then, is: When is a combination policy insurance? This question is dealt with in the discussion of Section 2042 later in this chapter, but some brief comments should be made here.

Risk shifting and risk distribution are the principal characteristics of insurance.7 Accordingly, if, under a combination policy, an insurance company assumes the risk of the insured’s premature death by way of a commitment at any given time to pay death benefits in excess of the total premiums that have been paid at such time (plus interest, which would of course represent part of the return under an annuity policy),8 a risk element is present that makes the policy one of insurance governed by Section 2042. However, it should be

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4 See ¶ 4.14.
6 Reg. § 20.2039-1(d).
7 Compare Helvering v. Estate of Le Gierse, 312 US 531 (1941), with Fidelity-Philadelphia Trust Co. v. Smith, 356 US 274 (1958). In All v. McCobb, 321 F2d 633 (2d Cir. 1963), the Second Circuit held that an unfunded death benefit plan for certain survivors of employees represented a personal liability of the employer that did not constitute an insurance contract for purposes of the exception to Section 2039(a). Cf. Essenfeld v. Comm’r, 311 F2d 208 (2d Cir. 1962) (involving exclusions from gross income).
8 See Estate of Keller v. Comm’r, 312 US 543 (1941); Estate of Montgomery v. Comm’r, 56 TC 489 (1971), aff’d per curiam, 458 F2d 616 (5th Cir.), cert. denied, 409 US 849 (1972) (rejecting as unimportant “investment” as opposed to “insurance” risk).
noted that a combination policy, properly classified as insurance at its inception, may change its character at a later date when the insurance risk evaporates. The regulations properly make the applicability of Section 2042 or Section 2039 depend on the nature of the contract at the time of the decedent’s death; if a retirement income policy with death benefits has matured during the life of the decedent (i.e., payments to the decedent have commenced), there is no longer an insurance element at death and Section 2039 controls the amount to be included in the gross estate. However, the insurance element can disappear before such a policy matures. Thus, the regulations provide that “if the decedent dies after the reserve value equals the death benefit, there is no longer an insurance element under the contract,” and Section 2039 controls, even though the policy may not have matured before the decedent’s death. Similarly, the regulations also specify that “a contract under which the death benefit could never exceed the total premiums paid, plus interest, contains no insurance element.”

[b] Pre-1931 Contracts

Section 2039 is effective for estates of decedents dying after August 16, 1954. But Section 2039(a) is, by its own language, limited to contracts and agreements entered into after March 3, 1931, which, it will be recalled, is one of the critical dates with respect to the application of Section 2036.

[3] Qualifications

Under Section 2039, the gross estate will include the value of an annuity or other payment receivable by any beneficiary only if, under a contract or agreement, an annuity or other payment was payable to the decedent or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another, for the decedent’s life or some similar period.

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9 Reg. § 20.2039-1(d).
10 Reg. § 20.2039-1(d).
11 Reg. § 20.2039-1(d).
12 IRC § 7851(a)(2)(A).
13 The unstated assumption seems to be that annuities now taxed under Section 2039 first became taxable upon the enactment of the forerunner of Section 2036 in 1931 and have continued to be taxable since that time either under Section 2036 or Section 2039. Prior to that time, the decedent’s expiring interest was not the occasion for a tax. Cf. May v. Heiner, 281 US 238 (1930). See ¶ 4.08[9], text accompanying note 243. The assumption may be shaky if Section 2036 cannot properly be applied. See infra ¶ 4.11[6]. Still, an attack on the application of Section 2039 to pre-1954 transfers should meet with no success. Cf. Comm’r v. Estate of Church, 335 US 632 (1949).
[a] Contract or Agreement

Section 2039 requires that there be a contract or agreement. According to the regulations, contracts and agreements include understandings, arrangements, or plans.\(^\text{14}\) Rulings exclude benefit payments paid under public laws where the decedent has no voice in the designation of beneficiaries or payments to them, such as certain veteran’s benefits to a surviving spouse\(^\text{15}\) and other survivor’s benefits.\(^\text{16}\) Also, the required contract or agreement is lacking in a situation where either the decedent or the beneficiaries have only a mere expectancy. The problem of a mere expectancy is not likely to arise in the case of ordinary commercial annuities; in fact, most of the provisions of Section 2039 can be rather routinely applied to such contracts. Not so, however, with regard to employees’ annuities; most of the interpretation problems under Section 2039 arise in the employment setting, which is why much of the discussion of this section centers around employees’ annuities. For example, if an employer retains complete discretion to determine whether payments will be made to the decedent and the decedent’s survivors, there is no contract subject to Section 2039.\(^\text{17}\) A question arises as to whether related employment contracts, plans, or agreements can be combined to determine whether the various requirements of Section 2039 are satisfied. The regulations provide\(^\text{18}\): “All rights and benefits accruing to an employee and to others by reason of the employment…are considered together in determining whether or not Section 2039(a) and (b) applies.” There has been some appropriate judicial acceptance of the conglomerate approach required by the regulations.\(^\text{19}\) However, the

\(^{14}\) Reg. $\S$ 20.2039-1(b)(1).


\(^{17}\) Estate of Barr v. Comm’r, 40 TC 227 (1963), acq. 1964-1 CB (Pt. 1) 4; Courtney v. United States, 84-2 USTC ¶ 13,580 (ND Ohio 1984). The result is essentially consistent with Regulations Section 20.2039-1(b)(2), Ex. 4, although the regulations warn that where the decedent’s employer consistently makes discretionary payments, such payments will be considered as made under a “contract or agreement.” Cf. Rev. Rul. 75-505, 1975-2 CB 364, holding that a state employer’s unilateral right to reduce benefits by a reduction in salaries of continuing employees was related to the valuation of payments rather than to the existence of a binding contract.

\(^{18}\) Reg. $\S$ 20.2039-1(b)(2), Ex. 6.

\(^{19}\) Estate of Bahen v. United States, 305 F2d 827 (Ct. Cl. 1962) (two separate but related plans, adopted by the same employer on different dates, were treated as a combination). See also Gray v. United States, 410 F2d 1094 (3d Cir. 1969); All v. McCobb, 321 F2d 633 (2d Cir. 1963); Eichstedt v. United States, 354 F. Supp. 484 (ND Cal. 1972); Looney v. United States, 569 F. Supp. 1569 (MD Ga. 1983). But see Estate of Schelberg v. Comm’r, 612 F2d 25 (2d Cir. 1979) (refusing to combine plans where one plan was a
courts have balked when the Commissioner has attempted to carry the matter too far. For example, salary payments to which the decedent had a right at death do not constitute “an annuity or other payment” to which the decedent was entitled so as to bring within Section 2039 post-death payments to the decedent’s surviving spouse, in which the decedent never had any interest whatever.\textsuperscript{20} However, if a decedent employee had a right to retirement benefits, which did not simply represent compensation for continuing services, that right may be viewed along with the decedent’s survivor’s benefits as a part of an annuity contract within the scope of Section 2039.\textsuperscript{21} To link survivorship benefits arising out of the decedent’s employment with the decedent’s regular salary benefits\textsuperscript{22} seems supportable as a policy matter, if Congress really seeks to tax survivors’ benefits that represent testamentary transfers; but there are obstacles under the present statute.

[b] Period for Which Interest Is Retained

The duration of the decedent’s interest does not present fresh problems of statutory interpretation. In this respect, the statutory language of Section 2039 has been lifted directly from Section 2036. The question is whether the decedent had the specified right or interest (1) for his life, (2) for a period not ascertainable without reference to his death, or (3) for a period that did not in fact end before his death. The meaning of this trilogy is the same as the meaning of the identical language in Section 2036\textsuperscript{23} and is covered in the discussion of that section earlier in this chapter.\textsuperscript{24}

\textsuperscript{20} Kramer v. United States, 406 F2d 1363 (Ct. Cl. 1969); Estate of Fusz v. Comm’r, 46 TC 214 (1966), acq. 1967-2 CB 2. See Estate of Barr v. Comm’r, 40 TC 227 (1963), acq. 1964-1 CB (Pt. 1) 4. A later revenue ruling followed the courts’ rationale in receding from the conglomerate approach where one of two plans covering the decedent was a wage continuation paid to survivors. Rev. Rul. 77-183, 1977-1 CB 274.


\textsuperscript{22} Cf. Rev. Rul. 77-183, 1977-1 CB 274.


\textsuperscript{24} See ¶ 4.08[2].
[c] Nature of Decedent’s Interest

A difficult portion of Section 2039(a) is the language requiring that “an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment.” At the outset it should be emphasized that the section is not restricted to conventional annuity payments but rather includes “annuity or other” payments, which the regulations state “may be equal or unequal, conditional or unconditional, periodic or sporadic” and of which there may be “one or more payments extending over any period of time.”

It is clear that the two statutory clauses, “payable to the decedent” and “possessed the right to receive,” have separate and distinct meanings. The former clause applies to a case where the decedent at death was actually receiving payments without regard to the question whether the decedent could require their continuation. On the other hand, the “right to receive” clause is satisfied if “the decedent had an enforceable right to receive payments at some time in the future, whether or not, at the time of his death, he had a present right to receive payments.” The regulations so interpreting the statute find support in the legislative history, which refers to the rules applicable under Section 2036 for determining whether the decedent had the “right to the income.” Under Section 2036, it has been held that one has such right even if another interest intervenes or if the right is contingent.

If the payments to the decedent have not commenced at the decedent’s death, Section 2039 will not apply unless, at death, the decedent’s rights to future payments are nonforfeitable. However, this requirement will be satisfied if the decedent has control of the conditions that must be fulfilled to prevent forfeiture or, at least, the conditions are beyond the control of a person other than the decedent. Obviously, the nonforfeiture and contract or agreement requirements under Section 2039 overlap, since an extreme case of forfeiture.

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26 Reg. § 20.2039-1(b)(1).
27 Reg. § 20.2039-1(b)(1); Estate of Wadewitz v. Comm’r, 339 F2d 980 (7th Cir. 1964); Estate of Bahen v. United States, 305 F2d 827 (Cl. Ct. 1962).
29 See, e.g., Marks v. Higgins, 213 F2d 884 (2d Cir. 1954). See ¶ 4.08[2].
30 Estate of Wadewitz v. Comm’r, 339 F2d 980 (7th Cir. 1964); Estate of Bahen v. United States, 305 F2d 827 (Cl. Ct. 1962).
31 Estate of Wadewitz v. Comm’r, 339 F2d 980 (7th Cir. 1964).
32 Estate of Bahen v. United States, 305 F2d 827 (Cl. Ct. 1962) (decedent entitled to lifetime payments only if prior to retirement he becomes totally incapacitated to perform other duties).
would be complete discretion in the employer to determine whether payments will be made. However, considerable doubt exists as to whether a contract or plan that has a comprehensive formula for determining benefits should be beyond the reach of Section 2039 merely because the employer retains the typical unilateral power to revoke or modify. The probability that such plans will not be revoked or substantially modified, except under unusual circumstances and generally only with the concurrence of the employee or the employee’s union, should not be ignored.33

[d] Nature of Beneficiary’s Interest

Most of the problems just discussed in connection with the decedent’s interest are not, of course, present in the case of the beneficiary’s interest. To the extent that problems are common, the phrase “annuity or other payments” will have the same meaning for the decedent’s and beneficiary’s interests.34 The regulations properly indicate that a forfeiture provision in connection with the beneficiary’s interest will not defeat the application of Section 2039 but will be taken into consideration in the valuation of the interest.35 It is interesting to note that an employer who has contributed to the cost of the decedent’s and beneficiary’s benefits will not be treated as a beneficiary for purposes of Section 2039, even though under the contract the employer is entitled to a refund of contributions after the decedent’s death.36 Clearly, in such circumstances the decedent should not be viewed as making the kind of testamentary transmission of wealth to the decedent’s employer that Congress seeks to subject to estate tax.

[4] Amount to Be Included

The general rule expressed in Section 2039(a) indicates that the value of amounts receivable by beneficiaries “by reason of surviving the decedent” shall be included in the gross estate when Section 2039 applies, but Section 2039(b) restricts this broad statement in an important manner. Before considering the Section 2039(b) restrictions, two points should be made regarding the value of amounts receivable.

34 Reg. § 20.2039-1(b)(1).
35 Reg. § 20.2039-1(b)(2), Ex. 2.
Valuation

Under Sections 2031 and 2032, the value of the survivor's interest is to be determined at the date of death or as of the alternate valuation date, and it is the fair market value of the interest that is to be considered.\(^\text{37}\) Annuities under contracts issued by companies regularly engaged in their issuance are to be valued in accordance with principles set out in Regulations Section 20.2031-8, which provides for valuation, as a rule, in accordance with the cost of "comparable" contracts issued by the company. Usually, the test of value is what it would cost at the date of death to acquire a policy for the survivor with benefits such as exist under the contract in question.\(^\text{38}\) It is the survivor's rights immediately after the decedent's death, not as of the moment just before death, that are to be valued in this fashion.\(^\text{39}\) An amount taxable under Section 2039 may be expressed in terms of a lump sum payable over a future period. In such cases, it is not the amount of the lump sum that must be included, but the lower commuted value that is the present value of the rights to future payments.\(^\text{40}\)

If the annuity payments receivable by survivors are not to be paid by a company that regularly engages in such business, a replacement-cost approach to valuation cannot be used. Instead, the valuation of such annuities is to be determined in accordance with appropriate valuation tables.\(^\text{41}\) The valuation tables cannot be used if the measuring life is "terminally ill"\(^\text{42}\) or if the tables

\(^{37}\) Reg. § 20.2031-1(b). For a discussion of the valuation of annuities on the alternate valuation date, see ¶ 4.03[3][b].

\(^{38}\) Cf. Estate of Welliver v. Comm'r, 8 TC 165 (1947). So-called variable annuities are becoming increasingly common. As future payments under such annuities are dependent upon the investment experience of a fund, it might appear that a serious valuation question is presented. However, such annuities are issued by companies regularly engaged in the business, so the replacement-cost approach to valuation eliminates the problem.


\(^{40}\) Estate of Beal v. Comm'r, 47 TC 269 (1966), acq. 1967-2 CB 1.

\(^{41}\) Reg. § 20.2031-7 (to value annuities after April 30, 2009); Reg. § 20.2031-7A (with regard to valuation of annuities for estates of decedents dying before May 1, 2009). As required by Section 7520(c)(3), the Service on May 7, 2009 revised Table S and Table U(1), the tables used to value annuities, interests for life or a term of years, and reversionary and remainder interests in property, to reflect the mortality experience from the 2000 census (Life Table 2000CM). Transition rules allow taxpayers to use tables based on either Life Table 90CM or Life Table 2000CM to value gift, charitable, and estate transfers made on or after May 1, 2009, but before July 1, 2009, but they must use the appropriate interest rate for the month in which the valuation date falls, regardless of which table is chosen. Reg. § 20.2031-7T(d)(3)(ii) . IRS Publications 1457 and 1458 (Rev. May 2009), both of which include examples for using the mortality component tables.

\(^{42}\) Reg. § 20.7520-3(b)(3). The term "terminally ill" describes an individual who has an incurable illness or other deteriorating physical condition that contributes to at least a 50 percent probability that the individual will die within one year. See ¶ 4.02[5], text accompanying notes 268–270.
provide a substantially unrealistic or unreasonable approach. There is disagreement with respect to the valuation of annuities in the form of nonassignable lottery winnings.

[b] Percentage Restriction

Section 2039(b) specifies that the amount actually includible in the decedent’s gross estate under Section 2039 is to be determined by reference to the following two factors: (1) the value of what is payable to survivors, which has just been discussed, and (2) the portion of the purchase price of the annuity or other contract that was paid by the decedent. In a nontechnical way these factors can be seen to raise two questions: First, what value have the survivors received? And second, to what extent does that value represent a transmission of wealth by the decedent? If A buys and pays for a joint-and-survivor annuity under which A and B receive payments while both are living and the payments are continued to A after the death of B, the value of A’s continuing right is within Section 2039(a) and therefore potentially taxable in B’s estate. But, as all the wealth giving rise to A’s continuing annuity originated with A, there is no transmission of B’s wealth that Congress would wish to tax. On these facts, Section 2039(b) produces the expected result (no inclusion), because under that provision the amount to be included is only such part of the value of the annuity or other payment receivable by beneficiaries as is proportionate to the part of the purchase price contributed by the decedent (zero). In this respect, the section resembles Section 2040(a), relating to joint interests. The Section 2039(b) restriction can be expressed as follows:

\[
\frac{\text{amount included (unknown)}}{\text{value of annuity}} = \frac{\text{decedent’s contribution}}{\text{purchase price}}
\]

43 Estate of Gribauskas v. Comm’r, 342 F3d 85 (2d Cir. 2003); Estate of Shackleford v. United States, 262 F3d 1068 (9th Cir. 2001).


45 See ¶ 4.12.


amount included = \( \frac{\text{decedent's contribution}}{\text{purchase price}} \times \text{value of annuity} \)

Thus, if, in the case of a joint-and-survivor annuity for husband and wife, the wife paid all the cost of the policy and the husband survives, the entire value of amounts payable to the husband is to be included. As suggested earlier, if in the same circumstances, it is the wife who survives, nothing will be included in the gross estate of the husband because he made no contribution.

The decedent’s contribution, as used in the foregoing formula, has a broader meaning than amounts paid directly by the decedent. For one thing, Section 2039(b) specifies that any contribution toward the purchase price of the contract made by an employer or former employer of the decedent by reason of the decedent’s employment shall be treated as a contribution by the decedent.\(^\text{46}\) The Senate Finance Committee Report\(^\text{47}\) indicates that employer contributions may be treated as those of the employee decedent, even in the absence of any express statement to this effect in the contract of employment. So the words “by reason of his employment” may be given a broad interpretation. It is possible that an employee’s annuity arrangement within the scope of Section 2039 is entirely unfunded so that there are no formal contributions by either employer or employee to the “purchase price” of a contract, the employer simply assuming the obligation to make future payments. In such circumstances, the statute should be interpreted to treat the purchase price as contributed 100 percent by the employer, which contribution is then, by Section 2039(b), attributed to the employee.\(^\text{48}\) Despite some deficiencies in the statute, there is no reason why unfunded plans should be treated differently from those that are funded.

The statute does not deal expressly with indirect contributions, such as the payment of a part of the purchase price by a wife with funds supplied by the husband. Sections 2039 and 2040(a) are similar in general scope and purpose and, despite uncertainties under Section 2039, the phrase “contributed by the decedent” should be interpreted to square with the far more precise language in Section 2040(a).\(^\text{49}\)

\(^{46}\) If the employer contributions were treated as community property under state law, then they should be treated as made one half by decedent and one half by decedent’s spouse.


\(^{48}\) See Estate of Beal v. Comm’r, 47 TC 269 (1966), acq. 1967-2 CB 1, which involved an annuity program that was not funded by the employer until after the decedent’s death.

\(^{49}\) See ¶¶ 4.12[4]–4.12[8].
[5] Private Annuities

It is sometimes difficult to determine whether a noncommercial arrangement constitutes a gratuitous transfer with a reservation of income rights for life or a transfer for consideration in the form of an agreement by the transferee to pay an annuity. If a decedent has transferred property reserving the right to the income for life, Section 2036 places the value of the property in the decedent’s gross estate. On the other hand, if a decedent has transferred property to another person who agrees to pay, periodically, amounts equal to the anticipated income from the property for the rest of the decedent’s life, Section 2036 probably does not apply. The rationale is that such an arrangement does not constitute a reservation of the right to the income from the property; the decedent acquires a mere contractual right to a specified payment. Thus, the transaction constitutes the purchase of an “annuity” rather than the retention of a life estate. The same result may follow even if the decedent retains a security interest in the property transferred to ensure payment of the contractual amounts.

The noncommercial aspect of a transaction does not foreclose the application of Section 2039 to private annuities. For example, assume that the decedent D transferred property to X, an individual, in exchange for X’s agreement to pay D a specified sum each year for D’s life and, upon D’s death, to make like payments to D’s child for life. Section 2039 would bring the value of the child’s interest into D’s gross estate.

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50 Estate of Becklenberg v. Comm’r, 273 F2d 297 (7th Cir. 1959), which was distinguished in an income tax case, Samuel v. Comm’r, 306 F2d 682 (1st Cir. 1962); Cain v. Comm’r, 37 TC 185 (1961), acq. 1962-2 CB 4; Estate of Bergan v. Comm’r, 1 TC 543 (1943), acq. 1943 CB 2; Rev. Rul. 77-193, 1977-1 CB 273. Cf. Greene v. United States, 237 F2d 848 (7th Cir. 1956) (where decedent retained the right to the income from the property but not less than $1,500 per year, any deficit to be paid by the transferee, and Section 2036(a)(1) was held to apply); Lazarus v. Comm’r, 58 TC 854 (1972) (income and gift tax liability incurred).

51 These cases are distinguishable from Regulations Section 20.2036-1(a)(2), where a unitrust or annuity trust interest retained by the transferor triggers Section 2036(a)(1) when the transferor predeceases the term of the retained interest. See ¶ 4.08[8], text accompanying note 220. Cf. ¶ 19.03[3][b], note 120. The Treasury’s position is proper, but the cases cited above are distinguishable because the underlying property does not necessarily generate the income.


Retention of a security interest has the adverse income tax consequence of accelerating the gain on the transferred property to the time of the transfer. Compare Comm’r v. Kahn’s Estate, 174 F2d 357 (3d Cir. 1949) (unsecured promise with no immediate capital gain) and Estate of Bell v. Comm’r, 60 TC 469 (1973) (secured promise with immediate recognition of gain).

52 IRC § 2039(a). However, a survivorship annuity for the decedent’s surviving spouse would result in a “wash” for estate tax purposes, because the value of the surviv-
Although a private annuity with no survivorship rights would appear to be a device that would avoid the gift and estate taxes, this is not necessarily the case. Because the annuity is not in an ordinary business context, if the value of the property transferred by the decedent exceeds the value of the annuity to be paid, the excess is a gift subject to tax.\(^5\) Similarly, an annuity is an estate tax-defeating device only if the annuity payments received are spent or otherwise disposed of. Where the annual annuity payments plus the decedent’s other income exceed the decedent’s expenses, any accumulated excess will be included in the decedent’s gross estate under Section 2033.\(^4\) Thus, generally, the transfer of property for a private annuity for the transferor’s life that is equal to the value of the property reaps a financial estate planning benefit if the transferor predeceases the transferor’s life expectancy,\(^5\) although the transferor may not think of death as being beneficial. However, if the transferor outlives the transferor’s life expectancy, the transaction can increase the transferor’s gross estate and be costly to the transferee. It is that type of gamble that has led some planners to pursue alternate methods of transferring property to family members for its full fair market value.\(^5\)

The private annuity creates some interesting income tax consequences for both the decedent and the transferee; those consequences must also be taken into consideration in determining whether use of the private annuity device is advisable.\(^5\)

\(^5\) The current income tax consequences to the transferor require the gain or loss on the transferred property to be recognized in the year the transaction is effected (rather than as payments are received). Prop. Reg. §§ 1.72-6(e), 1.1001-1(j) replacing Rev. Rul. 69-74,

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\(^3\) Rev. Rul. 69-74, 1969-1 CB 43. See Estate of Bell v. Comm’r, 60 TC 469 (1973). The creation of a private annuity will not trigger Section 2702. See ¶ 19.03[2][a], note 78.

\(^4\) Lifetime gifts up to the amount of the Section 2503(b), $14,000 per donee, annual exclusion can be helpful in reducing such accumulation. See ¶ 9.04[1].

\(^5\) But see Reg. § 25.7520-3(b)(3), which applies if the annuitant is terminally ill.

\(^6\) One alternative method that provides greater simplicity and certainty and that “freezes” the value of the transferor’s gross estate is an installment sale of the property. The note is included in the transferor’s gross estate under Section 2033. See ¶ 4.05[3], note 32. Collection of the note is an item of income in respect of a decedent. IRC § 691.

A second more glamorous alternative method is the use of a self-canceling installment note. The technique has the advantage of no inclusion of the extinguished note in the transferor’s gross estate. Estate of Moss v. Comm’r, 74 TC 1239 (1980), acq. 1981-1 CB 2. See ¶ 4.05[3], note 32. However, this does not avoid the transferor’s estate’s recognition of income from the note. See Frane v. Comm’r, 998 F2d 567 (8th Cir. 1993) (holding that the gain inherent in the note is taxable to the transferor’s estate under Section 691). See also Roszak, “Installment Sales Terminating at Death Versus Private Annuities as Estate Planning Devices,” 59 J. Tax’n 20 (1983); Banoff & Hartz, “New Tax Court Case Expands Opportunities for Self-Cancelling Installment Notes,” 76 J. Tax’n 332 (1992).
[6] Background of the Section

With respect to ordinary commercial annuities purchased in whole or in part by a decedent under which survivors or the decedent’s estate receive benefits upon the decedent’s death, the enactment of Section 2039 in 1954 did not represent a significant change in the law. For example, it has generally been assumed that if a contract provides for a refund to the decedent’s estate of a portion of the cost in the event of the decedent’s premature death, the amount of such refund could be treated as any other property interest of the decedent, includible in the gross estate under Section 2033. In the case of an ordinary commercial joint-and-survivor annuity or a self-and-survivor annuity, the estate tax consequences were very largely settled before the enactment of Section 2039 by the application of less explicit provisions to reach a result similar to that reached under the explicit section. On the other hand, prior to the 1954 Code, employees’ annuities were generally held not to be includible in the gross estate of the annuitant, and it is in this area that Section 2039 has the greatest impact, particularly in light of the continued if not increased importance of employee benefit plans and the renewed interest in unfunded deferred-compensation arrangements.

Prior to 1954, in instances in which the employee’s estate had no continuing rights after the employee’s death so that Section 2033 would not bring anything into the employee’s estate, the Treasury sought to impose estate tax on the value of the survivor’s interests under principles expressed in Sections 2035 through 2038. Because these rules applied only if the decedent had made a transfer of property, the Treasury had to establish, first, that there was a transfer and second, that the transfer satisfied the prerequisites for inclusion under Section 2035, Section 2036, Section 2037, or Section 2038.

Whether an identifiable transfer occurred in these circumstances was never fully settled. In some circumstances, the Tax Court held that an employee’s arrangements with the employee’s employer for the payment of bene-

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1969-1 CB 43, and applicable after October 18, 2006, with certain transactions applicable after April 18, 2007. See Prop. Reg. §§ 1.72-6(e)(2), 1.1001-1(j)(2). As annuity payments are received by the transferor, Section 72 (including Sections 72(b)(2) and 72(b)(3) for annuities purchased after July 1, 1986) is applicable. The income tax consequences to the transferee are discussed in Rev. Rul. 55-119. 1955-1 CB 352.


59 See, e.g., Estate of Mearkle v. Comm’r, 129 F2d 386 (3d Cir. 1942); Comm’r v. Clise, 122 F2d 989 (9th Cir. 1941), cert. denied, 315 US 821 (1942); Comm’r v. Estate of Wilder, 118 F2d 281 (5th Cir.), cert. denied, 314 US 634 (1941).

60 See, e.g., Estate of Howell v. Comm’r, 15 TC 224 (1950), acq. 1953-1 CB 4; Estate of Twogood v. Comm’r, 15 TC 989 (1950), acq. 1953-1 CB 6, nonacq. 1951-2 CB 6 (withdrawn), aff’d, 194 F2d 627 (2d Cir. 1952).
fits to survivors constituted a transfer of property that might provide a basis for estate tax liability. In slightly different circumstances, the Tax Court held the other way. In two Tax Court cases reaching opposite conclusions on the question whether there was a transfer, the Second and Third Circuits both held for the taxpayer on the ground that even if there was a transfer, the requisite interest was not retained by the decedent to bring into play the principles of Section 2036. After the enactment of the Technical Changes Act of 1949, the Treasury shifted its main line of attack on this problem from what is now Section 2036 to what is now Section 2037. It continued to argue that some such arrangements constituted transfers and that such transfers might fit the requirements of the provision concerning transfers taking effect at death. Restoration in 1954 of the requirement in Section 2037 that the decedent retain a reversionary interest in the property transferred would have made the Treasury's job more difficult. However, Section 2039 now affords a different basis for taxing employees' annuities that makes irrelevant the "transfer" question and makes more explicit the nature of the interest the decedent must have retained or possessed in order for tax liability to be imposed.

The 1954 legislation makes apparent the congressional acceptance of the proposition that employees' annuities "purchased" either by employee contributions or by the performance of services for the employer represent testamentary-like transfers that could just as properly be subject to estate tax as are transfers inherent in ordinary commercial annuities with survivorship features. However, for a thirty-year period from 1954 to 1985, Congress to some extent excluded different types of income tax deferred compensation arrangements from the gross estate of an employee or self-employed decedent. The exclusion provisions were exclusive; even though another gross estate provision such as Section 2036 seemed operative, the Section 2039 exclusion pre-

61 See, e.g., Estate of Leoni v. Comm'r, 7 TCM (CCH) 759 (1948).
63 See, e.g., Estate of Twogood v. Comm'r, 15 TC 989 (1950), acq. 1953-1 CB 6, nonacq. 1951-2 CB 6 (withdrawn), aff'd, 194 F2d 627 (2d Cir. 1952); Estate of Higgs v. Comm'r, 184 F2d 427 (3d Cir. 1950).
64 See IRC § 2037; ¶ 4.09[7].
68 See IRC §§ 2039(c), 2039(d), 2039(e), 2039(f) (prior to repeal in the Deficit Reduction Act of 1984, Pub. L. No. 98-396, § 525(a), 98 Stat. 494, 873 (1984), reprinted in 1984-3 CB (Vol. 1) 381), which were applicable to various types of employee benefits, self-employed (or HR 10) plans, and individual retirement arrangements.
vailed. The rules that dealt with qualification for the exclusion involved the
types of arrangements, the form of benefit payments, and the classification of
the annuity recipients. These rules were complex.

In 1982, Congress reduced what had been a blanket Section 2039 exclusion
to a maximum $100,000 exclusion. Both before and after the 1982 re-
striction, prior editions of this text stated with respect to the Section 2039
exclusions:

There may be good reason for the income tax deferral....The income tax
deferral is of some benefit to most who qualify for it but, as many estates
of employees are too small to incur any estate tax liability in any event,
the...exemptions confer advantages only on estates of rather well-to-do
decedents. There is reason to wonder whether Congress should not care-
fully reconsider the exclusions with a view to their complete elimina-
tion.

In enacting the Tax Reform Act of 1984, whether or not Congress did
“carefully reconsider” the exclusions, it repealed them entirely for estates of
decedents dying after 1984.

The repealed subsections are still effective for estates of decedents either dying
before 1985 or in “pay status” (with regard to the annuity) before 1985, if such decedents
had irrevocably elected the form of the benefit before July 18, 1984. Deficit Reduction
1, 382. The effective date is the same for subsection (c). Tax Reform Act of

See IRC §§ 2039(c), 2039(e) (prior to repeal in the Deficit Reduction Act of 1984,

See IRC §§ 2039(c), 2039(f) (prior to repeal in the Deficit Reduction Act of 1984,

See IRC § 2039(g) (prior to repeal in the Deficit Reduction Act of 1984, Pub. L.

R. Stephens, G. Maxfield, S. Lind & D. Calfee, Federal Estate and Gift Taxation

(1984), reprinted in 1984-3 CB (Vol. 1) 1, 381. At the same time, Congress enacted a
new subsection 2039(c), which was repealed in the Tax Reform Act of 1986 (Pub. L. No.

See Rev. Rul. 92-22, 1992-1 CB 313 (inclusion of individual retirement account (IRA) under Section 2039 because decedent was not in “pay status”).

2868 (1986), reprinted in 1986-3 CB (Vol. 1) 1, 785.

Section 2039
‡ 4.12

§ 4.12 SECTION 2040. JOINT INTERESTS

[1] Introduction

The lot of Congress, like that of a police officer, is often not a happy one. An initial decision is made to tax the transmission of wealth at death. Section 2033 is born, appropriately but unimaginatively measuring the tax by the value of property owned at death by a decedent and, at that time, passed on to others. Peripheral questions clamor for answers. One such question is what to do about the decedent’s co-ownership of property with another or others at the time of the decedent’s death. Co-ownership does not necessarily present fresh problems. An ordinary interest as a tenant-in-common is something that a decedent can pass along to others in the same way as any interest in property owned solely by the decedent. No special provision is needed and none has been enacted for such an interest; it is taxed under Section 2033. A parallel approach is taken, quite supportably, to a decedent’s interest in community property. What if the decedent’s joint property interest is one that cannot be passed on by will? If it is one that merely expires at death, Section 2033 will not tax it. Should it (a thorny question) be accorded estate tax significance? As determined by Congress, the answer is yes, but with qualifications.

The qualified statutory answers to the riddle of joint ownership with survivorship rights must take account of the special rule of Section 2040(b), which applies only to property owned jointly by the decedent and the dece-

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1 Are transfers near to (and prompted by thoughts of) death also taxed? Prior to 1976, transfers made within three years of and “in contemplation of death” were included in the decedent’s gross estate. In 1976, this largely subjective test was replaced by a flat rule that transfers made within three years of death were to be included in the decedent’s gross estate. After 1981, transfers, regardless of proximity to death, are not included in the decedent’s gross estate for purposes of computing the estate tax, unless they would have resulted in inclusion in the decedent’s gross estate under Section 2036, Section 2037, Section 2038, or Section 2042 if the interest had been retained by the decedent. Are transfers with income or enjoyment or some measure of control retained taxed? Yes, but according to some detailed rules. IRC § 2036. Are transfers that are not fully effective until the transferor’s death taxed? Certainly, but with some afterthoughts at least as to what conditions should invoke the tax and as to whether the decedent must retain some interest in the property, suggesting a death-time transfer by the decedent, even if the tax is measured differently. IRC § 2037. How about a transfer made during life but revocable until death? No problem; but what lines should be drawn in identifying control or imputed control in the decedent? IRC § 2038. Annuities payable to others after death but generated by the decedent’s wealth are taxed (IRC § 2039) and even property never owned by the decedent that at death the decedent effectively controlled is taxed (IRC § 2041).

2 See ¶ 4.05[5][a]. See also Reg. § 20.2040-1(b).

3 See ¶ 4.05[5][a].

4 See ¶ 4.05[5][a]. But see First Ky. Trust Co. v. United States, 737 F2d 557 (6th Cir. 1984).
dent’s spouse. That problem is discussed later in this segment; where the special rule does not apply, four answers are essentially possible:

1. If the decedent’s interest and that of the other co-owners were acquired gratuitously from outsiders (as by gift or bequest from others), a co-owner’s estate is taxed at death on the co-owner’s ratable share of the property, even though the co-owner’s interest simply expires with the co-owner.6

2. If the decedent’s wealth created all the joint interests (the decedent bought the property and gave others their interests in it), the entire value of the property is taxed in the decedent’s estate.7

3. If the decedent’s interest was acquired entirely gratuitously from another co-owner (one to whom the purchaser gave an interest), the decedent’s estate is not taxed at all at death.8

4. If wealth of the decedent and that of the other co-owner went into their acquisition of the property (each paid a part of the cost of acquisition), Congress attributes to the decedent, and taxes the decedent’s estate on, a portion of the property commensurate with the decedent’s share of the cost of acquisition.9

The foregoing introductory remarks seek to suggest what Section 2040 is all about. A more detailed analysis of the section is attempted in the following discussion.10

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6 See infra ¶ 4.12[10]; note the exceptions to the Section 2040(b) rule discussed infra ¶ 4.12[10], text accompanying notes 85–94.

7 IRC § 2040(a) (first clause), subject to the Section 2040(b) exception. Why, one might ask again, when others had present interests fully enjoyed at death (and on which gift tax may have been paid by the decedent), such as would prompt an exclusion under Section 2036? Does the philosophy behind Section 2037 supply a reason by analogy? Estate of Fox v. Comm’r, 69 TCM (CCH) 1719 (1995).

8 IRC § 2040(a); the “except” clause provides a full exclusion unless Section 2040(b) is applicable. This result is appropriate on the theory there has never been any gratuitous transmission of anything to anyone by the decedent.

9 IRC § 2040(a); the “except” clause, as interpreted, nails the decedent’s estate for “such part” unless Section 2040(b) is applicable. Reg. § 20.2040-1(c)(2). Accepting the valuation-at-death concept (see discussion of IRC § 2031 at ¶ 4.02), does this not fairly reflect the value transmitted by the decedent to surviving co-owners?


Section 2040
Forms of Ownership Covered

Section 2040 applies specifically to three types of property interests:

1. **Joint tenancies.** Property held by the decedent and another or others as “joint tenants” with a right of survivorship\(^\text{11}\) is within the section. Neither the name given a property interest by the parties themselves nor the characterization under state law is controlling. State law may be a critical factor in the determination of whether Section 2040 applies, but only as it bears on the respective rights of the parties and not as it relates to labels or terminology.\(^\text{12}\)

2. **Tenancies by the entirety.** Tenancies by the entirety are expressly within the section, although they will generally be subject to the rules contained in Section 2040(b).\(^\text{13}\) In general, although there are some differences, a tenancy by the entirety is a joint tenancy with a right of survivorship in which the only tenants are husband and wife.\(^\text{14}\)

3. **Joint bank accounts.** The statute specifically encompasses joint bank accounts where the deposit is payable to either co-owner or the survivor.\(^\text{15}\)

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\(\text{11}\) Cf. Reg. § 20.2040-1(a).

\(\text{12}\) In some states, if property is transferred to two or more persons in joint tenancy they are mere tenants-in-common, unless the controlling document expressly provides for a right of survivorship. See, e.g., Fla. Stat. ch. 689.15 (2012). In other states, the term “joint tenancy” automatically carries the survivorship right. See, e.g., Mass. Ann. Laws ch. 184, § 7 (2012); NY Est. Powers & Trusts Law § 6-2.2 (2012).

See Rev. Rul. 87-98, 1987-2 CB 207 (joint tenancy property with a right of survivorship was treated as community property under state law and, therefore, both halves of the community property were accorded a fair market basis under Sections 1014(a)(1) and 1014(b)(6)). The ruling is discussed (with some skepticism) in Andrews, “Community Property With Right of Survivorship: Uneasy Lies the Head That Wears a Crown of Surviving Spouse for Federal Income Tax Basis Purposes,” 17 Va. Tax Rev. 577 (1998).

\(\text{13}\) See infra ¶ 4.12[10].

\(\text{14}\) A joint tenancy is usually unilaterally severable by any of the joint owners, but in the case of a tenancy by the entirety, neither spouse acting alone can defeat the right of the survivor to take the entire property. Cf. Reg. § 25.2515-2(b)(2). The nature of a tenancy by the entirety is examined in 7 R. Powell, Powell on Real Property ch. 52 (Michael Allan Wolf ed., LexisNexis Matthew Bender 2011). See, e.g., NY Est. Powers & Trusts Law § 6-2.2(b) (2012).

\(\text{15}\) Again, local law may bear importantly on the coverage of the section, and, despite the layman’s notion, it is often far from clear whether a joint bank account survivor succeeds to the deposit. See Stephens, Jr., “Survivorship Rights in Joint Accounts,” 24 U. Fla. L. Rev. 476 (1972).
In addition to forms of co-ownership already referred to, Section 2040 includes “a bond or other instrument, in the name of the decedent and any other person and payable to either or the survivor.”

An issue sometimes arises as to whether at the decedent’s death the property was jointly held. Although this issue must be determined under controlling documents and local property law, a local adjudication of the issue is not necessarily determinative. Controversy arose in some cases over whether U.S. savings bonds purchased by the decedent and held initially by the decedent and another in joint ownership had been transferred outright to the survivor during the decedent’s life. The Treasury Savings Bond Regulations provide that no inter vivos gift by one co-owner to another is effective unless the bonds are reregistered or reissued by the government in the donee’s name. The courts of appeals disagreed on whether mere delivery of such bonds without reregistration or reissuance was sufficient to convert them from joint ownership within the scope of Section 2040 to outright ownership in a transferee, foreclosing the imposition of estate tax under Section 2040.

The controversy was settled by the Supreme Court in Chandler, in which the Court held that outright ownership cannot be established in a manner at variance with the bond regulations. Thus, in the case of U.S. savings bonds, registration or reis-

16 Reg. § 20.2040-1(b). Under local property law, the registration of a bond in joint names may not effect any transfer of a present property interest to the noncontributing party, such as is a usual characteristic of joint tenancies. A transfer takes place when the latter properly cashes in the bonds for personal use or upon the death of one of the co-owners. Nevertheless, such an arrangement seems to be within the term “joint tenancy” as used in Section 2040. See Rev. Rul. 68-269, 1968-1 CB 399, Situation 5. The ruling attempts to classify some other co-ownership arrangements as well.

17 See, e.g., Estate of Kincade v. Comm’t, 69 TC 247 (1977); Wilson v. Comm’t, 56 TC 579 (1971), acq. 1972-1 CB 2; Buckley v. Comm’t, 42 TCM (CCH) 1592 (1981); Estate of May v. Comm’t, 37 TCM (CCH) 137 (1978); Black v. Comm’t, 765 F2d 862 (9th Cir. 1985).


19 See Comm’t v. Estate of Bosch, 387 US 456 (1967); § 4.05[2][b].


21 The Third and Ninth Circuits held that mere delivery is sufficient to transfer ownership. Silverman v. McGinnes, 259 F2d 731 (3d Cir. 1958); Chandler v. United States, 312 F. Supp. 1263 (ND Cal. 1970), aff’d per curiam, 460 F2d 1281 (9th Cir. 1972). However, the Sixth Circuit and other lower courts relied on the bond regulations to support the application of Section 2040. Curry v. United States, 409 F2d 671 (6th Cir. 1969); Estate of Elliot v. Comm’t, 57 TC 152 (1971), aff’d per curiam after Chandler, 474 F2d 1008 (5th Cir. 1973); Chambless v. United States, 1970-1 USTC ¶ 12,655 (DSC 1970).

suance is needed to convert joint ownership to outright ownership outside the reach of Section 2040.

[3] Some Section 2040 Misconceptions

The impact of Section 2040 is considered in the next segment of this discussion, but it is important here that some common misconceptions be set aside.

1. It is immaterial that jointly owned property is not part of a decedent’s estate for purposes of probate or administration. As in the case of other estate tax provisions, liability for the federal estate tax is not dependent upon the decedent’s having a transferable property interest when the decedent died.

2. The value of the decedent’s interest in the jointly held property prior to the decedent’s death is by no means the measure of what is to be included in the decedent’s gross estate. All, a part, or none of the value of the jointly held property may be included in the gross estate regardless of the value of the decedent’s particular interest prior to the decedent’s death. Thus, the fact that a decedent held a one-half interest in a joint tenancy prior to death is not determinative of the amount included in the estate under Section 2040.

3. The estate tax treatment of property owned by the decedent and another as joint tenants is not affected by the fact that the creation of tenancy was treated as a gift for gift tax purposes, except with regard to the possible availability of a credit for gift tax paid. Payment of the gift tax does not make the property any less subject to estate tax; that is, the rules discussed here still determine what is to be included in the gross estate, even though for gift tax purposes there has been a completed gift of an interest in the property. The gift tax paid may

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23 See, e.g., IRC §§ 2035, 2036, 2037, 2038.

24 Compare the philosophy of Section 2040(a), which bases the amount of inclusion on the source of the property, with that of Section 2033, under which the interest in the property at a decedent’s death measures the amount included in the decedent’s estate.

25 See the discussion of vanishing Section 2012 at ¶ 3.04; Estate of Horner v. Comm’r, 130 F2d 649 (3d Cir. 1942). Cf. IRC § 2001(b)(2).

reduce the actual amount of estate tax to be paid by way of the gift tax credit\textsuperscript{27} or the subtraction for gift tax payable in the estate tax computation.\textsuperscript{28}

[4] Amount to Be Included

As stated previously, the basic policy of Section 2040(a) is to include in the decedent’s gross estate the value of jointly owned property, except to the extent that the surviving tenant or tenants contributed to the cost of the acquisition of the property. The general effect of this policy is to treat property owned jointly by the decedent and another as if it were owned outright by the one who was financially responsible for its acquisition. Thus, if A pays for Blackacre and has it conveyed to A and B as joint tenants, upon A’s death, B surviving, the entire value of Blackacre is included in A’s gross estate.\textsuperscript{29} But if B is the first to die, no part of the value of Blackacre will be included in B’s estate, for Section 2040 does not treat B as owner of the property to any extent where A paid the purchase price.\textsuperscript{30}

Section 2040(a) goes well beyond the obvious examples just discussed. The section provides that the decedent’s estate includes the entire value of the jointly held property, except such part as may be shown to have originally belonged to the survivor and never to have been received or acquired by the survivor from the decedent for less than an adequate and full consideration in money or money’s worth. If the survivor made a contribution, that part of the value of the property that is commensurate with the consideration furnished by the survivor is excluded from the decedent’s gross estate. Accordingly, the crucial question is: What part of the value of jointly held property, if any, can be

\textsuperscript{27} The philosophy behind the estate tax is different from that behind the gift tax in this area. The gift tax (like Section 2033) looks to the property interest created, whereas Section 2040(a) looks to the origin or source of the funds.

\textsuperscript{28} See discussion of Section 2001(b) at ¶¶ 2.01[1], 2.01[2]. Gift tax paid on transfers within three years of death is included in the decedent’s gross estate. IRC § 2035(b), discussed at ¶ 4.07[3].

\textsuperscript{29} See, e.g., Third Nat’l Bank & Trust Co. v. White, 45 F2d 911 (D. Mass. 1930), aff’d per curiam, 58 F2d 1085 (1st Cir.), aff’d per curiam, 287 US 577 (1932).

\textsuperscript{30} Estate of Koussevitsky v. Comm’r, 5 TC 650 (1945), acq. 1945 CB 4. If A and B (nonspouses) die simultaneously, then all of the property would be included in A’s estate under Section 2040(a). Estate of Julian Peabody v. Comm’r, 41 BTA 1 (1940). If the Uniform Simultaneous Death Act applied, one half would be included in A’s estate under Section 2040(a) and the other half under Section 2033; in addition, one half of the property would be included in B’s estate under Section 2033. Cf. Rev. Rul. 76-303, 1976-2 CB 266. See also Rev. Rul. 66-60, 1966-1 CB 221.
excluded from the gross estate? Some exclusion depends on the estate establishing two facts: (1) that the surviving joint tenant did make a contribution to the acquisition of the property or did receive the property jointly with the decedent by gift, bequest, devise, or inheritance from a third party, and (2) that the contribution does not represent cash or property acquired from the decedent for less than an adequate and full consideration.

[5] survivor’s contribution

Specifically, Section 2040(a) as modified by Section 2040(b) provides that if the decedent owned property jointly with another other than only the decedent’s spouse, the amount to be excluded from the decedent’s gross estate is that part of the value of the property that bears the same ratio to the entire value of the property as the consideration furnished by the survivor (which did not come from the decedent gratuitously) bears to the entire consideration paid for the property. This relationship can be stated as follows:

\[
\frac{\text{amount excluded}}{\text{entire value of property}} = \frac{\text{survivor’s consideration}}{\text{entire consideration paid}}
\]

\[
\text{amount excluded} = \frac{\text{survivor’s consideration}}{\text{entire consideration paid}} \times \text{entire value of property}
\]

It is important to note that the ratio obtained is applied to the value of the property at the date of death or the alternate valuation date. The value may of course be higher or lower than the amount of the purchase price. For example, if A contributed $7,500 and B contributed $2,500 to the acquisition of Blackacre for $10,000 as joint tenants, and if A dies survived by B at a time when the property is valued at $20,000, $15,000 will be included in A’s gross estate. If, instead, the property is valued at $8,000, then $6,000 will be included in A’s gross estate.

[6] Property Acquired by Gift From Others

The statute takes express notice that property owned by joint tenants with right of survivorship may have been acquired by the owners by gift, bequest, devise, or inheritance from another. In general, in such circumstances, upon the death of one of the owners, the property is treated for estate tax purposes just as if each owner had contributed an equal part of the purchase price. Inasmuch as there are always just two owners in the case of a tenancy by the entirety, it has long been specified in Section 2040(a) that if property so owned was acquired by gift, bequest, devise, or inheritance, then one half of the property is
to be included in the estate of the first to die. It is interesting to note that even without that specification, this result would be reached under Section 2040(b).

On the other hand, property acquired gratuitously from others may be held by several persons as joint tenants with rights of survivorship. Section 2040(b) generally does not apply here, and, if their interests are equal, the amount to be included in the estate of the first to die is determined by dividing the value of the property by the number of joint tenants. If there are only two joint tenants, then one half of the value of the property will still be included in the estate of the first to die. But if there are three, the part of the value to be included is one third, and so on. It should be reemphasized that the rule applies only if the jointly owned property was acquired from outsiders by gift, bequest, devise, or inheritance.

[7] Property Paid for by the Co-Owners

[a] The Tracing Requirement

Unfortunately, the exclusionary rules of Section 2040(a) inject into the statute an irksome tracing problem. Section 2040(a) specifically disregards any contribution toward the acquisition of jointly held property made by the surviving tenant out of property gratuitously acquired from the decedent.\(^3\) By proper interpretation, the proceeds from a disposition of such property are likewise generally disregarded.\(^3\) The main thrust of the statute is that only contributions from separate funds of the survivor are taken into account under the exclusionary rules. For example, if the decedent, \(D\), gave \(A\) $10,000, which \(A\) later used to pay one half of the purchase price of the property held by \(A\) and \(D\) at death as joint tenants, the entire value of the property would be included in \(D\)’s gross estate. Similarly, if \(D\) originally gave the property itself to \(A\), and \(A\) subsequently reconveyed it through a straw man to \(A\) and \(D\) as joint tenants, \(A\) is not treated as having contributed to the acquisition of the property, and its entire value is included in \(D\)’s gross estate if \(D\) is the first to die.\(^3\) No part of the value would be included in \(A\)’s estate under Section 2040 in either instance, if \(A\) was the first to die.\(^3\)

Clearly, the statute adopts a tracing rule by requiring a determination of whether a contribution to the purchase price by the surviving tenant was from

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\(^3\) See Estate of Lyons v. Comm’r, 35 TCM (CCH) 605 (1976).


\(^{34}\) There would also be no Section 2035 inclusion. See IRC § 2035(a)(2); ¶ 4.07[2][a][ii].
the surviving tenant’s own funds. More precisely, Section 2040(a) says the consideration provided by the survivor must never have been “acquired...from the decedent for less than an adequate and full consideration in money or money’s worth.” It is well established that a contribution originating as income from property acquired gratuitously from the decedent constitutes a contribution from the survivor’s separate funds, and the regulations so provide. Thus, a surviving tenant’s contribution to the purchase of jointly held property out of dividends from stock given to the survivor by the other tenant, the decedent, has been treated as made out of the survivor’s own separate funds.

What is “income” for these purposes? A troublesome question is whether a contribution made out of gain representing appreciation in the value of property received gratuitously from the decedent is attributable to the decedent or, instead, is to be treated as income from the property and thus separate funds of the surviving tenant. Proposed regulations under the 1954 Code, not finally adopted, took the flat position that such appreciation is not “income” from property within the rule that permits income from gift property to be treated as the surviving tenant’s separate contribution. A similar position in the current regulations is not expressed so comprehensively.

Two distinct situations should be recognized. In one circumstance, the surviving tenant who received property gratuitously from the decedent may have sold the property and thereafter contributed the proceeds, including the survivor’s gain. In this situation, the gain, measured by the appreciation from the time of the receipt of the gift to the time of the sale, has been treated as income and as part of the surviving tenant’s contribution. For example, assume the decedent, D, buys property...
for $1,000 and the property appreciates to $2,000, at which point D gives the property to A. A holds the property until its value reaches $5,000 and then sells it and uses the proceeds for A’s contribution in the acquisition of jointly held property that is held by D and A at the time of D’s death. The appreciation from the time of the gift to the time of the sale, $3,000, would be treated as income from the gift property, qualified as a contribution by surviving tenant A.\footnote{Eisner v. Macomber, 252 US 189 (1920)) necessarily creeps in because, absent a disposition of the gift property, the contribution of the gift property itself would simply be property “acquired by the donee...from the decedent” gratuitously, which the statute expressly says cannot be considered. However, there is no estate tax requirement that realized gain be “recognized.” Thus, a donee’s contribution of property acquired in a tax-free exchange, even though the donee’s gain went unrecognized under Section 1031, for example, should be treated as the donee’s separate contribution, except for the value at the time of the gift of the property acquired by gift.}

In the second situation, the surviving tenant, A, receives property gratuitously from the decedent, D, it appreciates, and thereafter A uses the property itself as A’s contribution to the acquisition of jointly held property. Here, at least according to the regulations, all of the property will be treated as having been paid for by D.\footnote{Reg. § 20.2040-1(c)(4).} Does this realization concept have an appropriate place in the estate tax? Maybe so, as it is conceptually difficult to carve out any separate funds where the very thing received gratuitously from the decedent constitutes the survivor’s contribution, but the conclusion seems less acceptable as a policy matter than as a matter of statutory interpretation. Obviously, the rules on survivor contributions create a unique tracing and allocation problem; under them, the proceeds of the sale of appreciated gift property are partly the separate funds of the donee and partly attributable to the donor decedent, but quite different consequences may attend the economically similar contribution of property freighted with unrealized gain. With the enactment of Section 2040(b), the statute has moved away from these difficulties with respect to husband-and-wife joint tenancies.

The first situation, involving a realized gain on property owned by the survivor,\footnote{Harvey v. United States, 185 F2d 463 (7th Cir. 1950).} may have to be differentiated from a situation in which the donee never owns the property outright. For example, what if the decedent, D, transfers property to D and the surviving tenant, A, as joint owners and the property appreciates in value, is sold by them while jointly owned, and the proceeds (including the realized gain) are reinvested in other jointly owned property? It has been held that the full value of the property is included in D’s gross estate.\footnote{Endicott Trust Co. v. United States, 305 F. Supp. 943 (NDNY 1969).} The court rejected the estate’s argument that one half of the re-
alized gain from the sale of the property should be treated as a separate contribution by A on the ground that A never held an outright, as opposed to a joint, interest in the property.\textsuperscript{46} Although treating a part of such realized appreciation as the property of and a contribution by A would allow an easy partial avoidance of Section 2040(a) by means of a near-death sale and repurchase of property,\textsuperscript{47} such a result would nevertheless be consistent with the “property ownership” (as opposed to “tax ownership”) theory adopted in other Section 2040(a) situations that also permit an easy partial avoidance of the section.\textsuperscript{48}

[b] Additions and Improvements

In addition to establishing the respective contributions to the initial cost of acquisition, it may be necessary to take account of amounts subsequently contributed. The regulations state that the total cost of acquisition includes the cost of “capital additions.”\textsuperscript{49} Curiously, the regulations and the cases as well are virtually silent on the exact significance of the cost of capital additions.\textsuperscript{50} For example, assume that D and A each contribute $100 to the purchase of unimproved real estate, taking title in the name of D and A as joint tenants. Assume that the property greatly appreciates over time to a value of $1,100. If D then makes a capital improvement at a cost to him of $100 and thereafter dies, how much is includible in D’s gross estate? Applying the regulations literally, D has contributed $200 and A contributed $100. Accordingly, if the property at the time of D’s death is worth $2,400 ($1,100 fair market value at the time of improvement, plus $100 improvement, plus $1,200 appreciation from date of last improvement to death), two thirds of that amount, or $1,600, would be includible in D’s estate on the theory that D contributed two thirds of the cost. Stated more in terms of the statutory language, because A, who survives, contributed one third of the cost, one third of the date-of-death value is excluded.

\textsuperscript{46} The propriety of the result in \textit{Endicott} is questionable. If income in the form of interest, dividends, or rent generated by jointly held property paid for one person is used to purchase other jointly held property, the property is deemed funded equally by both joint owners. Estate of Otte v. Comm’r, 31 TCM (CCH) 301 (1972); Rev. Rul. 56-519, 1956-2 CB 123. On the other hand, unrealized appreciation on jointly held property originally paid for by a decedent would result in no separate contribution by the co-owner if that property were exchanged for other property to be held jointly. \textit{Endicott} falls somewhere between these two situations. A realization of the appreciation on jointly held property would establish a portion of that appreciation as the survivor’s property under local law, seemingly bringing it within the ambit of Harvey v. United States, 185 F2d 463 (7th Cir. 1950).

\textsuperscript{47} There is an income tax obstacle, Section 1001.

\textsuperscript{48} See infra ¶ 4.12[9].

\textsuperscript{49} Reg. § 20.2040-1(a)(2).

\textsuperscript{50} The second and third sentences of Regulations Section 20.2040-1(a)(2) are vague, to say the least. Compare Reg. § 25.2515-1(c)(2).
from D’s estate. This first possible approach seems incorrect, because D’s contribution to the final value is exaggerated. In addition, in contemplation of a decedent’s death, a likely survivor could make a relatively minor capital improvement and effectively remove substantial value from a decedent’s estate.51

A second and seemingly correct approach would be to allocate to each of the co-owners a part of the appreciation commensurate with the co-owners’ contributions prior to the appreciation.52 Thus, in applying the exclusionary rules of Section 2040(a), D should be treated as having contributed the following sums: $100 (D’s share of the original cost), $450 (one half of the appreciation from the time of acquisition until the time of improvement), and $100 (D’s capital improvement), for a total of $650. Using like reasoning, A’s contributions would be $100 (A’s share of the original cost) and $450 (one half of the preimprovement appreciation), for a total of $550. The total cost of acquisition should be treated as $1,200 (fair market value after the improvement) for purposes of the exclusionary rule. Thus, the amount to be excluded from D’s estate would be $550 divided by $1,200 multiplied by $2,400, or $1,100 (the portion of date-of-death value commensurate with A’s contribution to total cost), as a result of A’s “contributions,”53 and only $1,300 would be included. The estate may have severe practical problems in establishing the value at the time of the improvement.

A third possible approach should be rejected along with the first one suggested. It would be merely to reduce the value of the property included in D’s gross estate by actual cash value of A’s contribution; on the facts of this example, $2,300 would be included. This mechanical approach would completely ignore the appreciation attributable to A’s contribution. Only one case has faced the issue,54 and the court may have adopted either the second or the third solution. In Peters, the decedent inherited some property and placed it in a joint tenancy, and the co-owners made improvements on it. The surviving joint tenant subsequently made further improvements before the decedent co-owner’s death. The Tax Court found in Peters that the property did not appreciate in value subsequent to any of the survivor’s improvements, and it taxed the decedent’s estate on the value of the property less the cost of the survivor’s improvements. Thus, under the Peters facts, the same result would

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51 Thus, in the text example, if D made no improvement but A made a $400 capital improvement immediately prior to D’s death, then five sixths of the value of the property would not be included in D’s estate, and only $400 would be included.

52 This would be in accord with the gift tax regulations under Section 2515 (prior to repeal in the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 403(c)(3)(B), 95 Stat. 172, 302 (1981), reprinted in 1981-2 CB 256, 325). Reg. § 25.2515-1(c)(2). It should be subject to the qualification of those regulations that the allocation would be made, unless appreciation is directly and identifiably traceable to a particular contribution.

53 Postimprovement appreciation continues to be partly contributed to A.

54 Estate of Peters v. Comm’r, 386 F2d 404 (4th Cir. 1967).
have been reached under either the second or the third solution, as none of the appreciation could be ascribed to the survivor’s contribution. However, the Tax Court indicated that if there had been appreciation after that contribution, a formula or ratio might have been needed to reach the proper result, which implies the court’s acceptance of the second solution. The Fourth Circuit in affirming did not expand the Tax Court’s rationale, nevertheless the result reached was correct.

[8] Burden of Proof

The burden of showing original ownership or contribution to the purchase price by the survivor falls upon the estate. Section 2040(a) specifically requires inclusion of the entire value of jointly held property, “except such part thereof as may be shown” to have originated with the survivor. As the cases illustrate, this can be a difficult burden, although where evidence indicates that the survivor did make a contribution, courts have held that the burden is met and have been willing to estimate the amount. Clearly, then, the lesson is simple: The decedent’s estate may be called upon through records, memoranda, canceled checks, duplicate deposit slips, and other documentary evidence to establish the time at which the transactions took place and the respective contributions. As in most areas of tax controversy, inadequacy of records usually works to the disadvantage of the taxpayer.

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57 As discussed supra ¶ 4.12[7][b] in connection with the contribution by the surviving tenant, the purchase price includes not only the cost of acquisition but also any improvements made to the property.
58 See, e.g., Estate of Heidt v. Comm’r, 8 TC 969 (1947), aff’d per curiam, 170 F2d 1021 (9th Cir. 1948); Estate of Balazs v. Comm’r, 42 TCM (CCH) 632 (1981).
60 Estate of Giacopuzzi v. Comm’r, 29 TCM (CCH) 1777 (1970) (entire value of a home owned jointly by mother and daughter was included in the mother’s estate because the daughter was unable to trace her earnings that she had given to her mother into payments on the home); Estate of Harden v. Comm’r, 72 TCM (CCH) 1139 (1996) (mother’s estate was unable to prove any deposits made to a joint bank account by son). Cf. Blood
In the case of bank accounts owned jointly at death, the burden of proof is even more difficult. Here, the decedent’s estate must show not only that the survivor made a contribution but also that the survivor did not withdraw the contribution made. As the nontax advantages of owning property jointly are limited, these requirements raise a question of whether, other than in the case of husband and wife, joint ownership should not be largely avoided.

If the surviving tenant has made a contribution to the acquisition of jointly owned property out of property acquired from the decedent, but acquired for full consideration, this constitutes a contribution out of the survivor’s separate funds. Prior to the enactment of current Section 2040(b) in 1981, many issues arose with respect to various types of interspousal contributions. For joint interspousal interests created after 1981, those issues are

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61 Estate of Drazen v. Comm’r, 48 TC 1 (1967); Estate of Brandt v. Comm’r, 8 TCM (CCH) 820 (1949). In Tuck v. United States, 282 F2d 405 (9th Cir. 1960), and English v. United States, 270 F2d 876 (7th Cir. 1959), there was a failure of proof that the survivor contributed separate funds to the acquisition of jointly held property.

62 If an estate planner encounters jointly owned property, the planner must make a careful study of the gift tax consequences of a possible severance of the property, as well as being alert to possible gift tax liability ignored at the time the joint ownership originated.

63 See infra ¶ 4.12[10].

64 For estate tax purposes, a relinquishment of dower, curtesy, or other marital rights in another’s estate does not constitute consideration. IRC § 2043(b), discussed at ¶ 4.15[1]. A wife’s performance of ordinary domestic services did not constitute a contribution on her part, under Section 2040(a). Estate of Lyons v. Comm’r, 35 TCM (CCH) 605 (1976). However, it was difficult to say, beyond the situation of domestic services, whether a wife had furnished consideration by virtue of work performed for her husband in a business setting, or whether she received a mere gratuity when he had property transferred to them jointly. Compare Berkowitz v. Comm’r, 108 F2d 319 (3d Cir. 1939), Richardon v. Helvering, 80 F2d 548 (DC Cir. 1935), and Estate of Otte v. Comm’r, 31 TCM (CCH) 301 (1972) (representing joint business efforts by husband and wife), with Rogan v. Kammereiner, 140 F2d 569 (9th Cir. 1944) (reaching a like result seemingly based on a mere agreement to share profits). Cf. Estate of Carpousis v. Comm’r, 33 TCM (CCH) 1143 (1974). But see Estate of Ensley v. Comm’r, 36 TCM (CCH) 1627 (1977), aff’d in unpub. op. (7th Cir. 1979); Estate of Ehret v. Comm’r, 35 TCM (CCH) 1432 (1976). See Whitesell, “Estate Taxation of Joint Tenancy Property Acquired by Spouses With Funds
generally moot, because Section 2040(b) simply includes only one half of interspousal survivorship property in the predeceasing spouse’s gross estate.\(^6^5\)

Under what circumstances in a non–Section 2040(b) situation will mortgage liability be treated as a contribution by the surviving tenant? At least one case has appropriately held that if the parties acquire property taking title as joint tenants and jointly assuming a mortgage, initially each joint tenant will be treated as making a contribution in the amount of one half of the mortgage liability assumed\(^6^6\); the Service accepts that position.\(^6^7\) If the mortgage liability so assumed is discharged with income from the property, the respective proportionate contributions would remain unchanged if the income from the property legally belongs one half to each tenant.\(^6^8\) Even though the mortgage liability is assumed jointly, if one of the two tenants discharges the liability out of separate funds, their respective contributions should be realigned and the amount paid treated entirely as a contribution by the tenant who paid off the mortgage: but here, as elsewhere,\(^6^9\) evidentiary problems regarding payments are difficult. There is no authority dealing with the question whether an acquisition of property subject to a mortgage (not assumed) will be treated similarly. For income tax purposes, the treatment is the same,\(^7^0\) and there are equally strong reasons for a similar estate tax result.

[9] Termination Prior to Death

Under the present case law, a pre-death disposition of property held jointly presents a planning technique for the reduction of the estate tax.\(^7^1\) If a decedent provided all of the consideration for property held by the decedent and some-

\(^6^5\) See infra ¶ 4.12[10]. But see infra ¶ 4.12[10], text accompanying notes 85–94.

\(^6^6\) Bremer v. Luff, 7 F. Supp. 148 (NDNY 1933).


\(^6^8\) Cf. Estate of Otte v. Comm’r, 31 TCM (CCH) 301 (1972).

\(^6^9\) Estate of Awrey v. Comm’r, 5 TC 222 (1945), acq. 1945 CB 1.

\(^7^0\) Crane v. Comm’r, 331 US 1 (1947); Parker v. Delaney, 186 F2d 455 (1st Cir. 1950), cert. denied, 341 US 926 (1951).

\(^7^1\) The technique requires a valid termination of the joint tenancy. See Estate of Bettin v. Comm’r, 33 TCM (CCH) 499 (1974), aff’d per curiam, 543 F2d 1269 (9th Cir. 1976) (involving an invalid termination). See also Ellis, “Estate and Gift Tax Planning for the Termination of Joint Interests,” 31 J. Tax’n 98 (1969), for a discussion of this area prior to the enactment of Section 2040(b). Pre-death disposition of jointly held property to
one other than the decedent’s spouse as joint tenants and the decedent predecedes the other person, the entire value of the property is included in the decedent’s gross estate under Section 2040(a). If, however, near the decedent’s death they sever the joint tenancy and create a tenancy in common, then only one half of the property is included in the decedent’s gross estate.

If the decedent and the other joint tenant transfer the property outright to a third party gratuitously, even within three years of the decedent’s death, none of the value of the property is includable in the decedent’s gross estate. The result follows no matter what would have been includable under Section 2040(a) had the property been retained until death. If the decedent and the other joint tenant transfer the property to a trust resolving a life estate for their joint lives, only one half of the property is includable in the decedent’s gross estate under Section 2036. The Commissioner has argued that the whole property should be included in the decedent’s estate, relying on the estate tax ownership concept embraced in \textit{United States v. Allen}, discussed in connection with Section 2036. This approach, however, has been rejected and a straight property ownership concept has been applied. The rationale for this result is that at the time of the transfer, the decedent had only a one-half interest in the property under local law, which was all the decedent could have trans-

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72 See, e.g., Third Nat’l Bank & Trust Co. v. White, 45 F2d 911 (D. Mass. 1930), aff’d per curiam, 58 F2d 1085 (1st Cir.), aff’d per curiam, 287 US 577 (1932).

73 IRC § 2033. Estate of Goldberg, TCM (CCH) 1120 (2010) (no effective pre-death severance under state law).

74 Neither Section 2040(a) nor Section 2035(a) is applicable. See IRC § 2035(a)(2); ¶ 4.07[2][a][ii]. The transfer is, of course, subject to gift tax with the decedent and the joint tenant each making a gift of one half of the value of the property. Under the unified transfer tax, the value of the gift is instrumental in determining the estate tax. See IRC § 2001(b)(1)(B); ¶¶ 2.01[1], 2.01[2]. See also IRC § 2035(b); ¶ 4.07[3].

75 Heasty v. United States, 306 F2d 57 (7th Cir. 1962); Black v. Comm’r, 765 F2d 862 (9th Cir. 1985); Glaser v. United States, 306 F2d 57 (7th Cir. 1962) (involving a tenancy by the entirety); Estate of Borner v. Comm’r, 25 TC 584 (1955), acq. 1969-2 CB xx-iii (tenancy by the entirety); Rev. Rul. 69-577, 1969-2 CB 173. But see Estate of May v. Comm’r, 37 TCM (CCH) 137 (1978), questionably holding that a joint tenancy still exists if the property is transferred to a revocable trust.


77 See ¶ 4.08[8][b].
ferred. The principle, which seems settled, is not invariably favorable to the estate. A possible adverse consequence could arise if the noncontributing tenant predeceased the other tenant because, in that situation, one half of the corpus would be included in the decedent’s gross estate. If no trust had been created, the noncontributor would still have enjoyed one half of the income from the jointly owned property for noncontributor’s life, but nothing would have been included in noncontributor’s gross estate.

The results of the cases square with a literal reading of Sections 2035 and 2036 but patently undermine the policy of Section 2040. Caution is in order; such circumstances invite legislative, even judicial, change. Legislation would be appropriate.

[10] The Section 2040(b) Exception

Many spouses own property, both realty and personalty, in joint ownership with right of survivorship principally to avoid the formal probate process. However, the estate tax consequences have often been adverse or at least complex; difficulty often arose in determining relative contributions to the acquisition of the property. In Section 2040(b), Congress created a major exception to the general rule of Section 2040(a) that alleviates the difficulty.

Section 2040(b)(1) provides a flat rule that one half of the value of property jointly owned is included in the estate of the predeceasing tenant in the case of a “qualified joint interest,” a term defined in Section 2040(b)(2). An interest qualifies only if the only co-owners are husband and wife and there is

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81 See supra ¶¶ 4.12[7], 4.12[8].

82 A post-1980 “qualified joint interest” should not be confused with a pre-1981 “qualified joint interest.” Section 2040(b), as it existed from 1977 through 1980, contained a similar rule that also resulted in inclusion of only one half of the value of the property in the predeceasing spouse’s gross estate. However, the earlier Section 2040(b) had several further requirements that had to be met before it became applicable. Those further requirements, some very intricate rules in repealed Sections 2040(d) and 2040(e) for qualifying pre-1977 joint tenancies for post-1976 Section 2040(b) treatment, and a second interspousal exception enacted in 1978 under Section 2040(c) related to farm and other business property held jointly, are considered in R. Stephens, G. Maxfield & S. Lind, Federal Estate and Gift Taxation ¶ 4.12[11] (Thomson Reuters/Tax & Accounting, 4th ed. 1978).
a right of survivorship.\textsuperscript{83} Thus, with respect to such interests, no matter who provided the consideration or in what relative proportion, one half of the value of the property is included in the predeceasing spouse’s gross estate.\textsuperscript{84}

There are two exceptions to the Section 2040(b) rules. First, the rule is inapplicable to qualified joint interests created prior to 1977.\textsuperscript{85} Second, concerned about collecting tax revenues from a surviving spouse who is not a U.S. citizen,\textsuperscript{86} Congress has generally made the Section 2040(b) rule inapplicable where the surviving spouse is not a U.S. citizen.\textsuperscript{87} Thus, with respect to a joint tenancy held only by spouses or a tenancy by the entirety where the surviving spouse is a noncitizen, the normal Section 2040(a) tracing rules generally apply.\textsuperscript{88} However, if prior to the filing of a decedent’s estate tax return, the surviving spouse becomes a U.S. citizen and the surviving spouse was a

\textsuperscript{83} IRC § 2040(b)(2)(B). Both requirements are always met in a tenancy by the entirety.

\textsuperscript{84} Inclusion under Section 2040(b) will essentially result in a “wash” (no net increase situation) as the included value of such property will qualify for the Section 2056 marital deduction. See ¶ 5.06. Full inclusion of such property would also result in a wash. Id. However, if only one half of the property is included in the decedent’s gross estate, only one half of the property will qualify for a Section 1014 basis. If property were funded with community property, it may be more advantageous to hold title to the property as community property. See IRC § 1014(b)(6), which steps up the basis of both halves of community property on the death of the predeceasing spouse. Cf. Rev. Rul. 87-98, 1987-2 CB 206 (property held by spouses as joint tenants with rights of survivorship classified as community property under state law).

\textsuperscript{85} Section 2040(b) as originally enacted applied only to joint interests created after 1976 (Tax Reform Act of 1976, Pub. L. No. 94-455, § 2002(d)(3), 90 Stat. 1520, 1856 (1976), reprinted in 1976-3 CB (Vol. 1) 1, 332), and the amendment of the section by the Economic Recovery Tax Act of 1981 (Pub. L. No. 97-34, § 403(c)(1), 95 Stat. 172, 301 (1981), reprinted in 1981-2 CB 256, 325), did not explicitly or implicitly repeal the effective date. In Gallenstein v. United States, 975 F2d 286 (6th Cir. 1992), an income tax case where a husband provided the entire consideration for a farm in which he and his spouse took title as joint tenants prior to 1977, the full value of the farm was properly included in his estate. His surviving spouse was therefore entitled, under Section 1014, to a stepped-up basis in the property equal to the property’s fair market value at the time of the husband’s death. The same result was reached in Patten v. United States, 116 F3d 1029 (4th Cir. 1997); Hahn v. Comm’r, 110 TC 140 (1998), acq. 2001-2 CB xv.

\textsuperscript{86} Seemingly, the thinking of Congress in making Section 2040(b) inapplicable is that if the joint property was funded by the decedent, it should be included in the decedent’s gross estate in the event that the Treasury might not be able to tax the property in the noncitizen spouse’s estate.

\textsuperscript{87} IRC § 2056(d)(1)(B). The provision could hardly be more hidden!

The Section 2040(a) rules also apply if the decedent spouse is not a U.S. citizen, but the property is subject to United States taxation under Section 2103. Reg. § 20.2056A-8(a)(1).

\textsuperscript{88} See supra ¶¶ 4.12[4]–4.12[9]. See Reg. § 20.2056A-8(c), Ex. 3. If the spouses acquired the property by gift, bequest, devise, or inheritance, only one half is includable in the decedent’s gross estate where the spouses are the only tenants. See supra ¶ 4.12[6].
U.S. resident at all times after the decedent spouse’s death and prior to becoming a citizen, Section 2040(b) remains applicable. If the noncitizen surviving spouse does not obtain citizenship, Section 2040(a) remains applicable, but to the extent that such property is included in the decedent spouse’s gross estate under Section 2040(a) and the surviving spouse transfers it to a qualified domestic trust (QDOT) it qualifies for a marital deduction and QDOT treatment resulting in a postponement of decedent spouse’s estate tax. To the extent that the property is included in the gross estate of both spouses, a Section 2013 credit is allowed regardless of the time span between their deaths.

In conjunction with the enactment of Section 2056(d)(1)(B), Congress generally restored the gift tax provisions of Sections 2515 and 2515A related to the creation of such joint tenancy and tenancy-by-the-entirety interests as they existed prior to their repeal in 1982. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 403(c)(3)(B), 95 Stat. 172, 302 (1981), reprinted in 1981-2 CB 256, 325. See IRC § 2523(i)(3). See also ¶ 10.01[3][f], note 117, explaining the interrelationship of Section 2040(a) and Section 2523(i)(3). As a result, in applying Section 2040(a), pursuant to the rules above, if the donor spouse predeceases the donee spouse, a transfer by the donor spouse made in creating a joint tenancy or a tenancy by the entirety prior to July 14, 1988, that was treated for gift tax purposes as a gift by donor to donee is treated as consideration originally belonging to the donee spouse in determining the value of the tenancy included in the donor spouse’s gross estate. Reg. § 20.2056A-8(a)(2). Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7815(d)(16), 103 Stat. 2106, 2419 (1989), reprinted in 1990-1 CB 210, 275. Accordingly, if the donee spouse survives, the amount of joint tenancy property included in the donor spouse’s gross estate is reduced proportionately by the amount of the gift. HR Rep. No. 247, 101st Cong., 1st Sess. 1429 (1989). See Reg. §§ 20.2056A-8(a)(2), 20.2056A-8(c), Ex. 1. If the donee spouse predeceases the donor spouse, any consideration treated as a gift by the donor spouse to the donee spouse is disregarded in applying Section 2040(a) to the donee spouse’s gross estate. Reg. §§ 20.2056A-8(a)(2), 20.2056A-8(c), Ex. 2.

See supra text accompanying note 88.

See infra note 88.

QDOTs are explained in detail at ¶ 5.07.

Although this does not seem to be a literal interpretation of the Code (see IRC § 2056(d)(2)), the Service has taken this position in the regulations. TD 8612, Supplementary Information, I. § 20.2056A-8 Special rules for joint property, 1995-2 CB 192, 196. Reg. § 20.2056A-8(a)(3). See ¶¶ 5.06[9], 5.07.

A hypothetical example might help to demonstrate the alternative consequences here. Assume donor D purchased real property in a joint tenancy with spouse S, who was not a U.S. citizen. No gift would occur on the purchase of the joint tenancy. IRC § 2523(i)(3). See ¶ 10.01[3][f], note 117. At D’s death, predeceasing S, if the property was worth $100,000 and the property was not transferred by S to a QDOT, $100,000 would be included in D’s gross estate (IRC § 2040(a)) and taxable estate (IRC § 2056(d)(1)(A)). At S’s death, if S still held the property that was then worth $200,000, the property would be included in D’s gross estate (IRC § 2040(a)).
[11] Background of the Section

Section 2040 traces its origin to the original enactment of the federal estate tax in 1916. Without such provisions, joint tenancies created by way of gifts by others to the joint tenants might have entirely escaped estate taxation on the death of the first such tenant even though tenancies created by purchase by the tenant first to die might have been fitted into the provisions (also in the tax laws since 1916), concerning transfers taking effect at death. In any event, in the early years when there was no gift tax, there was good reason for taxing the estate of a person who created a joint tenancy. This reason became less compelling with the advent of the gift tax provisions in 1932. Temporarily, for a period between 1954 and 1981, it once more became cogent with the adoption of gift tax provisions of the 1954 Code under which, in some circumstances, no gift tax liability arose upon the creation of the tenancy.

At an early date, the estate tax provisions on joint tenancies came in for their share of attack on constitutional grounds, but such attacks were uniformly unsuccessful. An early argument was that a joint tenancy created prior to the enactment of the estate tax was not subject to the special provisions on jointly held property, but the provisions were applied retrospectively. Another principal decision sustaining the constitutionality of Section 2040 is *Tyler v. United States*, and a brief history of other important constitutional decisions is recounted in *United States v. Jacobs*.

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S’s gross estate under Section 2033 or Section 2103 and S’s estate would qualify for a Section 2013 credit based on the prior $100,000 of inclusion in D’s gross estate.

Alternatively, if S timely transferred the property to a Section 2056A QDOT at D’s death and D’s executor made an election on D’s estate tax return, Section 2040(a) would still apply, and only $100,000 would be included in D’s gross estate; in addition, D would be allowed a $100,000 marital deduction (see IRC § 2056(d)(2)(A)). However, the property would be subject to estate tax under Section 2056A at its value at S’s death ($200,000), which tax would be imposed at D’s estate tax rates. Remember that the effect of a QDOT is merely to postpone payment of estate tax on property valuing that property at the time of the payment of the tax. See IRC §§ 2056A(b)(1)(B), 2056A(b)(2) ; ¶ 5.07[4][b]. Assuming, again, that S still held the property, the property also would be included in S’s gross estate under Section 2033 or Section 2103 at its $200,000 value. S’s gross estate would again qualify for a Section 2013 credit for D’s Section 2056A estate tax on D’s $200,000 of inclusion.

96 See discussion of Section 2037 at ¶ 4.09.
4.13 SECTION 2041. POWERS OF APPOINTMENT

[1] Introduction

A person who has a power of appointment over property has the authority to determine who, possibly including that individual, will become the beneficial owner of the property. This authority, which of course always goes along with outright ownership of property, is not, however, considered an interest in the property. If A creates a trust with suitable provision for income distribution and ultimately for distribution of the remainder but gives B a power of appointment over the trust, B has no property interest by virtue of B’s power. If B exercises the power by directing the trustee to transfer the property to C (the appointee), the property is considered to pass from A (the donor of the power) to C rather than from B (the donee of the power) to C. General principles of tax law respect this property law analysis of the nature of the power of appointment. Consequently, an individual who has a power of appointment over property at the time the individual dies does not have an “interest” in the property taxable in the individual’s estate under Section 2033. By the same token, if the individual has exercised the power during the individual’s life, such as the foregoing supposed appointment to C, the power holder has made no transfer of an “interest” in property such as could be taxed under Sections 2035 through 2038 if the exercise was testamentary in nature.

Nevertheless, the right to determine who may become the beneficial owner of property is such an important attribute of outright ownership that the question may be raised whether, for transfer tax purposes, it should be considered the equivalent of an ownership interest. Section 2041 (and Section 2514 of the gift tax) reflect a policy determination by Congress that sometimes this equivalence should be recognized. There is, however, a difference between retained control over property once owned by and transferred by an individual to others and control over property never actually owned by the power holder but simply received from an outside source. With regard to powers retained by a decedent in connection with lifetime transfers, Congress is content to rest tax liability on a fairly slender thread. In contrast, as is more fully developed in the discussion that follows, if all the decedent ever had was a power over the property, Congress requires that the power give the decedent a more significant kind of control to be equated with ownership for estate tax purposes.

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2 The point is developed more fully in the discussion of Section 2033 at ¶ 4.05[5][c], text accompanying notes 64–66.

3 See discussion of Sections 2036, 2037, and 2038 at ¶¶ 4.08, 4.09, and 4.10.

Section 2041
The intricacies of Section 2041, especially the statutory definition of “general power of appointment” in Section 2041(b), reflect the congressional struggle with the question of when a power over property is sufficiently broad in scope to justify treating it as the equivalent of ownership. If a power is equated with ownership, other portions of Section 2041 attempt to say whether possession of the power at death or some type of lifetime exercise of the power is an appropriate reason for imposing a tax on the power holder’s estate with respect to the property subject to the power.

[2] Powers Within Section 2041

Generally, a power of appointment is a right that may be exercised either during life or by will, not necessarily both,\textsuperscript{4} to direct who shall become the owner of the property subject to the power. The holder of the power also often has some interest in the property; for example, a person might be the income beneficiary of a trust and at the same time have the power to appoint the principal of the trust to whomever the power holder wished, either during life or at death; but a power holder can have a power of appointment over property with respect to which the power holder has no property interest whatsoever.

A power of appointment exists if an individual has a power to appoint to anyone in the world or merely to appoint to \textit{A} or \textit{B}, as the power holder may choose. Although a trust instrument may expressly give someone a “power,” nomenclature is of no importance in determining whether a particular right constitutes a power of appointment.\textsuperscript{5} A right to consume the principal of a trust is a power of appointment for federal tax purposes, and so is an unrestricted right of a person to substitute oneself for the existing trustee of a trust, if the trustee has a power of appointment.\textsuperscript{6} In the latter case, a person may ap-

\textsuperscript{4} Snyder v. United States, 203 F. Supp. 195 (WD Ky. 1962); Jenkins v. United States, 428 F2d 538 (5th Cir. 1970) (Section 2041 applicable even though the decedent could exercise the power only during life).

\textsuperscript{5} Maytag v. United States, 72-2 USTC ¶ 12,895 (D. Colo. 1972), aff’d, 493 F2d 995 (10th Cir. 1974).

\textsuperscript{6} Reg. § 20.2041-1(b)(1). See Estate of Small v. Comm’r, 3 TCM (CCH) 2 (1944). See also ¶ 4.08[5][a]. But see Priv. Ltr. Ruls. 200734010 (Apr. 19, 2007) (beneficiary’s power to appoint successor trustee restricted to appointment of qualified bank or trust company), 9741009 (July 8, 1997) (no power to appoint oneself trustee even though trustee held a general power), and 200024007 (Mar. 7, 2000) (power to appoint self as trustee but as trustee no power to appoint property to oneself), all citing Rev. Rul. 95-58, 1995-2 CB 191. See ¶ 4.08[5][a], text accompanying notes 99, 100.

The Service proposed a revenue ruling that would allow families to use private trust companies as trustees of family trusts in carefully defined situations without adverse estate tax consequences under Section 2041 for either the grantor(s) or beneficiaries of the trusts. Notice 2008-63, 2008-2 CB 261. See Priv. Ltr. Rul. 200548035 (Aug. 2, 2005) (same); Priv. Ltr. Rul. 200229013 (Apr. 9, 2002) (sole shareholders of corporation that controlled
pear to have only the power to name oneself trustee, but, realistically, if the
effect of the designation is to give the person a power of appointment over the
property in question, the person has a power within the scope of Section 2041.

[a] Relationship to Other Sections

A power of appointment exists if the decedent has the power to affect the
beneficial enjoyment of trust property or its income by altering, amending, or
revoking a trust instrument or terminating the trust.\(^7\) Such authority in the de-
cedent is sometimes the basis for the imposition of tax under Sections 2036
and 2038 and so a question arises about an apparent statutory overlap. The
regulations attempt to say which section applies, appropriately emphasizing
that Section 2041 never operates to exclude from a decedent’s gross estate the
value of property that is includable under other sections.\(^8\)

If \(D\) created a trust for the benefit of \(B\) but reserved an unlimited right to
amend the trust, \(D\) would have a power of disposition over the property that is
in the nature of a power of appointment. However, it is not considered a
power within the scope of Section 2041. The Treasury interprets the section
not to apply to powers “reserved by the decedent to himself,” which are within
the scope of other sections, such as here Section 2038.\(^9\) Thus, Section 2038, or
maybe Section 2036 but not Section 2041, would determine what was includ-
able in the decedent’s gross estate on these facts. By the same line of reason-
ing, it is possible for a decedent to have both a Section 2038–type power and

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\(^7\) Reg. § 20.2041-1(b)(1). Neither a power to amend the administrative provisions of
a trust instrument nor a power to manage, invest, control assets, or to allocate receipts and
disbursements in a fiduciary capacity is a power of appointment. Id. Cf. infra note 18.

\(^8\) Reg. § 20.2041-1(b)(2). See Estate of Halpern v. Comm’r, 70 TCM (CCH) 229,
234 (1995) (“[t]he structure of subtitle B—Estate and Gift Taxes—requires the contrary
interpretation that sections 2038 and 2041 are mutually exclusive”).

\(^9\) Reg. § 20.2041-1(b)(2). The “reserved” power exception in the regulations is not as
explicit as it should be, and the weakness has generated other problems. The non–Section
2041 powers should be identified explicitly as powers over property interests that have
been transferred by the decedent. Thus, if \(D\) transfers property in trust reserving a right to
appoint the remainder to other than the one named in the trust instrument, \(D\)’s power is
outside Section 2041 regarding the property transferred. What about the subsequent in-
come accumulations? It can be argued on these facts that post-transfer income was never
\(D\)’s (see contra United States v. O’Malley, 383 US 627 (1966), discussed at ¶ 4.08[8][a])
and that the power over it is outside the scope of Sections 2036 and 2038. Thus, Section
2041 might properly be applied to determine whether the accumulated income was taxable
in \(D\)’s estate. The discussion that follows will indicate that under Section 2041, \(D\) would
have to have more significant control over the income for it to be taxed to \(D\)’s estate than
would be the case under either Section 2036 or Section 2038. Is this not appropriate?
a Section 2041-type power over different portions of property in a single trust. If D created the trust reserving an unlimited right to amend its terms, D’s power would be within the scope of Section 2038. If another person later transferred property to the same trust and it came within reach of D’s power to amend, D’s power over the latter transferred property would not be a “reserved” power, and the includability of that portion of the trust would be determined under Section 2041.10

[b] Powers That Overlap Interests

If the decedent has an actual ownership interest in the property, Section 2033 brings the value of that interest into the decedent’s gross estate even if the decedent also has a power of appointment over the interest that, under Section 2041, would require something less or perhaps nothing at all to be included. The regulations illustrate this principle as follows:11

If a trust created by S provides for payment of the income to A for life with power in A to appoint the remainder by will and, in default of such appointment for payment of the income to A’s widow, W, for her life and for payment of the remainder to A’s estate, the value of A’s interest in the remainder is includible in his gross estate under section 2033 regardless of its includability under section 2041.

However, if, in this case, a gift to A’s estate does not create a Section 2033 property interest in A, Section 2041 seems to handle the problem adequately.12

A power of appointment recognized under Section 2041 may arise outside the area of express trusts. For example, a testamentary bequest to a beneficiary “with full power to sell or dispose of same” and further provision for disposi-

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10 Estate of Shaeffer v. Comm’r, 12 TC 1047 (1949); Buckley v. Comm’r, 42 TCM (CCH) 1592 (1981). The Shaeffer case also reflects the possibility that, depending on local law, “a power of appointment may be created by implication.” Estate of Shaeffer, supra, at 1047, 1051. But see First Nat’l Bank of Middlesex County v. United States, 72-2 USTC ¶ 12,872 (DNJ 1972). On the other hand, a power of appointment seemingly expressly created may lose its estate tax significance if there is an agreement, binding under state law, that the power will not be exercised. Estate of Cook v. Comm’r, 29 TCM (CCH) 298 (1970).

11 Reg. § 20.2041-1(b)(2).

12 It is difficult to read this example as giving A anything more than a life interest plus a general testamentary power; the remainder comes into being upon A’s death, and A’s estate is hardly A. This is not the equivalent of a gift to A or A’s estate that would simply give A outright ownership. However, Section 2041 would tax the entire value of the property in A’s estate because, by forgoing the exercise of A’s express power, A can direct the disposition of the property by A’s will, giving A implicitly a general power of appointment. Cf. United States v. Keeter, 461 F2d 714 (5th Cir. 1972). It is unimportant, therefore, whether A’s express power is general or nongeneral and whether A has a recognizable “interest” in the property at death.
tion of property undisposed of upon the beneficiary’s death has been held to create a Section 2041 power in the beneficiary.\(^\text{13}\) The court determined under local law that even though the beneficiary could not dispose of the property by gift, she could, under the terms of the testamentary bequest, appoint the property received under the bequest to herself or her creditors during her lifetime.\(^\text{14}\)

Another uniquely created power may be seen to rise out of the terms of an insurance policy that provides for the payment of the income from the policy proceeds to a beneficiary for life and then a distribution of the proceeds to the beneficiary’s executors or administrators. It is obvious that such a disposition confers no beneficial interest on the fiduciary and that the proceeds would go to the beneficiary’s heirs in case of intestacy, but that provisions in the beneficiary’s will could determine who receives the proceeds. The last possibility indicates the beneficiary has a general testamentary power over the proceeds, as one court has held,\(^\text{15}\) even though it may take some ingenuity to find it.\(^\text{16}\)

[3] Definition of “General Power”

While it is profitable to explore what is meant by the term “power of appointment,” Section 2041 generally imposes estate tax liability only with respect to the value of property subject to a general power of appointment.\(^\text{17}\) The way in which the section applies depends in part on when the power was created; and, in some instances, the question whether a power is “general” depends on the date of the creation of the power. The critical date is October 21, 1942. In the discussion that follows, a power created on or before October 21, 1942, will be referred to as a pre-1942 power; one created after October 21, 1942, will be referred to as a post-1942 power. In either case the statute deals only with general powers; it seems wise to depart from the order of Section 2041 and begin with paragraph (1) of Section 2041(b), which defines “general power.”


\(^\text{14}\) See also Rev. Rul. 69-342, 1969-1 CB 221; TAM 200532049 (Mar. 23, 2005); infra ¶ 4.13[3].

\(^\text{15}\) United States v. Keeter, 461 F2d 714 (5th Cir. 1972). See also Pittsburgh Nat’l Bank v. United States, 319 F. Supp. 176 (WD Pa. 1970) (a decedent’s power as co-trustee to sell the trust corpus, which under the governing instrument would cause a termination of the trust and distribution to the decedent and others, was held to constitute a Section 2041 power).

\(^\text{16}\) Contra Second Nat’l Bank of Danville v. Dallman, 209 F2d 321 (7th Cir. 1954). See ¶ 4.05[6], note 76.

\(^\text{17}\) IRC § 2041(a)(3), discussed infra ¶ 4.13[8][b], indicates one very minor exception. See Texas Commerce Bank v. United States, 807 F. Supp. 50 (SD Tex. 1992).
The estate tax definition of “general power” is at variance with traditional property law concepts. The basic rule in Section 2041(b)(1) is that a power is general if it “is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate”—roughly speaking, one that can be exercised directly or indirectly for the decedent’s own benefit. If the decedent can appoint to any of these appointees, the decedent has a general power, subject to important exceptions discussed later.

Whether one has the legal right to appoint to oneself or others is determined by the interpretation of the governing instrument under local law. This issue sometimes arises in connection with the marital deduction. The extent of the legal right to appoint depends on local statutes and local case law, but not necessarily on a local adjudication. If, under state law, a trust provision

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18 See Rev. Rul. 79-159, 1979-1 CB 301; Priv. Ltr. Rul. 9936052 (June 16, 1999) (right to take larger distributions than provided in an IRA was a general power of appointment); TAM 9431004 (Aug. 5, 1994) (ability to mortgage real estate held in trust constituted a general power of appointment, rather than an administrative power). But see Rev. Rul. 77-460, 1977-2 CB 323 (no general power of appointment where decedent had no power to control disposition); Priv. Ltr. Rul. 201229005 (Mar. 26, 2012) (settlor’s son’s testamentary power to appoint to “settlor’s issue” not a general power because son could not appoint to himself); FSA 199930026 (Apr. 29, 1999) (fiduciary obligation as trustee precluded a power of appointment to oneself); Priv. Ltr Rul. 200748008 (July 25, 2007) (same).

19 Emphasizing the use of the disjunctive “or” in the phrase “the decedent, his estate, his creditors or the creditors of his estate,” the Tax Court has held that a power to appoint only to the decedent’s estate is a general power. Estate of Edelman v. Comm’r, 38 TC 972 (1962); Smith v. United States, 557 F. Supp. 723 (D. Conn. 1982) (same); TAM 200907025 (Oct. 28, 2008) (same). However, relying on First Nat’l Bank of Omaha v. United States, 681 F2d 534 (8th Cir. 1982), cert. denied, 459 US 1104 (1983), the Service has ruled that when the language in a trust conferring a power of appointment over property is precatory in nature, the person to whom the power is conferred is not considered to hold a general power of appointment. See Priv. Ltr. Rul. 9304020 (Nov. 2, 1992).


21 See ¶¶ 5.06[8][b][iii], 5.06[8][b][iv].

A decedent may hold a general power under a duty of consistency, for example, where a marital deduction was allowed under Section 2056(b)(5) in a predeceasing spouse’s estate. TAM 200407018 (July 8, 2008). Cf. Estate of Letts v. Comm’r, 109 TC 290 (1997). But see Estate of Posner v. Comm’r, 87 TCM (CCH) 1288 (2004) (no general power of appointment where duty of consistency requirements not met).


In a series of private letter rulings a state judicial reformation of a drafting error has precluded a general power of appointment. Priv. Ltr. Ruls. 201214022 (Dec. 14, 2011),
purporting to give the decedent a right to invade the corpus of a trust is invalid, the decedent does not have a power of appointment under Section 2041, general or otherwise.\textsuperscript{23} However, whether the rights the decedent enjoys under state law constitute a general power for estate tax purposes is a federal question as to which local characterization of one’s right is not controlling.\textsuperscript{24}

\textbf{[4] Exceptions to General Definition}

There are a number of exceptions to the basic rule on what constitutes a general power of appointment.

\textbf{[a] Power Limited by a Standard}

The first exception relates to a power exercisable in favor of the decedent. The decedent may be given a power to appoint to anyone in the world; this is clearly a general power of appointment. In other cases, the decedent may be given a power to consume, invade, or appropriate property for the decedent’s own benefit; this is also within the basic definition of “general power,” as it is a power to appoint to oneself. However, under Section 2041(b)(1)(A), if a power may be exercised only in accordance with an ascertainable standard relating to the decedent’s health, education, support, or maintenance, it is not treated as a general power of appointment.\textsuperscript{25} An otherwise ascertainable standard that does not relate to the decedent’s health, education, support, or maintenance is inadequate. This is one of several provisions in Section 2041 that create substantial flexibility in the use of powers to accomplish legitimate fam-

\textsuperscript{23} Rev. Rul. 54-153, 1954-1 CB 185 (New York law); Priv. Ltr. Rul. 200014002 (Nov. 29, 1999) (Missouri law). See also Rev. Rul. 53-243, 1953-2 CB 267 (the power is a general power in the absence of such a statute).

\textsuperscript{24} Morgan v. Comm’r, 309 US 78 (1940), opinion amended and reh’g denied, 309 US 626 (1940). Cf. Blair v. Comm’r, 300 US 5 (1937); Estate of Aldrich v. Comm’r, 425 F2d 1395 (5th Cir. 1970). See discussion of state and federal law question under Section 2033 at \textsuperscript{¶} 4.05[2]. The Service has indicated that it will not recognize state legislation that retroactively changes an individual’s property rights or powers after federal tax consequences have attached. Rev. Proc. 94-44, 1994-2 CB 683.

ily objectives without onerous estate tax consequences. Especially in the case of modest trusts, the maintenance of the beneficiary may sometimes require an encroachment on the principal. If the beneficiary has the right to get at principal only for that purpose, there seems to be little reason for imposing tax on the beneficiary’s estate with respect to that right.  

A critical question is whether the decedent’s power is in fact limited by an ascertainable standard. The regulations provide that a power exercisable for “comfort, welfare, or happiness” of the power holder is not limited by an ascertainable standard. They also treat the statute as raising the question of whether the right to invade is “reasonably measurable in terms of…needs for health, education or support (or any combination of them)” and treat “maintenance” as a useless appendage having the same meaning as “support.” With regard to “support,” early proposed regulations in the same paragraph provided: “The meaning is not limited to the bare necessities of life and includes other reasonable living expenses, but it does not necessarily extend to all expenditures that might be considered customary in the decedent’s position in life.” However, the adopted regulations reflect a somewhat less narrow view of the support concept by omitting the italicized portion of the preceding quotation.

The drafter can stay within the Treasury’s view of the invasion exception by limiting the right to exercise for the holder’s “support,” “support in reasonable comfort,” “support in his accustomed manner of living,” “education, including college and professional education,” “health,” and “medical, dental, hospital and nursing expenses and expenses of invalidism.” Beyond these guidelines it is difficult to generalize. Seemingly inconsistent results are not uncommon. For example, “support, care and comfort” has been held not to

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26 See infra ¶ 4.13[8][a]. However, some features of the tax on generation-skipping transfers are antagonistic to this concept. See IRC § 2612(b); ¶ 13.02[3].


29 See discussion of an ascertainable standard under Section 2038 at ¶ 4.10[5].

30 Reg. § 20.2041-1(c)(2); Priv. Ltr. Rul. 9713008 (Dec. 10, 1996) (“care” was also synonymous with support where the standard examined authorized invasion for “proper care, maintenance and support”).

31 Reg. § 20.2041-1(c)(2).

32 Reg. § 20.2041-1(c)(2). The regulations provide that a power to invade for support can be within the exception regardless of “whether the beneficiary is required to exhaust his other income before the power can be exercised.”
constitute an ascertainable standard, while “maintenance, comfort and happiness” has been upheld. The reason for these inconsistencies is that the federal courts generally look to state law to determine whether a standard exists. Although the federal courts are rarely bound by the local adjudication of a case, they do nevertheless give proper regard to state adjudications of cases employing similar standards. This leads to the type of discrepancy illustrated earlier.

33 Whelan v. United States, 81-1 USTC ¶ 13,393 (SD Cal. 1980) (California law); Priv. Ltr. Rul. 200637021 (June 2, 2006) (care, maintenance, and support an ascertainable standard under state law).
34 Brantingham v. United States, 631 F2d 542 (7th Cir. 1980) (Massachusetts law).
35 Morgan v. Comm’r, 309 US 78 (1940), opinion amended and rehe’g denied, 309 US 626 (1940). Retroactive state legislation may not be respected. See supra ¶ 4.13[3], note 24.
37 See supra text accompanying notes 33, 34. Cases have held the following standards adequate: Vissering v. Comm’r, 990 F2d 578 (10th Cir. 1993) (Florida law) (decedent’s power to invade trust corpus to the “extent required for his continued comfort” did not constitute a general power of appointment); Finlay v. United States, 752 F2d 246 (6th Cir. 1985) (Tennessee law) (invasion “if she the beneficiary desires”); Sowell v. Comm’r, 708 F2d 1564 (10th Cir. 1983) (New Mexico law) (“emergency or illness”); Estate of Chancellor v. Comm’r, 102 TCM (CCH) 70 (2011) (Mississippi law) (“welfare or other appropriate expenditure needed”); Hunter v. United States, 597 F. Supp. 1293 (WD Pa. 1984) (“any emergency”); Wahlfield v. United States, 47 AFTR2d 81-1565 (CD Ill. 1980) (“financial emergency…as a result of accident, illness, or other natural circumstances”); Pitfield Nat’l Bank v. United States, 181 F. Supp. 851 (D. Mass. 1960) (Massachusetts law) (invasion “as he the beneficiary may…request, being…the sole judge of his needs”); Barritt v. Tomlinson, 129 F. Supp. 642 (SD Fla. 1955) (Florida law) (“the right to use all or any part of the principal as she the beneficiary may see fit”); Estate of Chancellor v. Comm’r, 102 TCM (CCH) 70 (2011) (Mississippi law) (“the necessary maintenance, education, health care, sustenance, welfare or other appropriate expenditures needed by [beneficiaries]…taking into consideration the standards of living to which they are accustomed.”); Estate of Strauss v. Comm’r, 69 TCM CCH 2825 (1995) (Illinois law) (“care and comfort considering his standard of living”).

It is apparent that a trust can be set up for a beneficiary and a considerable amount of leeway provided for the beneficiary’s use of the corpus without inviting estate tax liability upon the death of the beneficiary. Nevertheless, close cases decided for and against taxpayers suggest caution.38

[b] Certain Pre-1942 Powers

Under Section 2041(b)(1)(B), another power that is within the basic definition of “general power” is not to be treated as a general power. This exception concerns only pre-1942 powers. If a pre-1942 power can be exercised by the decedent only in conjunction with some other person, it is not a general power for estate tax purposes. It is immaterial who the person may be or what rights or interests the person may have or have had in the property. The reasons for the exception are more historical than logical.39 This exception is clear cut, but it affords little or no opportunity for current estate planning, relating, as it does, only to powers that have been created at a much earlier date.

[c] Post-1942 Powers With Another Person

A much more complicated set of exceptions to the basic definition of “general power” is found in Section 2041(b)(1)(C). As noted, Section 2041(b)(1)(B) places pre-1942 powers, exercisable by the decedent only in conjunction with another person, any other person, outside the category of general powers. Under Section 2041(b)(1)(C), three exceptions are provided relating to post-1942 powers that may be exercised by the decedent only in conjunction with another person. In the following discussion of these three rules, it is important to keep in mind that the question is only whether or to what extent the power is to be treated as a general power; if the power is found to be general, further considerations, subsequently discussed, then come into play to determine the effect of the power on the decedent’s gross estate.


38 See supra note 37.

But a determination that the power is *not* general usually means that the property subject to the power will not be included in the decedent’s gross estate.

**[i] Power held with the creator of the power.** If the decedent can exercise a power only in conjunction with its creator, the decedent does not have a general power of appointment. Of course, in these circumstances, Sections 2036 and 2038 may bring the value of the property or some part of it into the estate of the creator of the power for federal estate tax purposes. Either estate or gift tax liability will result upon the death of the creator of the power or the creator’s lifetime exercise or relinquishment of it, and perhaps both estate *and* gift tax liability in the case of such exercise or relinquishment. These reasons support the exception.\(^{40}\)

**[ii] Power held with an adverse party.** If the decedent can exercise a power only in conjunction with someone who has a substantial interest in the appointive property, which interest will be adversely affected by an exercise of the power in favor of the decedent, the decedent does not have a general power of appointment. It has been held that A has an interest adverse to the exercise of a power in favor of B if A has “a present or future chance to obtain a personal benefit from the property” subject to B’s power.\(^{41}\) But a mere co-trustee has no interest, adverse or otherwise.\(^{42}\) Similarly, if C has a beneficial interest in a trust that would be adversely affected by an exercise of the power in favor of D, D’s power is not rendered nongeneral by a requirement that C’s spouse, E, join in the exercise of the power; E might suffer some adversity if C is deprived of C’s interest, but E has no chance for direct personal benefit from the property.\(^{43}\)

Other interpretations of the adverse interest exception, even if settled, seem more controversial. For example, if D has a power to appoint to D the corpus of a trust under which B is otherwise entitled to the income for life and R to the remainder, D has a general power of appointment. But such a power is rendered nongeneral under the exception if D can exercise the power only in conjunction with B, or only with R, for both have interests adverse to an exer-

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\(^{42}\) Miller v. United States, 387 F2d 866 (3d Cir. 1968). Cf. Picciano v. United States, 81-2 USTC ¶ 13,433 (WD Ohio 1981). See also Rev. Rul. 82-156, 1982-2 CB 216 (general power could be exercised either with an adverse party or with a trustee (who was not adverse) was held to be a Section 2041 power); Priv. Ltr. Rul. 8704005 (Oct. 9, 1986) (trustee was an adverse party; thus, no general power).

cise of the power in D’s favor. The statute seems to contemplate a “total” exempti-
emtion of such powers, even though realistically it would seem that if the
power could be exercised only with B, D could buy off B for the value of B’s
life interest and thus gain the right to defeat R altogether. Should D then be
regarded as having a general power to the extent of the value of the remainder
interest? The problem seems to be more muddled than clarified by the state-
ment in the Senate Finance Committee Report on the Powers of Appointment
Act of 1951 that “principles developed under the income and gift taxes will be
applicable in determining whether an interest is substantial and the amount of
property in which the adversity exists.”

Perhaps within permissible limits of interpretation better sense can be
made of the statute if it is recognized that what may be referred to broadly as
a general power may in fact authorize the holder to deal with the property in
several different ways. If so, the holder should be viewed as having several
powers, which can be tested separately to see if they are general. Thus, in the
preceding example, D’s general power might enable D to appoint the remain-
der, after B’s interest, to anyone. If so, should D not be viewed as having a
general power over the remainder interest even if exercisable only with B? B’s
interest would not be adverse to an exercise of such a power.

The statute makes it unnecessary to speculate whether one who would
have a right to appoint the property in question to oneself after the death of
the decedent has an interest in the property and, if so, whether such an interest
would be adversely affected by an exercise of the decedent’s power. By ex-
press provision, such a future power is to be deemed an interest and the inter-

[—] Power held with an equally interested party. After the application
of the first and second rules, just discussed, the decedent may have a general
power, even if the power was exercisable only in conjunction with another
person, if the person was not the creator of the power and did not have a sub-
stantial interest in the property that would be adversely affected by an exercise
in favor of the decedent. However, clause (iii) of Section 2041(b)(1)(C) makes

\[44\] Reg. §§ 20.2041-3(c)(2), Exs. 1, 2; Priv. Ltr. Rul. 199933020 (May 19, 1999).
\[46\] Cf. Camp v. Comm’r, 195 F2d 999, 1004 (1st Cir. 1952).
(five or five power in part was a general power of appointment but not a general power to
the extent held with an adverse party).
a further limited exception applicable to a case in which the other person who must join is one in whose favor the power may be exercised. The rule appears to be based on a concept of self-interest. If the decedent’s power to appoint to himself, his estate, his creditors, or the creditors of his estate can be exercised only in conjunction with one other person in whose favor the power may also be exercised, only one half of the value of the property will be treated as subject to a general power of appointment in the decedent. The apparent reasoning here is that upon an exercise of the power, the other person would, or at least could, insist that half of the property be appointed to that other person so that in practical effect the decedent should be treated as if the decedent owned only one half of the property.\(^4\) This reasoning carries over to a situation in which more than one other person in whose favor the power may be exercised is required to join. Thus, if there are two other possible appointees with whom the decedent must join in order to exercise the power, only one third of the value of the property is treated as subject to a general power of appointment for the purpose of determining the decedent’s gross estate.\(^5\)

This rule creates an interesting situation from the point of view of a drafter of a will. By requiring that several persons who are possible appointees join in the exercise of a power, the drafter can reduce the value of a property interest that may be included in the estate of a particular decedent. But, of course, the estate of any of the others may include a portion of the value of the property. If the estate of one who must join is to be protected from possible estate tax liability, such person must be removed from the class of persons in whose favor the property can be appointed, which may defeat the drafter’s purpose, or the power must be exercisable by the survivors alone after death.

In applying the second and third rules just discussed, which may operate to render a post-1942 power that is otherwise general, nongeneral in whole or in part because another who must join in its exercise is a permissive appointee, the statute expressly indicates that a power is to be treated as exercisable in

\(^4\) If the exceptions in clauses (ii) and (iii) of Section 2041(b)(1)(C) appear similar, the difference is that (iii) will come into play where (ii) is not applicable because the co-holder’s power does not survive the decedent’s death.

\(^5\) Reg. § 20.2041-3(c)(3); Rev. Rul. 77-158, 1977-1 CB 285, Rev. Rul. 76-503, 1976-2 CB 275 (both applying Section 2041(b)(1)(C)(iii) where joint trustees who are replaced at death or resignation by a successor trustee held power by unanimous vote or majority vote, respectively).

A series of private letter rulings under Section 2514 have held that members of a distribution committee do not have a general power of appointment. See Priv. Ltr. Ruls. 200612002 (Nov. 23, 2005), 200637025 (June 5, 2006), 200647001 (Aug. 7, 2006), 200715005 (Jan. 3, 2007), 200729025 (Apr. 10, 2007), 200731019 (May 1, 2007). However, the Office of Chief Counsel has questioned whether the gift tax private letter rulings are consistent with Revenue Rulings 76-503 and 77-158, IR-2007-127 (July 9, 2007). But see Priv. Ltr. Rul. 201310002 (Mar. 8, 2013), again holding that members of a distribution committee have no general power of appointment. See also ¶ 10.01[8], note 33, for consequences to the donor.
favor of a person if it can be exercised to benefit the person directly, or in favor of the person’s estate, creditors, or the creditors of the estate. This, of course, parallels the basic test of whether a person has a general power of appointment.

[d] Judicious Use of Powers

The major revision of the powers-of-appointment provisions in 1951, since which time there has been no substantial change,51 was not designed to raise the greatest possible amount of revenue. On the contrary, a principal purpose was to make the law simple and definite enough to be understood and applied by the average lawyer. It may surely be questioned whether the “simple and definite” objective was achieved, but even so, one should recognize that Congress has left considerable room for the judicious use of powers of appointment in planning at substantial tax savings. To some extent, this is reflected in the previous discussion of the numerous exceptions to the basic definition of general powers. It will be further evident in the ensuing discussion of the actual tax treatment of such powers.52 In making advantageous use of powers, the tax on generation-skipping transfers must also be considered.53

[5] Introduction to Treatment of General Powers

With the foregoing discussion of what constitutes a general power of appointment in mind, it is now necessary to consider the statutory estate tax treatment of powers. The need for a statutory provision dealing specifically with powers arises in part out of the fact that a power of appointment, even when it strongly resembles ownership, is not an interest in property within the scope of Section 2033. The Supreme Court has so held with respect to a trust created by another under which the decedent had the exclusive enjoyment of property during life, the right to absolute ownership upon attaining a specified age, and the sole and unrestricted right to designate who should have the trust property after the decedent’s death.54 The present effect of this decision is to foreclose the application of Section 2033 to property with respect to which the decedent had only a power of appointment, even though the combination of circumstances just suggested seems to identify realistic ownership of property. The

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51 Cf. IRC §§ 2045, 2518.
52 See infra ¶ 4.13[8][a]. See also Halbach, “The Use of Powers of Appointment in Estate Planning,” 45 Iowa L. Rev. 691 (1960); “Use and Drafting of Powers of Appointment,” 1 Real Prop., Prob. & Tr. J. 307 (1966). Both articles are concerned with the pre-1986 law under which there was no tax on generation-skipping transfers.
53 See Chapters 12–18, especially ¶¶ 13.02[2][d], 17.02[3][b].
decision has not been overruled. When the decedent has a power of appointment but no interest recognized as within Section 2033, and when other sections are likewise inapplicable, what, if anything, may be included in the decedent’s gross estate must be determined under Section 2041.

As previously indicated, pre-1942 and post-1942 powers must be considered separately. In general, a pre-1942 power, as the term is used here, is one that was created on or before October 21, 1942; the date of its creation is the date the instrument creating it became effective. Thus, if the power was created by an inter vivos instrument, the date of creation was the date of delivery of the instrument, even if the instrument was revocable, because it would be effective until revoked. A power created by will is created at the date of the creator testator’s death, because a will is not effective until then.

[6] Treatment of Pre-1942 Powers

A pre-1942 power of appointment held by the decedent gives rise to estate tax inclusion only if the power is a general power and the decedent exercises the power. It is perfectly clear that if the decedent had a general power and took appropriate action under local law to exercise that power by will, a renunciation by the appointees that may prevent the property from “passing” under the power will not save the decedent’s estate from liability under Section 2041. This once-settled principle is probably unaffected by the provisions on disclaimers that retract the transfer but not necessarily the exercise of the power. Moreover, it also appears to be settled that even if the decedent by will exercises a general power of appointment in favor of the takers in default of exercise so that the exercise is ineffective in the sense that the appointees would have received the property anyway, the statute is satisfied. However, an invalid attempt to exercise is not treated as an exercise of the power.

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55 Reg. § 20.2041-1(e).
56 Under Section 2041(b)(3), some powers not actually coming into existence until later are treated as pre-1942 powers. Specifically, a power created by a will executed on or before the critical date is to be considered a pre-1942 power even if the creator of the power does not die until later; but this special rule on the date of creation applies only if the creator has died before July 1, 1949, without republishing one’s will, by codicil or otherwise, after the critical 1942 date.
58 IRC §§ 2046, 2518; ¶¶ 4.18, 10.07.
60 Keating v. Mayer, 236 F2d 478 (3d Cir. 1956); Reg. § 20.2041-1(d). See also United States v. Keeter, 461 F2d 714 (5th Cir. 1972).
[a] Exercise of Power

The risk in the present rule is one of an unwitting exercise of a pre-1942 power.\(^62\) In *Keating v. Mayer*\(^63\) the power was not expressly exercised but tax liability resulted, because, under a Pennsylvania statute, a general devise of real estate or a bequest of personal property described in a general way operated as an exercise of a power over such property unless a contrary intention appeared in the will. An exercise of a pre-1942 power in favor of the takers in default gives rise to tax that is entirely avoidable without any change in the disposition of the property, for nonexercise of a pre-1942 power is not taxable.

Although it is suggested in the court’s opinion in *Keating*\(^64\) that the exercise need not be “effective” to constitute an exercise within Section 2041, the use of the term may be misleading. The taxpayer’s argument was that the Pennsylvania courts viewed the exercise to those who would take in default as a nullity because they would get the property anyway. That an exercise was “ineffective” in this sense will not save the estate from Section 2041. But the Treasury recognizes that there is no exercise unless the decedent takes the appropriate steps under local law to accomplish such exercise.\(^65\) For example, in *Keating* there was an exercise only because Pennsylvania law said the general provisions in the will had that effect.\(^66\) An express attempt to exercise a power by a provision in a will that was subsequently held invalid would not be within the statute. In this sense, at least, an ineffective exercise is not an exercise under Section 2041.

Of course, not every exercise of a general pre-1942 power will cause the value of the property subject to the power to be included in the decedent’s gross estate; the power must be exercised either by will or in some other manner akin to testamentary disposition in order to cause estate tax liability.\(^67\) It is clear enough that if a person who has a general pre-1942 power exercises the power by will, the person’s gross estate will include the value of the property subject to the power. If the power is exercised only in part, that is, if by will the decedent appoints only a part of the property subject to the power and per-

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\(^64\) Keating v. Mayer, 236 F2d 478, 481 (3d Cir. 1956).


\(^66\) But see White v. United States, 81-1 USTC ¶ 13,404 (SD Ind. 1981) (New York and Illinois law).

\(^67\) The possibility of gift tax liability arising out of a lifetime exercise is dealt with in the discussion of Section 2514 at ¶ 10.04.
mits the rest to pass by default, possibly only the value of the property actually appointed is included in the person’s gross estate. On the other hand, there is authority for including the whole property even though the exercise of the power related to only a part (a life estate) of the property. Caution suggests a conscious hands-off policy with regard to pre-1942 powers, if non-estate tax considerations permit it.

What other manner of exercise will also result in estate tax liability? Section 2041(a)(1)(B) provides that if a pre-1942 general power is exercised by a disposition of a type that would be caught by Sections 2035 through 2038 if an actual transfer of property were involved, estate tax liability results. Accordingly, an exercise with retained life interests (Section 2036), an exercise effective at the decedent’s death (Section 2037), or a revocable exercise of the power (Section 2038) is an exercise of a power that is treated the same as an exercise by will at death. For example, assume X created a trust before 1942 under which the income was payable to B for life, remainder to whomever D may appoint by deed during D’s life and, in default of appointment, to R. D has a general power of appointment over the remainder. If D exercises the power by providing that upon the death of B, the income is to be paid to D for life with a remainder to R, D has made a lifetime exercise of a power within the purview of Section 2036, that is, an exercise with a reservation of the right to the income for life. If D later dies while B is still living, Section 2041 brings into D’s gross estate the value of the property over which D exercised the power, that is, the entire value of the trust property less the value of B’s outstanding life interest. If D dies after B, the entire value of the trust property is included in D’s estate because it is the date-of-death or alternate date value of the interest over which D exercised the power that is to be included in D’s gross estate, and B’s outstanding interest will have been extinguished by B’s death.

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68 Estate of Wooster v. Comm’r, 9 TC 742 (1947); Reg. § 20.2041-2(f).
69 Estate of Gartland v. Comm’r, 293 F2d 575 (7th Cir. 1961), cert. denied, 368 US 954 (1962).
70 However, income tax basis considerations combined with a large unified credit may lead to a different course of action. The exercise of a pre-1942 power may result in a direct skip generation-skipping transfer. See ¶ 13.02[4][b], text accompanying notes 265–268.
71 Under current law, a pre-1942 power can interact with Section 2035 only in extremely limited circumstances. If a decedent had held a pre-1942 power that the decedent previously exercised retaining a Section 2036, Section 2037, or Section 2038 interest or power and the decedent then relinquished such interest or power within three years of death, Section 2041(a)(1)(B) would apply interacting with Section 2035.
72 Reg. § 20.2041-2(c), Ex. 2. See the discussion of Section 2036 at ¶ 4.08. See Henderson v. Rogan, 159 F2d 855 (9th Cir.), cert. denied, 331 US 843 (1947) (decided the same way under the forerunner of Section 2037).
73 See discussion of Sections 2031 and 2032 at ¶¶ 4.02, 4.03.

Section 2041
[b] Failure to Exercise

The statute is explicit that a failure to exercise shall not be deemed an exercise (not treated as a negative exercise) of a pre-1942 power. Although this seems superfluous, it is likely in many cases that inaction on the part of the decedent accomplishes the same thing that the decedent would undertake to accomplish by an exercise of the power; the one who takes in default may be the one to whom the decedent would appoint. Be that as it may, inaction with respect to a pre-1942 power does not result in estate tax liability.

[c] Complete Release

Moreover, the statute also specifies that a complete release of a general pre-1942 power is not to be deemed an exercise of the power. Again, this may be the rough equivalent of an exercise of the power, for by such release the decedent may have secured the rights of the taker in default, which may be just what the decedent would have otherwise done by an exercise of the decedent’s power at death. In any event, such complete release will not cause estate tax liability because, with respect to pre-1942 powers, liability results only from an exercise of a general power, and the statute says expressly that a complete release shall not be deemed an exercise.74 There is a problem, however, as to what constitutes a “complete” release; the regulations include a somewhat obscure example of a partial exercise of a power coupled with a subsequent complete release, which may be viewed as an exercise rather than a release.75 In this light, unless non-estate tax reasons call for an exercise of a pre-1942 power, inaction rather than release seems the safest course, although income tax basis considerations combined with the unified credit may lead to a different course of action. In the case of inaction, all the decedent needs to worry about is inadvertent exercise, such as apparently occurred in the Keating case discussed earlier, if the decedent would escape estate tax liability.

[d] Partial Release of Pre-1942 Powers

The statute also deals expressly with the effect of partial release and subsequent exercise of pre-1942 general powers. The problem dealt with here is whether by a partial release of a general pre-1942 power it can be converted to a nongeneral power, the exercise of which will not result in estate tax liability. The general answer is that it cannot be converted; this is only implicit in the statute, but the regulations expressly and appropriately provide, subject to a

75 Reg. § 20.2041-2(d).
minor exception,\textsuperscript{76} that the exercise of a pre-1942 power that was a general power but that has been partially released so as to make it no longer a general power will constitute the exercise of a general power of appointment.\textsuperscript{77} Such an interpretation seems warranted, as any other rule would obviously permit a frustration of the clear statutory purpose.

\section*{[7] Treatment of Post-1942 Powers}

As previously stated, post-1942 powers are treated differently than pre-1942 powers. The principal differences are that the later created powers need not be exercised by the decedent in order to cause tax liability to the decedent’s estate, and that estate tax liability may result even from the complete release of these powers. Here, a release is treated as a negative exercise of the power, but, again, the power must as a rule be a general power to be caught by the statute.

The rules on post-1942 powers appear in Section 2041(a)(2). Several tests determine whether the value of property subject to a post-1942 general power of appointment in the decedent must be included in the decedent’s gross estate.

\textsuperscript{76} In very limited circumstances, powers that were originally pre-1942 general powers may be effectively removed from the general power category. The statutory rule is that if a pre-1942 general power is partially released either prior to November 1, 1951, or not later than six months after the termination of a legal disability if the donee of the power was under such disability on October 21, 1942, whichever date is later, so that the power is no longer a general power of appointment, the exercise of the power shall not be deemed to be an exercise of a general power of appointment. IRC § 2041(a)(1) (last sentence). See Priv. Ltr. Rul. 200812022 (Nov. 7, 2007). This, of course, does not present a major tax loophole; conversion of a general pre-1942 power to a nongeneral one can be accomplished to defeat the application of Section 2041 only if action was reasonably taken in 1951 or earlier, or if the donee was under a disability in 1942 and the action is taken shortly after the removal of the disability.

There is litigation on whether a pre-1942 general power has been effectively reduced to a nongeneral power before the critical dates. See, e.g., Estate of Drake v. Comm’r, 67 TC 844 (1977). Cf. Simons v. United States, 135 F. Supp. 461 (EDNY), aff’d per curiam, 227 F2d 168 (2d Cir. 1955), cert. denied, 350 US 949 (1956).

The Tax Court has held that a transaction, which in form was an exercise of a general pre-1942 power followed by a release prior to November 1, 1951, was in substance a reduction of the power followed by a release so that Section 2041 was inapplicable. Estate of Lombard v. Comm’r, 46 TC 310 (1966), acq. 1967-1 CB 2. The court stated that the congressional purpose for this exemption from estate tax in the case of a pre–November 1, 1951, release was to protect from tax a donee of a power who disabled himself from exercising the power for the benefit of others than those in the exempted class. Other courts have also advanced this liberal interpretation of the provisions regarding release before November 1, 1951. Kynett v. United States, 201 F. Supp. 609 (ED Pa. 1962); Emery v. United States, 153 F. Supp. 248 (D. Mass. 1957).

\textsuperscript{77} Reg. § 20.2041-2(e).
[a] Possession

First, did the decedent have a general power of appointment at the time of death? In other words, possession of a post-1942 general power of appointment is now treated as the equivalent of ownership of the property subject to the power for federal estate tax purposes.\footnote{Estate of Council v. Comm'r, 65 TC 594 (1975), acq. 1976-2 CB 1 (decedent had made an inter vivos exercise of a power so there was no possession of the power at her death). Cf. supra ¶ 4.13[3], note 21.} The Treasury has ruled that a person can have a general power even though at all times after its creation the person is under a legal disability to exercise it,\footnote{Rev. Rul. 75-351, 1975-2 CB 368; Rev. Rul. 55-518, 1955-2 CB 384. It is probably of no significance that while this principle was expressed in Proposed Regulations Section 20.2041-3(b), Notice of Proposed Rulemaking, 21 Fed. Reg. 7850, 7882 (1956), it does not appear in the current regulations.} and the courts agree.\footnote{All circuits that have considered this issue agree that the incompetency of a holder of a power will not make the power unexercisable for estate tax purposes. Boeving v. United States, 650 F2d 493 (8th Cir. 1981); Estate of Gilchrist v. Comm'r, 630 F2d 176 (10th Cir. 1980); Estate of Alperstein v. Comm'r, 613 F2d 1213 (2d Cir. 1979), cert. denied, 446 US 918 (1980); Pennsylvania Bank & Trust Co. v. United States, 597 F2d 382 (3d Cir.), cert. denied, 444 US 980 (1979); Fish v. United States, 432 F2d 1278 (9th Cir. 1970). The anomalous lower court cases have been overruled. See R. Stephens, G. Maxfield & S. Lind, Federal Estate and Gift Taxation ¶ 4.13[6][a], note 77 (Thomson Reuters/Tax & Accounting, 4th ed. 1978).} It has also been held that mere possession of a post-1942 general power of appointment is sufficient to cause inclusion of the property in a decedent’s gross estate even though the decedent is unaware of the power’s existence.\footnote{Estate of Freeman v. Comm'r, 67 TC 202 (1976). In Freeman, the decedent was aware of the existence of the trust itself as he was receiving an income interest from the trust and was simply unaware of his power over the trust. It is possible to parade a “horrible” here: D confers on A, a mortal enemy, a lifetime general power of which A is unaware either because D hides its existence or A is in a coma and mortally ill. D does this simply to charge A’s estate with a higher tax. Certainly, an enlightened judge would hold Section 2041 inapplicable under these facts. There is less a lack-of-knowledge problem with respect to a pre-1942 power of appointment because mere possession of the power does not trigger adverse tax consequences. In a somewhat similar situation, the Service has taken the position that a general power of appointment over an interest in a revocable trust created by another is included in the power holder’s gross estate under Section 2041(a)(2). Priv. Ltr. Rul. 200403094 (Sept. 24, 2003); Priv. Ltr. Rul. 200604028 (Sept. 30, 2005) (same but also holding that if predeceasing spouse power holder exercises the power, there is a gift by surviving spouse to predeceasing spouse which qualifies for a marital deduction and predeceasing spouse is the transferor of the property). Cf. ¶ 4.05[5][b], text accompanying notes 57, 58; ¶ 11.03[4][c], note 78.} Moreover,
even if the decedent has only an inter vivos power that cannot be exercised by will, the decedent is treated as having the power at death.\footnote{Snyder v. United States, 203 F. Supp. 195 (WD Ky. 1962); Jenkins v. United States, 428 F2d 538 (5th Cir. 1970) (Section 2041 applicable even though the decedent could exercise the power only during life).} Does the decedent have a general power of appointment \textit{at the time of death} if the decedent’s exercise of the power is not to be effective until a stated period after exercise, or if the decedent cannot exercise the power except after giving notice for a stated period of the decedent’s decision to do so, and if, in either event, prior to death the decedent has taken no such action? An express affirmative answer to this question is given by the statute, foreclosing the obvious controversy that might otherwise ensue but leaving open a related problem. It is clear that if the decedent’s power is exercisable only upon the happening of some event, such as attaining age thirty, and the event has not occurred before the decedent’s death, the decedent does not have a power at death.\footnote{Reg. § 20.2041-3(b). See Priv. Ltr. Rul. 8516011 (Jan. 3, 1985); TAM 200847015 (July 30, 2008) (power exercisable pursuant to spendthrift clause, which had not been triggered).} However, if the event is within the decedent’s control, such as dismissal of a trustee if one has such a right and the right to appoint oneself, and if one can thus acquire a power exercisable by the trustee, it seems equally clear that the decedent will be treated as possessing the power even though the decedent has taken no action toward obtaining the power, and notwithstanding the fact that the decedent might be required to give the trustee notice prior to dismissal.\footnote{Reg. § 20.2041-3(b). See Estate of Kurz v. Comm’r, 101 TC 44 (1993), reconsideration denied, 67 TCM (CCH) 2978 (1994) (holding that there was a general power but stating that to preclude the possession of a general power owing to a contingency or condition, the condition must not be illusory, and must be accompanied by some significant nontax consequences independent of the power holder’s ability to exercise the power).} The Commissioner successfully advanced this argument in a case arising under analogous language in Section 2038 concerning the existence of a power to alter, amend, revoke, or terminate,\footnote{Estate of Loughridge v. Comm’r, 183 F2d 294 (10th Cir.), cert. denied, 340 US 830 (1950).} even though the statute concerns notice prior to exercise or prior to effectiveness of an exercise rather than notice prior to actual acquisition of the power. If the power can be exercised only after giving notice, presumably the value of the property included in the gross estate would be discounted for the period required to elapse between the time of the decedent’s death and the time the power could have been exercised.\footnote{Cf. Reg. § 20.2038-1(b). Nevertheless, the discounted value might be included in the decedent’s estate. For example, if the decedent had an income interest with a general power exercisable after six months’ notice, there would be a Section 2041 “adjustment” in}
As is true, mutatis mutandis, with respect to all special statutory provisions defining the gross estate, it is not necessary that a decedent’s power extend to an entire property or fund. For example, a decedent might have a power to invade the corpus of a $100,000 trust only to the extent of $5,000. This would constitute a power of appointment to the extent of $5,000 that, if in existence at the time of the decedent’s death, would require $5,000 to be included in the decedent’s gross estate even though the entire corpus of the trust greatly exceeded that amount.87

[b] Exercise

Second, a pre-death exercise of a post-1942 general power in a testamentary fashion requires inclusion of the value of the property subject to the power in the gross estate. It will be observed that the statute does not specify tax liability in the event of an exercise of a post-1942 general power by will as it does in the case of pre-1942 powers. This does not relieve an estate of liability, however, for if the power is exercised by will, the decedent “has” the power at death, and of course, as to post-1942 powers, this brings the value of the property into the estate without regard to the question of exercise.

The statutory rule on the effect of lifetime exercise (though not what constitutes exercise) is the same for both pre-1942 and post-1942 general powers. Again, the question is whether the exercise involves a disposition that would be covered by Sections 203588 through 2038 if the exercise were a conventional transfer of property. The significance of this is previously indicated more fully in connection with the discussion of pre-1942 powers. It is worth noting that if a decedent has exercised a power by appointing to the decedent, such a lifetime exercise of a power is not a testamentary exercise within the statute, because the decedent has made no transfer to another such as is contemplated by Sections 2035 through 2038. This is entirely appropriate, however, because after invasion by the decedent, the property acquired in that fashion becomes property actually owned by the decedent. If retained until death, it will be a part of the decedent’s actual estate covered by Section 2033. If given away before then, it may be subject to gift tax or remain a part of the

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88 A post-1942 power can interact with Section 2035 only in extremely limited circumstances. If a decedent had held a post-1942 power that the decedent previously exercised retaining a Section 2036, Section 2037, or Section 2038 interest or power and the decedent then relinquished such interest or power within three years of death, Section 2041(a)(2) would apply, interacting with Section 2035.
decedent’s gross estate under other sections, or both. But in any event, Section 2041 need not and will not apply.

[c] Release

The third basic rule with respect to post-1942 general powers is that a lifetime release of the power by the decedent is the equivalent of an exercise of the power. If the release is made in a testamentary fashion, the value of the property is in the decedent’s gross estate for federal tax purposes. This should be contrasted with the express provision in Section 2041(a)(1) to the effect that a complete release of a pre-1942 power shall not be deemed an exercise of the power, exercise being necessary with respect to estate tax liability concerning such powers. Thus, it may be said, no estate tax liability will result from a complete lifetime release of a pre-1942 power, but if a post-1942 power is released during life, estate tax liability with respect to the property subject to the power depends on the manner of release. The same test applies here as applies with regard to lifetime exercise of pre-1942 powers, namely: Does the release involve a disposition that would be covered by Sections 2035 through 2038 if the release were a conventional transfer of property? If a general power is released and the power holder retains no interest in or power over the property, there are no estate tax consequences, even if that release occurs within three years of the power holder’s death. Other releases may result in estate tax consequences. For example, if the decedent is the income beneficiary of a trust and has a general power to appoint the entire property to anyone, the decedent’s inter vivos release of the power is treated as a transfer under Section 2514(b) and, upon the decedent’s death, the property subject to the power will be included in the decedent’s estate under Section 2041(a)(2) because, had the release been a transfer of property, the property would be includible in the decedent’s gross estate under Section 2036.

A release of a general power of appointment may be indirect. For example, if, during life, an individual holds a nongeneral power of appointment over the corpus of a trust created by another along with a general power to appoint it by will, an inter vivos exercise of the nongeneral power also constitutes a release of the general power.

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89. The release is treated as a transfer of property for gift tax purposes. See IRC § 2514(b).
90. Estate of Robinson v. Comm’r, 101 TC 499 (1993) (no taxable gift of the residuary trust because there was no transfer).
[d] Disclaimer or Renunciation

Section 2518 provides a uniform rule for disclaimers under the estate, gift, and generation-skipping transfer taxes that allows an individual who is given a post-1942 general power of appointment to avoid any tax consequences with respect to the power. The basic disclaimer problem cannot arise with regard to pre-1942 powers, for even if a supposed disclaimer or renunciation of such a power were treated as a release, the release in any event is without estate tax significance. Section 2518 is intended to clear up many of the disclaimer problems under Section 2041 and other Code sections.

Disclaimers can arise in some unexpected circumstances. For example, a revenue ruling properly held that a widow’s failure to exercise her statutory right to her forced share of her predeceasing spouse’s estate prior to her death constituted a disclaimer of a general power of appointment. The ruling arose

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93 IRC § 2518, discussed at ¶ 10.07.
94 IRC § 2046; see ¶ 4.18.
95 For a discussion of the requirements of Section 2518, see ¶ 10.07[2].
96 IRC § 2654(c), discussed at ¶ 17.04[3], regarding disclaimers in the case of generation-skipping transfers.
97 Cf. IRC § 2514(b).
98 See especially IRC § 2518(c)(2). A disclaimer or renunciation of a general power of appointment created after December 31, 1976, is not considered to be the release of the power if the disclaimer or renunciation is a qualified disclaimer as described in Section 2518. If the disclaimer or renunciation is not a qualified disclaimer, it is considered a release of the power by the disclaimant. Reg. § 20.2041-3(d)(6)(i).
99 Prior to the enactment of the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, reprinted in 1976-3 CB (Vol. 1) 1, there were several problems created by Section 2041(a)(2), which expressly stated that “a disclaimer or renunciation of such a power of appointment shall not be deemed a release of such power.” IRC § 2041(a)(2), prior to amendment in the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2009(b)(4), 90 Stat. 1520, 1894 (1976), reprinted in 1976-3 CB (Vol. 1) 1, 370. A beneficiary’s attempted renunciation of an intestate share in another’s estate had been held to constitute an actual taxable transfer of the property interest involved subject to gift or estate tax, rather than a mere rejection, owing to the court’s finding that the beneficiary’s interest had vested. Hardenbergh v. Comm’r, 198 F2d 63 (8th Cir.), cert. denied, 344 US 836 (1952). Compare Brown v. Routzahn, 63 F2d 914 (6th Cir.), cert. denied, 290 US 641 (1933). The quoted provision clearly contemplated a right to renounce a power tax-free without regard to the question of vesting; the regulations, at least by inference, indicated that a renunciation could be made within “a reasonable time” after one learned of the existence of the power. Reg. § 20.2041-3(d)(6). See also S. Rep. No. 382, 82d Cong., 1st Sess. 6 (1951). But this had nothing to do with the renunciation of a vested property interest. Furthermore, the Treasury appropriately took the position that (1) after acceptance, a power could not be renounced—attempted renunciation would then be treated as a release, and (2) a power could not be accepted in part and renounced in part—renunciation contemplated an “unqualified refusal to accept the rights to which one is entitled.” Reg. § 20.2041-3(d)(6).
100 Rev. Rul. 74-492, 1974-2 CB 298.
prior to the effective date of Section 2518;\textsuperscript{[101]} after the enactment of that provision, the opposite result might be reached owing to a failure to meet the statutory requirement that disclaimers be written.\textsuperscript{[102]}

\[\text{e] Lapse}\]

Section 2041(b)(2) defines “release of a post-1942 power” to include the lapse of a power during the donee’s lifetime, subject to some important exceptions.\textsuperscript{[103]} Thus, basically, both release and lapse are the equivalent of exercise.\textsuperscript{[104]} For example, if one has a noncumulative power to invade a trust to the extent of $20,000 each calendar year, one’s failure to exercise the power in any year involves a lapse of the power, which in turn has the same estate tax significance as an exercise of the power in favor of the person who will take in default.\textsuperscript{[105]} However, it should be remembered that not every release (or lapse) causes estate tax liability. If, in the example as given, the one who has the power is also the life income beneficiary of the trust, the person will be regarded as having made a transfer of a portion of the corpus (which one could have appointed to oneself), while retaining a right to the income from such portion for life, making the lapse taxable within the principle of Section 2036\textsuperscript{[106]} but subject to the “five-or-five” qualifications. If the one who has the power has no other right or interest in the trust property, the lapse may cause gift tax liability but will not cause estate tax liability.

\[\text{f] The Five or Five Rule}\]

The exceptions to the general rule (lapse equals release) are generous. The statute expressly makes the general rule inapplicable if the power that lapsed was such that during any calendar year its exercise was limited to $5,000 or to 5 percent of the value of the property out of which the exercise of the power could have been satisfied, whichever is greater.\textsuperscript{[107]} Moreover, if

\textsuperscript{[101]} Section 2518 is effective only after December 31, 1976. Reg. § 25.2518-1(a). See ¶ 10.07[3].

\textsuperscript{[102]} IRC § 2518(b)(1).

\textsuperscript{[103]} See infra ¶ 4.13[7][f].

\textsuperscript{[104]} The Service has indicated that state legislation preventing a trustee-beneficiary from exercising a power of appointment in favor of oneself will not be considered a lapse for purposes of Section 2041(b)(2). Rev. Proc. 94-44, 1994-2 CB 6 (Florida statute); Priv. Ltr. Rul. 9852031 (Sept. 29, 1998) (California statute).

\textsuperscript{[105]} A lapse has been accorded a full significance even though the power holder was incompetent. Fish v. United States, 432 F2d 1278 (9th Cir. 1970).

\textsuperscript{[106]} Reg. § 20.2041-3(d)(3).

\textsuperscript{[107]} Failure of a taxpayer to establish the value of the trust will result in use of the $5,000 amount as the floor. Estate of Noland v. Comm’r, 47 TCM (CCH) 1640 (1984).
the lapsed power exceeds $5,000 or 5 percent, its lapse is to be treated as a release only to the extent of the excess.

Under these exceptions, if the decedent could invade a $200,000 trust fund to the extent of $5,000 each year, and the decedent never exercised the power and the value of the fund remained unchanged, the decedent’s failure to exercise the right for any year prior to the year in which the decedent died (and the attending lapse of the power) would be without estate tax significance. Both the $5,000 rule and the 5 percent rule would shield the estate from liability on these facts. If the decedent withdrew amounts under the decedent’s power, or if, for other reasons, the fund diminished in value even to less than $100,000, the decedent’s estate would still escape all possibility of liability for a lapse in any year under the $5,000 rule. That is, if a decedent’s power is restricted to a withdrawal of $5,000, the lapse can be ignored. If the 5 percent rule must be resorted to, however, it is 5 percent of the value at the time of the lapse from which the amount of the exception is determined, as will be explained.

It is very important to note that the lapse rule applies only to lapses during life. If the decedent had not exercised the power in the year the decedent died, the decedent would have held the power at death, and the value of the property subject to the power at death would be included in the decedent’s gross estate.

What if the decedent had a noncumulative right to invade a $30,000 trust fund of which the decedent was the life beneficiary in an amount not to exceed $10,000 each year? From what has been said, it might seem that if the decedent let ten years go by and never exercised the right, the decedent would have made ten transfers of $5,000 (the excess over the annual $5,000 exemption) within the concept of Section 2036. The regulations appropriately provide, however, that the total amount included cannot exceed the date-of-death or alternate date value of the trust. The actual amount to be included raises some complexity. Broadly, the regulations require a determination annually of the percentages of the trust fund (valued at the date of the lapse of the power

See Covey, “The Estate Planning Benefits Available Via a $5,000 and 5 Percent Withdrawal Power,” 34 J. Tax’n 98 (1971).

The same result would occur to the extent that the decedent had not exercised the power if the decedent had exercised only part of the power during life. Reg. § 20.2041-3(d)(3).


For example, assume G gives C a five-or-five power over corpus only in the month of January of each year. If G dies in the month of January, the property subject to the power would be included in G’s gross estate under Section 2041(a)(2). If, instead, C dies in any month other than January, none of the corpus is included in C’s gross estate under Section 2041(a)(2).
as stated above) that could have been appointed under the lapsed power in excess of the allowed $5,000 or 5 percent exemptions. The aggregate of these percentages is to be applied to the date-of-death or alternate date value of the trust to determine the amount to include, which cannot exceed 100 percent in light of the limitation mentioned above.\footnote{Reg. § 20.2041-3(d)(4); S. Rep. No. 382, 82d Cong., 1st Sess. 7 (1951). The mechanical percentage approach to lifetime lapses does not yield a sound result if any year after a lapse the power is exercised. Presumably, in such a case, it would be necessary to make a less arithmetic determination of the portion of date-of-death value that should be included in the gross estate.}

The operation of the 5 percent rule can be illustrated by an example. Suppose X makes a transfer in trust to D for life, remainder to R. D is given a noncumulative power to invade corpus to the extent of $20,000 per year. At the end of the first year, assume that the corpus is worth $200,000 and, at relevant times in the second year, the corpus is worth $300,000. If D never exercises D’s power to invade and dies in the second year after the transfer, $35,000 will be included in D’s gross estate. As to year one, D had a power to invade to the extent of $20,000, and as the corpus at the end of the year was worth $200,000, the 5 percent rule would seem to mean only $10,000 would be subject to tax. However, it is not $10,000 that would be includible in the gross estate, but rather $15,000 ($10,000/$200,000 multiplied by $300,000, the date-of-death value of the trust corpus, $200,000, representing the value of the property out of which the exercise of the power could have been satisfied at the time it lapsed). Since D died in the second year possessing the power to invade to the extent of $20,000, the full $20,000 would be includible with respect to the second year, for a total of $35,000.

If the decedent’s power is limited to only part of the property, only that part is used to measure the 5 percent exclusion.\footnote{Rev. Rul. 66-87, 1966-1 CB 217.} For example, assume the decedent was a lifetime beneficiary of a trust and, as the beneficiary, has had the noncumulative right to withdraw income from the trust each year. Any income not so withdrawn was to be accumulated and added to the corpus. For purposes of determining the 5 percent limitation provided by Section 2041(b)(2)(B), only the trust income is “the assets out of which...the exercise of the lapsed power could have been satisfied.” Thus, the 5 percent exclusion is based on the value of the trust income rather than on the trust corpus from which the income was derived.\footnote{See Fish v. United States, 432 F2d 1278 (9th Cir. 1970).}
[8] Nongeneral Powers

[a] The Use of Nongeneral Powers

As one begins to digest the message of the previous discussion related to exceptions as to the post-1942 general power of appointment rules, a planning opportunity begins to emerge. The net effect of the exceptions to the general rule on the lifetime lapse of currently exercisable powers, taken together with certain exceptions to the definition of “general powers” and the parallel gift tax provisions, has afforded planners great flexibility through an informed use of powers of appointment.113 A beneficiary can be given significant interests in and powers over property held in a trust, that are not treated as a general power of appointment and they do not result in the property subject to the power being included in the beneficiary’s gross estate. The property subject to the power bypasses the beneficiary’s gross estate. For example, if a transferor gives a life estate in trust to a beneficiary, the beneficiary’s life estate in the trust is not included in the beneficiary’s gross estate at death under Section 2033 or any other estate tax provision.114 A power to invade the corpus of the trust for the beneficiary’s “health, education, support, and maintenance” does not result in the property subject to the power being included in the beneficiary’s gross estate.115 And a lifetime lapse of a power to invade corpus for the beneficiary to the extent of the greater of $5,000 or 5 percent of the corpus will not increase the beneficiary’s gross estate,116 except to the extent that such a power is held at the beneficiary’s death.117 The beneficiary may hold a testamentary power to appoint the property to anyone in the world other than the beneficiary’s estate or the creditors of the beneficiary’s estate. Generally, a testamentary nongeneral power of appointment is not drafted so broadly, but no matter how broadly it is drafted, subject to the limitation in the prior sentence, the power does not rise to the level of a general power of appointment and does not result in inclusion of the property in the beneficiary power holder’s

114 See ¶ 4.05[5][b], text accompanying notes 51, 52. However, the termination of the beneficiary’s interest may trigger the generation-skipping transfer tax. See ¶¶ 4.05[5][c], text accompanying note 60, 13.02[2].
115 IRC § 2041(b)(1)(A). See supra ¶ 4.13[4][a].
116 IRC § 2041(b)(2). See supra ¶ 4.13[7][f]. Technically, this is not a nongeneral power, but is an exception to the general power of appointment rules; generally (but see infra text accompanying note 117), if unexercised, it has the same consequences as a nongeneral power. If the power is exercised and the amount is retained until death, the amount will be included in the beneficiary’s gross estate under Section 2033.
117 IRC § 2041(a)(2). See supra ¶ 4.13[7][f], text accompanying notes 108, 109.
gross estate. In combination, the interests and powers granted a beneficiary may come very close to the equivalent of outright ownership, but without gross estate inclusion where the beneficiary is named trustee of the trust. Such a trust is commonly referred to as a “bypass” trust because the corpus of the trust is not included in the beneficiary’s gross estate, it simply bypasses the beneficiary’s gross estate.

[b] Nongeneral Powers That Are Treated as General Powers

Thus far in this discussion of possible estate tax liability concerning powers of appointment, it has been assumed that a power that is not a general power as defined in the statute cannot result in estate tax liability under Section 2041. But there is one provision in the section that may require the inclusion in the gross estate of the value of property subject to a post-1942 nongeneral power. The provision is of very limited interest because of restrictions of local property law. Section 2041(a)(3) requires that there be included in the gross estate the value of property with respect to which the decedent by will, or otherwise in a testamentary fashion as indicated by Sections 2035 through 2037, has exercised a post-1942 power (note omission of the word “general”) by creating another power (note again it does not say “general”), but only if under local law the newly created power can be exercised to postpone the vesting of the estate or interest in property or suspend ownership for a period ascertainable without regard to the date of creation of the first power.

Even though this provision on nongeneral powers will rarely be of significance, the purpose behind it may be of interest. If local law permitted an in-

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118 See IRC § 2041(b)(1); Reg. § 20.2041-1(c)(1); Priv. Ltr. Rul. 199904001 (Oct. 19, 1998). See also supra ¶ 4.13[3].

119 There is minimal potential gross estate inclusion (see supra note 117) and potential generation-skipping transfer tax consequences (see supra note 114).

120 It is unclear why Section 2038 is omitted from this list.

121 The section should not apply in states that have abolished the Rule Against Perpetuities because no postponement of vesting or suspending occurs.

122 Estate of Murphey v. Comm’r, 71 TC 671 (1979) (Section 2041(a)(3) inapplicable because date of creation of first power not altered); Priv. Ltr. Rul. 201029011 (Apr. 12, 2010) (exercise of nongeneral power of appointment did not result in inclusion under 2041(a)(3)).
definite suspension of absolute ownership of property through a succession of exercises of nongeneral powers of appointment, a nongeneral power could be created and exercised by the creation of another nongeneral power that again could be exercised by the creation of a nongeneral power, and so on indefinitely. In this fashion, except for the tax on generation-skipping transfers, practical ownership of property could be passed on from generation to generation, always outside the reach of federal estate tax, except for the provision under discussion. Such potential avoidance is foreclosed by Section 2041(a)(3).

[9] Amount to Be Included

In the foregoing discussion, it has been necessary to anticipate the question of the amount to be included in a decedent’s estate when, for one reason or another, Section 2041 is brought into play. In summary, when a pre-1942 power is involved, Section 2041 includes in the gross estate the date-of-death or alternate value of the property with respect to which the power was taxably exercised. When a post-1942 power is involved, there must be included the date-of-death or alternate date value of the property subject to the power the decedent had at death or with respect to which the decedent had in a taxable manner exercised or released the power. The special rule on lapsed powers will be recalled. The general proposition is that the power itself need not be valued; it is the value of the property that the decedent could or did appoint that is brought into the decedent’s gross estate.

[10] Background of the Section

The first federal estate tax statute did not deal expressly with powers of appointment, and the Supreme Court held that a power of appointment was not an interest in property subject to tax under the forerunner of Section 2033. Perhaps anticipating this decision, Congress added a section on powers in

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124 See Estate of Hartzell v. Comm’r, 68 TCM (CCH) 1243 (1994) (holding that because stock was properly distributed, stock was not subject to the decedent’s power of appointment).


The new provision taxed the value of property passing under a general power of appointment exercised by the decedent by will. It also subject to estate tax the passing of property under a lifetime exercise of a general power, if such exercise was in contemplation of or intended to take effect at or after death, in keeping with the principles applicable at the time to other lifetime transfers. This was the estate tax statutory law on powers until 1942.

From 1919 to 1942, many serious difficulties were encountered in the administration of the powers provision. The statute did not define “general” power, and borrowing from property law concepts, the courts tended to give the term a very restricted definition. Some doubt existed as to what constituted the “exercise” of a power, which is still a question under the present statute as to pre-1942 powers. A further problem was presented when a general power was exercised in favor of the takers in default and they disclaimed any right under the appointment but took the property in their capacity as remainderpersons; in such circumstances, the property was held not to “pass” under the exercise of the power, leaving an essential element of the statute unsatisfied.

In 1942, Congress undertook a general revision of the powers-of-appointment section. The general power concept was abandoned in favor of a statutory definition of “taxable power of appointment.” Moreover, the requirement of exercise was abandoned so that tax was imposed if the decedent had the power at death, but the statute also taxed lifetime exercise or releases of a testamentary nature. On the other hand, the section was not given full retroactive effect and persons were given an opportunity to make a tax-free release of taxable powers created before the change in the statute. The date October 21, 1942, which figures prominently in the new section, is the date of adoption of the 1942 Act.

The 1942 revision was not successful. Some of the difficulties encountered under it cannot appropriately be set out here. In 1951, Congress again undertook extended revision by enactment of the Powers of Appointment Act.
of 1951,\textsuperscript{133} which, without substantial change, was carried over into Section 2041 of the 1954 and 1986 Codes.

\section{SECTION 2042. PROCEEDS OF LIFE INSURANCE}

\subsection{Introduction}

Section 2042 presents two basic inclusionary rules. The proceeds of insurance policies on a decedent’s life are to be included in the insured’s gross estate if they are (1) receivable by the executor, or (2) receivable by other beneficiaries and the decedent had any incidents of ownership in the policy at death. But these are only seemingly simple and workable directives. Outside their obvious areas of coverage, these provisions leave the tax administrator and the courts, not to mention taxpayers, in some confusion. Both tests present difficulties, and neither is invariably clear as to its scope nor always supportable in its philosophy. These frailties emerge in the examination that follows, but first some preliminary observations should be made.\textsuperscript{1}

It is important to recognize that this section deals only with insurance policies on the decedent’s life. If a decedent owns an insurance policy on the life of another person and predeceases that person, this section is inapplicable. This is not to say that the value of such an insurance policy will escape taxation in the decedent’s estate. On the contrary, it is property owned by the decedent at death and includible under Section 2033.\textsuperscript{2} And a decedent’s lifetime gratuitous transfer of an insurance policy on another’s life may bring into play other sections,\textsuperscript{3} but again Section 2042 would not result in inclusion. It should also be observed at the outset that when insurance on the decedent’s life is involved so


\textsuperscript{2} See, e.g., Estate of DuPont v. Comm’r, 18 TC 1134 (1952), aff’d, 233 F2d 210 (3d Cir.), cert. denied, 352 US 878 (1956). If the decedent’s executor elects Section 2032 and the insured dies within the six-month period after the decedent’s death, the amount paid by the insurance company is included in the decedent’s gross estate. Rev. Rul. 63-52, 1963-1 CB 173. See also discussion of Section 2033 at ¶ 4.05[6].

\textsuperscript{3} See IRC §§ 2035, 2036, 2037, 2038, discussed at ¶¶ 4.07, 4.08, 4.09, 4.10, respectively.
that Section 2042 is applicable, its provisions are not necessarily exclusive, and another section may also apply to produce a result yielding more or less tax than would be obtained from the application of Section 2042 alone.4


The significance of Section 2042 can be grasped only through an understanding of the term “insurance” as used in the federal tax laws. Conventional policies of all kinds, which guard against the financial hazards of premature death, are clearly within the concept. But either the distribution or the shifting of the risk of premature death is an essential element of life insurance. Conventional endowment-type policies also calling for the payment of death benefits cease to be insurance when the terminal reserve value equals the death benefit,5 because, by that time, the insurer has, in effect, salted enough away out of premiums to pay the proceeds without incurring a loss.

Insurance that provides for unconditional payments only in the case of accidental death is within the insurance concept6; and so is the double indemnity feature of conventional life contracts.7 The title or description of the agreement is unimportant as long as life insurance elements are present.

However, suppose a common carrier or other commercial or industrial company maintains liability insurance that obligates an insurer to reimburse or pay directly any damages that the company may incur in connection with an accident but that further provides that the insurer may negotiate a settlement with the injured party or the party’s estate or survivors conditioned upon a release of the company from liability. Payments to an estate or survivors under such arrangements do not constitute the proceeds of insurance on the decedent’s life and are not includible in the decedent’s gross estate under Section 20428 or, probably, under any other section.9 Death benefits payable under such a policy are conditioned upon either a determination of legal liability of

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4 The relationship of Section 2042 to other inclusion sections is dealt with more fully infra ¶ 4.14[9].
5 Reg. § 20.2039-1(d). Moreover, an employer’s unfunded death benefits plan does not involve a shifting or spreading of the risk of premature death. All v. McCobb, 321 F2d 633 (2d Cir. 1963). See “Exceptions Expressed in Section 2039(a): Life Insurance Policies,” in the discussion of Section 2039 at ¶ 4.11[2][a].
8 Rev. Rul. 57-54, 1957-1 CB 298.
9 Cf. Rev. Rul. 54-19, 1954-1 CB 179; see ¶ 4.05[8], concerning the taxability of amounts recoverable under so-called survival statutes.

Section 2042
the insured company or a compromise of a claim of its liability. If, in contrast, the policy called for unconditional payment of a fixed sum merely on proof of accidental death, Section 2042 would apply.

Insurance is not restricted to policies issued by companies regularly engaged in the insurance business. Death benefits paid by fraternal beneficial societies operating under the lodge system are insurance, and even less formal arrangements have been similarly classified. For example, if one purchases a seat on the New York Stock Exchange, one acquires a right to have the so-called Gratuity Fund of the Exchange pay one’s survivors a minimum of $20,000 upon one’s death. Depending on length of tenure, the maximum moves up to $100,000. Even at a time when other resources had made the fund self-supporting, making member contributions unnecessary, a court found present the element of distribution of risk of death and held that the amounts payable by the fund constituted insurance for estate tax purposes.

Other death benefit arrangements arising in connection with employment present some difficulties. Of course, group life insurance policies are just as clearly life insurance policies as conventional individual policies. On the other hand, death benefits in the form of a mere refund of an employee’s contributions to a retirement plan that are paid to survivors do not constitute insurance, because there is no element of risk shifting or risk distribution.

Death benefits not classified as insurance may be taxed as annuities, as indicated in the discussion of Section 2039, and if such amounts are payable to the estate of the decedent as of right, they will be included in the decedent’s gross estate as property owned by the decedent. On the other hand, if the payments to the estate of the decedent or the decedent’s survivors represent a mere expectancy or gift rather than a payment required by a contractual obli-
A contract that would usually constitute life insurance for purposes of Section 2042 may lose its character as insurance if it is acquired as part of a broader arrangement with an insurance company. For example, if a conventional life insurance policy is purchased in a transaction in which, for a single premium, the insured also acquires a single-life, nonrefundable annuity policy, no life insurance may emerge for estate tax purposes. Life insurance and life-measured annuities are opposites; from the company’s standpoint, its gain depends on longevity in the case of one and transiency in the case of the other. In other words, these combination arrangements lack the critical element of the shifting or distributing of the risk of premature death, if the insurer’s gain on the early termination of the annuity payment will offset the insurer’s loss on the early payment of the insurance proceeds. Although the foregoing is not an exhaustive consideration of what constitutes insurance for estate tax purposes, the statutory treatment of amounts that are recognized as the proceeds of insurance on the decedent’s life will now be considered.

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20 This takes a combination arrangement out of the mainstream of the discussion here but leaves open the question of how such arrangements affect estate tax liability. There are several possibilities: (1) if the insured retains both the annuity and the insurance, the annuity, expiring at death, will be ignored, but the insured’s ownership of the policy will cause its inclusion under Section 2033, in the amount of the full proceeds (cf. Goodman v. Granger, 243 F2d 264 (3d Cir.), cert. denied, 355 US 835 (1957)); (2) if the insured makes a complete gift of both not within three years of death, only gift tax but no estate tax would result; (3) if the insured assigns the annuity but keeps the insurance policy, the results are the same as in (1) above; and (4) if the insured transfers the insurance policy outright but retains the annuity, the amount of the insurance proceeds will be included in the insured’s gross estate, not under Section 2042 as insurance, but as an “other payment” under Section 2039. This result could not easily be reached under the statute as it existed prior to 1954. See Fidelity-Philadelphia Trust Co. v. Smith, 356 US 274 (1958). But the addition of Section 2039 changed the picture sharply. See Estate of Montgomery v. Comm’r, 56 TC 489 (1971), aff’d per curiam, 458 F2d 616 (5th Cir.), cert. denied, 409 US 849 (1972).
[3] Amounts Receivable by or for the Estate

If the proceeds of insurance on the decedent’s life are “receivable by the executor” of the decedent’s estate, they are a part of the decedent’s gross estate for tax purposes. Section 2042(1) so provides. This provision is not interpreted strictly to require one named in a will as “executor” to be entitled to the proceeds. Certainly, if no will is executed but insurance proceeds come into the hands of an administrator, the statutory requirement is satisfied. In fact, the Treasury has long given this provision an even broader meaning, and insurance proceeds are “receivable by the executor” if they are “receivable by or for the benefit of the estate.” The test under Section 2042(1), then, is whether the proceeds are either payable into the estate or legally committed to the discharge of obligations of the estate. Thus, insurance proceeds nominally payable to other named beneficiaries may still be “receivable by the executor” within the meaning of the statute if, or to the extent that, such beneficiaries are legally bound to use the proceeds to discharge the estate’s obligations, such as taxes, debts, or other charges. And insurance payable to a creditor as security for a loan to the decedent is “receivable by the executor,” presumably up to the amount of the loan, although the amount included may be offset by a deduction under Section 2053.

[a] Meaning of “Executor”

There is a technical flaw in the statute but it does not actually affect this insurance provision. Section 2203 purports to define “executor” for all estate tax purposes as the executor or administrator or, if neither is appointed, “then any person in actual or constructive possession of any property of the decedent.” Categorical as this definition may seem, it cannot properly be, and is not, taken into account in the interpretation of the clause “receivable by the executor” in the insurance section. The definition of “executor” serves other purposes, such as indicating who must file estate tax returns and pay the tax.

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21 Reg. § 20.2042-1(b)(1). For unusual applications of Section 2042(1), see Draper Estate v. Comm’r, 536 F2d 944 (1st Cir. 1976); First Ky. Trust Co. v. United States, 737 F2d 557 (6th Cir. 1984).


23 Reg. § 20.2042-1(b)(1). If insurance proceeds are payable to a named beneficiary but in fact are used, though not legally required to be used, for estate obligations, the named beneficiary has made a gift to the estate beneficiaries.

24 Reg. § 20.2042-1(b)(1). Bintliff v. United States, 462 F2d 403 (5th Cir. 1972). See discussion of Section 2053 at ¶ 5.03.

25 See discussion of Section 2203 at ¶ 8.02.
Just as in some circumstances insurance payable to named beneficiaries may be “receivable by the executor” within the meaning of the statute, there are circumstances in which proceeds payable to the executor, according to the terms of the policy, will not be so regarded for tax purposes. In some states, statutes have provided that the surviving spouse and children are entitled to the husband’s or father’s life insurance proceeds that are not otherwise committed by will or by the terms of the policy.\(^{26}\) Under such statutes, insurance proceeds nominally payable to the estate or the executor inure to the benefit of such survivors and are treated as insurance payable to other beneficiaries and are not within Section 2042(1),\(^ {27}\) although they still may be subject to inclusion under Section 2042(2), as is indicated in the following discussion. As is often true with respect to other sections as well, the vagaries of state law directly affect the practical operation of the insurance section.

[b] Simultaneous Death

A comparable problem is presented by the simultaneous death of the insured and a primary beneficiary if the beneficiary is not the owner of the policy on the insured’s life.\(^ {28}\) In such circumstances, the Uniform Simultaneous Death Act presumes the insured survived.\(^ {29}\) If the secondary beneficiary is the insured’s estate, the proceeds will be included under Section 2042(1). If some third party is the secondary beneficiary, the result under Section 2042(2) is not altered by the simultaneous deaths, because the result under that provision, as explained below, is dependent upon the decedent’s incidents of ownership in the policy, not upon who is the beneficiary of the policy.

[c] Is Insured’s Wealth Transmitted?

Section 2042(1) of the insurance section may well be regarded as a precautionary and perhaps unnecessary provision. In an early case, the proceeds of an insurance policy owned by a decedent until death were paid to the decedent’s executor. The court held that they were includible in the decedent’s

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\(^{27}\) Webster v. Comm’r, 120 F2d 514 (5th Cir. 1941).

\(^{28}\) For an example of a situation of simultaneous death in a community property state, see Estate of Marks v. Comm’r, 94 TC 720 (1990), in which a husband and wife took out an insurance policy on the life of the other. The Tax Court held that under state (Louisiana) law, each policy was the separate property of the noninsured spouse who purchased and owned it, not the property of the spouse whose life was insured. See ¶ 4.05[6] for a discussion of the Section 2033 problems that arise on the simultaneous death of the insured and one who owns a policy on the insured’s life.

gross estate, as property owned by the decedent and subject to debts and claims, under the forerunner of present Section 2033. It seems certain the same result would be reached today in the absence of Section 2042. The discussion here only concerns something clearly owned by the decedent that happens to increase in value at the moment of the decedent’s death. It is not clear that the same result would follow if another, who was the outright owner of a policy on the decedent’s life, directed the payment of the proceeds to the decedent’s estate by way of beneficiary designation. Here, the decedent would never have any interest in the proceeds. However, speculation under Section 2033 is hardly profitable when Section 2042(1) clearly includes in the decedent’s gross estate the proceeds of insurance on the decedent’s life that are paid to the decedent’s estate.

The philosophy behind Section 2042(1) is open to challenge. If a person, D, acquires insurance on D’s life and holds onto it so that the proceeds actually fatten D’s estate upon D’s death, it seems fair enough to subject the proceeds to estate tax; that is, the usual transmission of wealth by D can be identified. The policy of Section 2042(1) that prescribes the same result if another, A, acquires the policy and holds onto it until D’s death but designates D’s estate as beneficiary, may be more open to question on the ground that it is A’s wealth that is transmitted. What if A arranged for the policy but D paid all the premiums, or vice versa? In Section 2042(1), Congress looks only very narrowly at whether something is paid to or for the benefit of the estate and really not at all at who did what and with what and to whom; and this is not in keeping with other sections defining the gross estate that, although sometimes too sophisticatedly, seek to identify wealth transmission of a testamentary nature by D as a basis for taxing D’s estate. Nevertheless, D can direct the transmission of the wealth involved.

[4] Amounts Receivable by Other Beneficiaries

The law has vacillated on the treatment of insurance proceeds paid to beneficiaries other than the estate. However, Section 2042(2) now provides a single

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30 Mimnaugh v. United States, 7 AFTR 8940 (Ct. Cl. 1928), cert. denied, 280 US 563 (1929).
32 Adverse comments in this and the next paragraph should be measured against the competing philosophies of the Fifth and Seventh Circuits, reflected in the discussion of Second Nat’l Bank of Danville v. Dallman and United States v. Keeter, at ¶ 4.13[2][b], text accompanying notes 15, 16. The long reach of Section 2042(1) may be supported by the Fifth Circuit’s view that a decedent has a general power under Section 2041 over amounts coming into the decedent’s estate.
33 See supra note 32.
test for determining whether amounts receivable by beneficiaries other than the estate under insurance policies on the decedent’s life are includible in the decedent’s gross estate. If at death the decedent had any of the incidents of ownership in the policy, exercisable alone or in conjunction with any person, the proceeds form a part of the decedent’s gross estate. If the decedent had no such incident, they do not. After an initial exploration of Section 2042(2), it is necessary to consider ownership incidents a decedent may have, not merely in the decedent’s personal capacity but, for example, as trustee or in some similar position.

[a] Incidents of Ownership

The “incidents” test is statutory recognition of the concept of ownership as a bundle of rights. Full ownership is not required by Section 2042(2); if the decedent had at death one or more of the rights that go to make up complete ownership, Congress has decided that is enough to bring the proceeds of the policy into the decedent’s estate. Except in one respect soon to be mentioned, the statute does not define “incidents of ownership.” However, in the course of enactment of the Revenue Act of 1942 when this provision was added to the statute, the House Ways and Means Committee listed some such incidents, although the list was not presented as exhaustive. They are “the right of the insured or his estate to the economic benefits of the insurance, the power to change the beneficiary,” “the power to assign it, the power to revoke an assignment, the power to pledge the policy for a loan,” or “the power to obtain from the insurer a loan against the policy.”

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34 Under Section 811(g) (1939), an alternative test, now long abandoned, was whether the decedent had directly or indirectly paid the insurance premiums. Doubt that premium payments could constitutionally support an estate tax on insurance payable to other beneficiaries was removed in United States v. Manufacturers Nat’l Bank of Detroit, 363 US 194 (1960).

35 Estate of Margrave v. Comm’r, 618 F2d 34 (8th Cir. 1980). The decedent’s inter vivos revocable trust was named beneficiary of a life insurance policy on the decedent’s life owned by his spouse, but his spouse retained the right to change beneficiaries. At the decedent’s death, he held only the mere expectancy of receiving the proceeds in the trust, and the court held that the expectancy was not sufficient to cause Section 2042(2) inclusion. The Service agrees. Rev. Rul. 81-166, 1981-1 CB 477. Estate of O’Daniel v. United States, 6 F3d 321 (5th Cir. 1993) (no legal power to exercise incidents of ownership). See also Estate of Keitel v. Comm’r, 60 TCM (CCH) 425 (1990) (decedent held incidents).


37 This has been held to include a power to veto another person’s change of beneficiary. Schwager v. Comm’r, 64 TC 781 (1975). Cf. Rev. Rul. 75-70, 1975-1 CB 301.

38 Priv. Ltr. Rul. 9745019 (Aug. 8, 1997) (no power to surrender split dollar life insurance policy where power subject to owner’s option to pay the cash surrender value).

surrender value of the policy. In general, the Treasury and the courts have accepted these illustrations of incidents of ownership when they involve an economic benefit to the decedent.41

Thus, the Supreme Court has held flight insurance proceeds includible in a decedent’s gross estate on the ground that the decedent had the legal right to change the beneficiary of the policy, even though as a practical matter the decedent could not exercise the right while the plane was in flight.42 The Tax Court has also held insurance proceeds payable to the decedent’s children includible, even though the decedent’s retained incident of ownership in the policy was only the right to borrow on the policy for the purpose of paying the premiums.43 Less surprisingly, perhaps, the Fifth Circuit has held a policy assigned to a third party includible in the decedent’s gross estate where the policy was collateral for a loan taken out by the decedent.44 However, the Third Circuit has held that a decedent’s power to veto the assignment of a policy on the decedent’s life to a person lacking an insurable interest is not an incident of ownership.45

[b] Reversionary Interest

By express provision in Section 2042(2), a reversionary interest is an incident of ownership only if the value of the reversionary interest exceeded 5 percent of the value of the policy immediately before the decedent’s death. It is immaterial whether the reversionary interest arose by express provision in the insurance policy or any instrument of transfer or by operation of law. The stat-

43 Estate of McCoy v. Comm’r, 20 TCM (CCH) 224 (1961).
44 Prichard v. United States, 397 F2d 60 (5th Cir. 1968), involving a community property situation. It is possible where a policy has been assigned as security for a loan that both paragraphs (1) and (2) of Section 2042 will apply. See the district court’s opinion in Prichard v. United States, 255 F. Supp. 552 (ND Tex. 1966). Compare Estate of Glade v. Comm’r, 37 TCM (CCH) 1318 (1978), with Bintliff v. United States, 462 F2d 403 (5th Cir. 1972).
45 Rockwell v. Comm’r, 779 F2d 931 (3d Cir. 1985).
ute, not fully defining “reversionary interest,” nevertheless specifies that it includes “a possibility that the policy, or the proceeds of the policy, may return to the decedent or his estate, or may be subject to a power of disposition by him.”46 These concepts are so closely parallel to the provisions of Section 2037(b) that a separate extended discussion is not undertaken here.47

As in the case of Section 2037, a reversionary interest is disregarded if its value does not exceed 5 percent of the value of the policy immediately before death. In other words, a very remote reversionary interest is not treated as an incident of ownership. The regulations recognize that the question of the relative value of the reversionary interest here is to be determined in accordance with the same principles as are applied under Section 2037.48 But they also recognize that controlling powers in others, which would affect the value of the decedent’s reversionary interest, must be taken into account, as illustrated by the following example from the regulations49:

[T]he decedent would not be considered to have a reversionary interest in the policy of a value in excess of 5 percent if the power to obtain the cash surrender value existed in some other person immediately before the decedent’s death and was exercisable by such other person alone and in all events.

Two further brief observations may be made. First, in making an assignment of an insurance policy with a view to escaping estate tax liability, the provisions of the policy must be closely examined. If the policy itself confers ultimate, indefeasible rights on the decedent or the decedent’s estate, such provisions may give rise to a damaging reversionary interest no matter how complete and outright the assignment may otherwise be. In this connection, it should be said that pre-1954 and perhaps more recent assignments of many existing policies should be carefully reviewed. Before the enactment of the 1954 Code, an individual knew the individual’s estate would include insurance on the individual’s life if the individual had paid the premiums on such insurance. There was no occasion to worry about ownership of, or incidents of ownership in, the policy in these circumstances; the proceeds would be includible without regard to such considerations. Now, of course, a complete assignment of all interest in the policy, if not within three years of death, will defeat the estate tax, even if the decedent pays or has paid all premiums; but any effort to take advantage of this principle must be carefully undertaken.

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48 Reg. § 20.2042-1(c)(3). See ¶ 4.09[4][f].
49 Reg. § 20.2042-1(c)(3).
Second, the statute makes no reference to a remainder, as opposed to a reversionary interest. Two thoughts occur. One, is a remainder interest an incident of ownership? The statute contains no express indication to the contrary. Two, the 5 percent rule that expressly excludes from “incidents of ownership” a remote reversionary interest (perhaps raising a negative inference that a remainder is an incident of ownership) is not phrased so as to apply to a remainder interest. If that exclusionary rule does not apply, a virtually valueless contingent remainder in a policy never otherwise owned by the decedent might be held to be an “incident of ownership” that would require the inclusion of the proceeds in the decedent’s gross estate.

Suppose, for example, a wife takes out an insurance policy on her husband’s life making herself primary beneficiary and their many children and grandchildren the contingent beneficiaries. The husband may have no interest in the policy except that, by its terms, his estate is the ultimate beneficiary if all other beneficiaries predecease him. He would have a remainder interest quite possibly of little or no value at the time of his death. However, if this is an incident of ownership and not a “reversionary interest,” is the effect to tax his estate on the full proceeds of the policy? The result should be rejected even if it requires bold judicial action. Elsewhere in this discussion, it is suggested that something may be a Section 2042(2) incident in one setting but not in another. Here, if all the decedent ever had is a remote (less than 5 percent) contingent interest in a policy that never reached fruition and that terminated at the decedent’s death, the decedent’s estate simply should not be taxed. A very remote contingent remainder might be viewed as an incident of ownership of no “economic benefit” to the decedent.

[c] Effect of Policy Terms

Whether a decedent had any of the incidents of ownership in an insurance policy is generally determined by the terms of the policy itself. If the decedent’s estate claims that for some reason, the policy is not determinative, the courts may look to the substance of the transaction to determine who held the incidents of ownership. However, the express language of the policy obvi-

50 The point seems not to have been argued in Estate of Karagheusian v. Comm’r, 233 F2d 197 (2d Cir. 1956).
51 See infra ¶ 4.14(4)[e].
52 See infra ¶ 4.14(4)[f].
ously prevails over any contrary unenforceable intentions of the parties, and the burden of proof to overcome any terms of the policy is upon the decedent’s estate. Although this result may seem inequitable in some situations, the alternative of permitting wholesale exceptions to the application of the express policy language seems far less attractive, particularly when attention to this matter by the decedent and counsel prior to the decedent’s death will eliminate the problem.

[d] Buy-Sell Agreements

Partners, members of limited liability companies, and corporate shareholders sometimes enter into buy-sell agreements that are funded with life insurance. The terms of the agreements may conflict with the terms of the supporting policies. If, for example, surviving shareholders are required to purchase the stock of a deceased shareholder with the proceeds of insurance on the shareholder’s life, the proceeds must be available to them for that purpose at the shareholder’s death. Under local law, an agreement of this type may therefore amount to a surrender of the right to change beneficiaries, seemingly conferred on the decedent by the insurance contract, and support a decision that the decedent had no incidents of ownership. It seems less likely, absent ownership incidents in the decedent under express terms of the insurance policy, that a court will find such incidents arising out of collateral agreements. A person could also become outright owner of a policy by way of transfer by

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58 See TAM 9349002 (Aug. 25, 1993) (decedent’s power under buy-sell agreement to withhold consent to exercise of policy rights under life insurance policy purchased by corporate trustee pursuant to buy-sell agreement provided decedent incidents of ownership of policy).


60 See, e.g., Estate of Infante v. Comm’r, 29 TCM (CCH) 903 (1970).
its initial owner, without such complete ownership incidents being reflected at all in the terms of the policy. In the buy-sell agreement situation, matters are sometimes complicated by a potential problem of double inclusion, with the decedent’s stock, interest in a limited liability company, or partnership interest being taxed as the decedent’s property under Section 2033, but with that interest possibly including at least part of the value of the insurance taxed to the decedent’s gross estate under Section 2042. The avoidance of the problem is examined more fully later in this discussion.

[e] “Incidents” in Context

A certain amount of sophistication is required to interpret a statutory phrase one way in one circumstance and a different way in another. Nevertheless, if Section 2042(2) is to fit gracefully into the overall scheme of federal estate taxation, the Treasury and the courts must be just that ambidextrous. It usually seems fair enough to accord the term “incidents of ownership” a very broad meaning. Thus, if a person takes out and pays for a policy on the person’s life, later assigning it to others but retaining a mere right to substitute A for B as beneficiary, Section 2042(2) taxes the person’s estate at death on the proceeds. The circumstances are analogous to those governed by the lifetime transfer sections, Sections 2036 through 2038 (indeed may actually be within them), where relatively little retained interest or control is seen as a sufficient reason for the imposition of tax.

Suppose, however, that all the wealth represented by the policy is that of someone other than the decedent whose life is insured. Outside the area of insurance, such wealth is generally taxed in a decedent’s estate either not at all or only to the extent that the decedent has some control over the property that may be used directly or indirectly for the decedent’s benefit. The required administrative and judicial ambidexterity under Section 2042(2) then, is this: (1) if the origin of the insurance is such that some form of wealth transfer by the decedent is evident, very slender Section 2036–, Section 2037–, and Section 2038–type rights should be regarded as incidents of ownership; but (2) if the policy is not generated at all by the decedent’s wealth or is disassociated from the decedent by a prior outright gift, then only stronger Section 2041–type rights should be recognized as incidents of ownership. Such a reading of Sec-

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61 If the transfer is for valuable consideration (not a gift), receipt of the proceeds by a corporate shareholder (but not a partner or member of a limited liability company) will result in income tax consequences. IRC § 101(a)(2).
62 See infra ¶ 4.14[5]; Reg. § 20.2042-1(c)(6).
63 Cf. IRC §§ 2039, 2040. But see IRC § 2040(b).
64 Cf. IRC § 2041.
65 Cf. IRC § 2041(b).
tion 2042(2) is in keeping with the clear inference in the legislative history that when Congress amended the life insurance rules in 1954, an objective was to bring the treatment of life insurance more in line with the treatment accorded other forms of wealth. No doubt the statute should be more explicit; in its present form it offers a judge little guidance as to what kinds of “incidents” to look for in a given case.

In Estate of Skifter v. Commissioner, the decedent had been the owner of a policy of insurance on his life. More than three years before his death, he transferred the policy to his wife. Upon her death, which occurred before his, the policy fell into a trust of which the decedent was trustee. Through his powers as trustee, he had the right to change beneficiaries under the policy, but not in any way to benefit himself. A mechanical, syllogistic approach to the problem would be to say: The right to change beneficiaries is an incident of ownership; decedent had that right; Section 2042(2) taxes the policy in his estate. But both the Tax Court and the Second Circuit rejected this line of reasoning, which would result in treating life insurance differently from other forms of property. Instead, the decedent’s power to change the beneficiaries was not treated as an incident of ownership. The critical factor in Skifter is clearly not that the decedent’s power could be exercised only as a trustee. If the decedent had created the trust, the proceeds should be included in the decedent’s estate. If the decedent’s right to change the beneficiaries included a

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66 S. Rep. No. 1622, 83d Cong., 2d Sess. 124 (1954): “No other property is subject to estate tax where the decedent initially purchased it and then long before his death gave away all rights to the property and to discriminate against life insurance in this regard is not justified.”

67 Estate of Skifter v. Comm’r, 468 F2d 699 (2d Cir. 1972), aff’g 56 TC 1190 (1971).

68 It might be argued that Section 2038 would apply to this situation on the theory that the policy was once transferred gratuitously by the decedent and he could at death change interests in it. Contra White v. Poor, 296 US 98 (1935). But see, overruling White v. Poor, the phrase in Section 2038(a)(1), “without regard to when or from what source the decedent acquired such power.” But this interpretation should be rejected when, as here, the decedent has made a no-strings transfer of the property. Reed Estate v. United States, 1975-1 USTC ¶ 13,073 (ND Fla. 1975). It is the transferee’s transfer to the trust that made the insurance proceeds only conditionally payable, and Section 2038 should be held inapplicable. The possible application of Section 2038 was apparently not raised in Skifter.

69 Similarly, if the decedent transferred the policy to another person or to a trust but the decedent retained any incidents of ownership in it, inclusion would occur. Prichard v. United States, 397 F2d 60 (5th Cir. 1968). Cf. Estate of Lumpkin v. Comm’r, 474 F2d 1092 (5th Cir. 1973); Estate of Connelly v. United States, 551 F2d 545 (3d Cir. 1977) (in which the court improperly distinguished Lumpkin). In Connelly, the court should have included the portion of the proceeds over which the decedent in conjunction with others held a power to alter the time of the beneficiary’s enjoyment. In Rev. Rul. 81-128, 1981-1 CB 469, the Service announced it will not follow Connelly except in the Third Circuit.
power to appoint proceeds to the decedent, the decedent’s estate would clearly be taxable. Therefore, the Skifter result should apply only where the decedent either previously made an outright gift of the policy, completely disassociating the policy, or never had any connection with the policy, and at the decedent’s death the only power held was one under which the decedent could not obtain the economic benefits of the policy. While the Fifth Circuit disagrees with the Skifter result, the Service has accepted the Skifter interpretation of Section 2042.

[f] Economic Benefit

The Tax Court seems prepared to give a narrow meaning to “incidents of ownership” under all circumstances, restricting the term to incidents from which the decedent derives some economic benefit. In Jordahl, on facts something less than compelling, the court found no “economic benefit” in a decedent who as trustee could borrow on policies of insurance on his life held in a trust created by him, but only in order to pay premiums. The Sixth Circuit has taken a similar view. It is a question of whether this position is too generous. In any event, in some courts there is still room to argue that the term

Results here often parallel results under Sections 2036 and 2038. See, e.g., Rev. Rul. 2011-28, 2011-2 CB 830 (grantor’s retained power, exercisable in a nonfiduciary capacity to acquire insurance policy held in trust and to substitute properties of an equivalent value with fiduciary trustee’s approval is not an incident of ownership); cf. Rev. Rul 2008-22, 2008-1 CB 796, discussed at ¶ 4.08[6][a], text accompanying note 119, and ¶ 4.10[4][d], text accompanying notes 46–47; Priv. Ltr. Rul. 9832039 (May 13, 1998) (transferor’s power to remove trustee for cause and reappoint another trustee other than the transferor was not an incident of ownership); Priv. Ltr. Rul. 200314009 (Dec. 17, 2002) (reformation to limit reappointment to trustee other than settler or related or subservient party was not an incident of ownership); cf. Rev. Rul. 95-58, 1995-2 CB 191, discussed at ¶ 4.08[5][a], text accompanying notes 99–100, and ¶ 4.10[4][g], note 58.

70 Cf. IRC § 2041(b).

71 Estate of Fruehauf v. Comm’r, 427 F2d 80 (6th Cir. 1970); Estate of Karagheusian v. Comm’r, 233 F2d 197 (2d Cir. 1956); Gesner v. United States, 600 F2d 1349 (Cl. Cir. 1979). But see Hunter v. United States, 624 F2d 833 (8th Cir. 1980); Priv. Ltr. Rul. 9602010 (Sept. 29, 1995) (no inclusion where no general power to appoint to oneself).

72 Tereberry v. United States, 517 F2d 286 (5th Cir. 1975), cert. denied, 424 US 977 (1976); Rose v. United States, 511 F2d 259 (5th Cir. 1975).


75 Estate of Fruehauf v. Comm’r, 427 F2d 80 (6th Cir. 1970).

76 The Tax Court’s position was bolstered by the fact that any power the decedent had was limited by his fiduciary duties. Cf. United States v. Byrum, 408 US 125, reh’g denied, 409 US 898 (1972).
“economic benefit” in the regulations modifies and limits the scope of the examples of ownership incidents that follow it.

[5] Incidents Incidentally Held

The foregoing discussion of the meaning of the phrase “incidents of ownership” encompasses the question of whether the decedent had “possessed” in a direct way any such incidents. Further consideration must now be given to the question of whether some indirect relationships that a decedent has to a policy on the decedent’s life are enough to confer on the decedent proscribed ownership incidents.

[a] Shareholder in a Corporation

For example, the decedent may be a substantial shareholder in a corporation that owns a policy of insurance on the decedent’s life. If the proceeds of a policy on the life of a controlling shareholder of a corporation are payable to the corporation, the corporation’s incidents of ownership will not be attributed to the decedent and Section 2042(2) will not apply to include the proceeds in the decedent’s gross estate. The rationale behind this provision is that inclusion of both the proceeds of the policy under Section 2042(2) and the value of the decedent’s stock interest, which under the regulations would be enhanced by the proceeds, would result in an unfair double inclusion in the decedent’s gross estate. However, if the proceeds are not paid to or for the benefit of the corporation, the regulation provides that if the decedent has legal or equitable ownership of more than 50 percent of the combined voting power of the stock

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77 Reg. § 20.2042-1(c)(2).
78 Query whether the Tax Court’s view gets some collateral support from the 5 percent test for reversions under Section 2042(2) and the regulations (Reg. § 20.2042-1(c)(6)) sometimes allocating proceeds between an insured’s estate and his corporation in accordance with provision for payment.
79 Reg. §§ 20.2042-1(c)(2), 20.2042-1(c)(6). See supra ¶ 4.14[4][d]. The regulations make it clear that the same rule applies if the proceeds must be used to defray corporate indebtedness so as to increase the net worth of the corporation.
80 Reg. § 20.2031-2(f). Regulations Section 20.2042-1(c)(6) provides that if a portion of the proceeds are paid to the corporation and a portion to a third party, that portion paid to the corporation will not be included in the decedent’s estate under Section 2042(2).
of the corporation, the corporation’s ownership incidents will be attributed to the decedent for purpose of Section 2042(2). Such attribution has both legislative and judicial support where the decedent is the sole shareholder of the corporation. There is limited legislative and judicial authority to the same effect where the decedent owns something less than all the stock. It is ques-

82 The decedent is then a controlling shareholder. Regulations Section 20.2042-1(c)(6) provides that this includes stock whose legal title is held directly by the decedent, by the decedent and another person jointly (to the extent of the decedent’s Section 2040(a) share), and by a trustee of a voting trust (to the extent of the decedent’s beneficial interest) or any other trust with respect to which at death the decedent was treated as an owner under Sections 671 through 679. See Priv. Ltr. Rul. 9746004 (Aug. 8, 1997) (no 50 percent ownership where decedent and spouse each held only 36 percent of corporate stock as community property). The regulation applies only if the proceeds are paid to a third person for a nonbusiness purpose. Reg. § 20.2042-1(c)(6).


However, the regulations specifically provide that in the case of group term life insurance (as defined in Regulations Sections 1.79-0 and 1.79-1), the power to surrender or cancel a policy held by a corporation shall not be attributed to a decedent through the decedent’s stock ownership. Cf. Rev. Rul. 83-148, 1983-2 CB 157, applying the group term rule in a partnership context.


86 Cockrill v. O’Hara, 302 F. Supp. 1365 (MD Tenn. 1969); Estate of Dimen v. Comm’r, 72 TC 198 (1979), aff’d without op. (2d Cir. 1980).

87 Estate of Levy v. Comm’r, 70 TC 873 (1978) (regulation upheld in the case of an 80.4 percent shareholder). Cf. Rev. Rul. 82-141, 1982-2 CB 209. Rev. Rul. 90-21, 1990-1 CB 172, amplifies Revenue Ruling 82-141 regarding application of the attribution role of Regulations Section 20.2042-1(c)(6) in a Section 2035 context. Revenue Ruling 82-141 provided that life insurance proceeds were includible in a deceased stockholder’s gross estate under Section 2035(a) if, within three years of death, the decedent’s corporation had transferred the incidents of ownership of a policy on the decedent’s life. Revenue Ruling 90-21 amplifies Revenue Ruling 82-141 to provide that the same analysis would still apply upon a subsequent disposition of the controlling interest. In addition, Revenue Ruling 90-21 provides that life insurance proceeds will be included in a deceased stockholders estate under Section 2035(a) if, within three years of death, the decedent transfers the controlling interest in a corporation that owns a life insurance policy on the deceased stockholder’s life.

tionable whether the regulation should gain full judicial acceptance. The attribution of one’s ownership to another is of course common in the tax laws, but more often on the basis of the statute rather than judicially or administratively.

[b] Partnership’s Insurance on Partner

Parallel results may arise in the case of life insurance owned by a partnership on the life of a partner. The aggregate (as opposed to corporate entity) nature of partnerships makes it possible to say more readily in such circumstances that the supposed partnership’s ownership incidents are really those of all the partners as individuals. Therefore, the insured partner has ownership incidents “in connection with” the other partners, which would seem to bring the insurance proceeds into the partner’s estate under Section 2042(2), and no doubt that result will follow if the proceeds are payable to an individual such as the decedent’s spouse or child, without regard to the decedent’s partnership interest. There is no reason why Section 2042(2) should not be given its literal meaning in such circumstances.

However, in other instances it may be inappropriate to apply Section 2042(2) literally to insurance on the lives of the partners. If the policy is an asset of the partnership, it may, depending on agreement among the partners, enter into the measure of the value of the deceased partner’s interest includible in the partner’s gross estate under Section 2033. If so, Section 2042(2) should apply no more in this setting than in the corporate setting. The problem, again, is one of potential double inclusion, and the answer would seem to be, again, to take some liberties with the literal terms of Section 2042(2) when Section 2033 is adequate to handle the job.

88 But cf. Estate of Horne v. Comm’r, 64 TC 1020 (1975), especially 1024 note 5.
89 See, e.g., IRC §§ 267(d), 707(b), 318.
90 See, e.g., Helvering v. Clifford, 309 US 331 (1940).
91 Since a limited liability company is treated as a partnership for federal tax purposes, similar consequences are applicable to a life insurance policy on the life of a member of a limited liability company. See ¶ 4.05[7][c].
93 Estate of Knipp v. Comm’r, 25 TC 153 (1955), aff’d on another issue, 244 F2d 436 (4th Cir.), cert. denied, 355 US 827 (1957) (no Section 2042(2) for ten policies on decedent’s life owned and paid to partnership; however, eleventh policy not owned by partnership was included under Section 2042(2)); Priv. Ltr. Rul. 9623024 (Mar. 6, 1996) (no Section 2042(2) double inclusion); Priv. Ltr. Rul. 9843024 (July 24, 1998) (same); Priv. Ltr. Rul. 200111038 (Dec. 15, 2000) (same). See also Priv. Ltr. Rul. 200947006 (July 20, 2009) (proceeds paid to partnership at taxpayer’s death not included in tax-
Nevertheless, the rights of partners are almost entirely a matter of contract or agreement. It is possible that the amount to which the estate of a deceased partner is entitled will be determined without regard at all to the proceeds of insurance on the partner’s life, even though the proceeds may be paid directly to the partnership. If this is the case, the best analysis would seem to be that the deceased partner has, within the concept of Section 2042(2), transmitted wealth to the surviving partners. And this would seem to be so even if, voluntarily or in accordance with an agreement, they use the insurance proceeds to purchase the deceased partner’s interest from the partner’s estate. The thought here is analogous to the one found in the regulations relating to life insurance in the corporation setting; that is, if the insurance proceeds do not operate to enlarge the decedent’s gross estate through the enhancement of a business interest, Section 2042(2) should be applied literally because of the essentially nonentity nature of a partnership. In other circumstances, both as to partnerships and corporations, one given to reading the statutory language closely cannot help but feel uncomfortable.

In general, no special problem is presented by a partner’s personal ownership of an insurance policy on the life of a partner. If, under the policy, the insured partner has an incident of ownership such as the right to change beneficiaries, the proceeds of the policy should be included in the decedent’s gross estate. Sometimes, however, it is the intention of the partners that the insured partner have no such control even though the policy expressly gives the partner the right to change beneficiaries. Despite such “policy” facts, the courts have been appropriately willing to hold that the decedent had no ownership incidents where the insurance company had merely erred and the incidents conferred on the decedent were inconsistent with an agreement between the partners.94

It is interesting to speculate whether reciprocal life insurance arrangements between partners should be treated under Section 2042(2) in a manner analogous to the treatment of reciprocal or crossed trusts under the lifetime transfer sections.95 An argument can be made that if partner A insures the life of partner B, A retaining all ownership incidents in the policy, in exchange for partner B insuring the life of partner A, and each names beneficiaries in accordance with the wishes of the insured, upon the death of either partner, that partner should be treated as having incidents of ownership in the policy held by the other on the partner’s life. The Treasury refused to apply this reciprocal payer’s gross estate following proposed transactions by which two family trusts will take ownership of partnership, which will then own and be the designated beneficiary of the policies; Priv. Ltr. Rul. 200948001 (July 20, 2009) (same); Priv. Ltr. Rul. 200949004 (July 20, 2009). See supra ¶ 4.14[5][a], text accompanying notes 79–81.


95 See ¶ 4.08[7][d].

Section 2042
concept in Revenue Ruling 56-397. Even so, it would seem that the insured could sometimes control the distribution of the proceeds of the insurance on the insured’s life under such circumstances. That may have been unlikely in the buy-and-sell setting of the revenue ruling, but in other circumstances, a threat to direct the proceeds of the partner’s policy to, for instance, the Red Cross might well ensure compliance with the wishes of the insured concerning the beneficiaries of the policy on the insured’s life.

[6] Special Life Insurance Arrangements

[a] Assignment of Group Term Insurance

Life insurance takes many forms. With today’s emphasis on collective bargaining and fringe benefits, a popular form of insurance is employer-funded group term life insurance. Although such insurance has attributes that make it more difficult to assign than regular policies, an employee may effectively transfer all incidents of ownership in a group policy so that upon the employee’s death the proceeds will not be included in the employee’s gross estate. Even a nonconvertible policy may be effectively assigned. The Commissioner had contended that such policies were not fully assignable, because the employee’s power to terminate the policy by terminating employment was an incident of ownership, but that contention has been abandoned. Consequently, an employee may effectively assign a nonconvertible group policy if the employee assigns all of the employee’s rights. Even if the employee has a conversion privilege that would convert the policy to an individual policy should the individual cease employment, that is not an incident of ownership and the policy will not be included in the employee’s estate. Of course, an effective assignment of the policy does not preclude the

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96 Rev. Rul. 56-397, 1956-2 CB 599.
97 The factual situation of this ruling is distinguishable in that the proceeds were paid to the owner of the policy and not to beneficiaries named in accordance with the insured’s wishes.
98 Rev. Rul. 69-54, 1969-1 CB 221. See also supra ¶ 4.14[5][a], text accompanying note 84.
102 Estate of Smead v. Comm’r, 78 TC 43 (1982), holding that such a conversion privilege was too contingent and remote to be an incident of ownership under Section 2042(2).
possibility that the assignment will leave the employee's estate taxable under Section 2035(a).\textsuperscript{103}

[b] Split Dollar Life Insurance

Generally, a split dollar life insurance arrangement involves an ownership arrangement of a life insurance policy\textsuperscript{104} where there is a splitting of the interests in the life insurance policy through either a sharing of the costs or of the benefits of the policy or both. The original form of split dollar life insurance arrangements involved an employer-employee joint ownership of an ordinary life policy where the employer owned the "equity" or cash surrender value interest in the policy and the employee owned the "term" or insurance interest in the policy\textsuperscript{105} or a "reverse" split dollar life insurance arrangement where the above interests were reversed with the employee owning the equity interest and the employer owning the term interest.\textsuperscript{106} Split dollar life insurance arrangements now also include arrangements between a corporation and a shareholder\textsuperscript{107} and between private parties.\textsuperscript{108} Generally, a split dollar life insurance policy now involves any arrangement between an owner and nonowner of a life insurance contract under which either party to the arrangement pays all or

\textsuperscript{103} Cf. Landorf v. United States, 408 F2d 461 (Ct. Cl. 1969); Kahn v. United States, 1972-2 USTC \ ¶ 12,890 (ND Ga. 1972); Rev. Rul. 80-289, 1980-2 CB 270. See infra \ ¶ 4.14[9][b].

\textsuperscript{104} Term insurance generally is not a type of insurance that is held as split dollar life insurance. See Rev. Rul. 64-328, 1964-2 CB 11 (now obsolete, see Rev. Rul. 2003-105, 2003-2 CB 696). See also Regulations Section 1.61-22(b)(1)(iii), which does not preclude term insurance from regulatory treatment, but does provide that a Section 79 group term life insurance policy is generally not a split dollar life insurance arrangement.

\textsuperscript{105} Rev. Rul. 64-328, 1964-2 CB 11 (now obsolete, see Rev. Rul. 2003-105, 2003-2 CB 696). Such an arrangement permits the employer to provide a fringe benefit to an employee, but also allows the employer to recoup its investment at the insured's death or earlier termination of the arrangement. An employee benefits by acquiring insurance protection at a low cost and by having a leveraged value of the policy if there is a transfer of the employee's interest in the policy. Id. The premium paying arrangement could fall into several different classifications including a split with the employer paying all the premiums, a classical split with the employer paying premiums in an amount equal to the increase in the cash surrender value of the policy, or a level split premium amount between the employer and employee.

\textsuperscript{106} See Priv. Ltr. Rul. 9026041 (Mar. 30, 1990). Cf. Priv. Ltr. Rul. 9636033 (Mar. 12, 1996) (private reverse split dollar arrangement). Since the employer owns the initial "term" insurance protection, this type of policy is appropriate to provide an employer "key person" type of insurance protection and also provide the employee the cash value of the insurance policy. The benefits vary depending on how the proceeds are split.


\textsuperscript{108} See Reg. §§ 1.61-22(b)(1), 1.61-22(b)(2).
part of the premiums and at least one of the parties paying premiums is entitled to recover all or a portion of the premiums where such recovery is to be made from, or secured by, the proceeds of the contract.\textsuperscript{109}

The Treasury has issued regulations dealing with split dollar life insurance arrangements.\textsuperscript{110} Most of the complicated tax consequences considered in the regulations with respect to split dollar life insurance arrangements involve the income tax consequences of such arrangements.\textsuperscript{111} The regulations defer to general estate tax principles the determination of the estate tax consequences of split dollar life insurance arrangements.\textsuperscript{112} Thus, the rules of Section 2042 apply\textsuperscript{113} and authority found in rulings and cases decided prior to the promulgation of the regulations are used to determine the extent to which the proceeds of split dollar arrangements are currently included within an insured decedent’s gross estate. For example, to the extent that proceeds of a split dollar life insurance arrangement are paid directly or indirectly to the insured decedent’s executor,\textsuperscript{114} those proceeds should be included within the decedent’s gross estate under Section 2042(1) with a deduction allowed under Section 2053(a)(4) for the value of any other person’s right to recover a portion of those proceeds.\textsuperscript{115} Similarly, if the insured decedent directly or indirectly held any incidents of ownership over the policy on the insured decedent’s life, the proceeds should be included in the insured’s gross estate under Section 2042(2),\textsuperscript{116} again with a Section 2053(a)(4)\textsuperscript{117} deduction for the value of any other person’s right to recover a portion of the proceeds of such policy from the beneficiary of the proceeds.\textsuperscript{118} Although this is the appropriate statutory result, some courts have simply included the proceeds net of the value of such other persons’ rights in the proceeds in the insured’s gross estate under Section


\textsuperscript{111} Reg. §§ 1.61-22, 1.83-3(e), 1.83-6(a)(5), 1.301-1(q), 1.7872-15. The regulations also provide gift tax consequences of such arrangements. See ¶ 10.01[3][g].


\textsuperscript{113} If a third-party owner of some portion of the policy predeceased the insured, that portion of the value of the policy would be included in the third-party’s gross estate under Section 2033. See ¶ 4.05[6].


\textsuperscript{115} Cf. IRC § 2053(c)(1)(A).

\textsuperscript{116} See supra ¶ 4.14[4].

\textsuperscript{117} Cf. IRC § 2053(c)(1)(A).

A transfer of incidents of ownership by the insured decedent of a split dollar arrangement within three years of death will cause the proceeds of the policy to be included in the insured decedent’s gross estate under Section 2035(a), again reduced by the value of any other person’s right to such proceeds as the result of a Section 2053(a)(4) deduction.\(^{120}\)

As in the case of non-split dollar life insurance arrangements,\(^{121}\) incidents of ownership may be indirectly held by an insured if the insured owns a controlling interest in a corporation and the corporation owns incidents of ownership in the policy.\(^{122}\) In such circumstances, if the corporation’s share of the proceeds is not paid to the corporation\(^{123}\) or is not paid in a manner that otherwise increases the value of the insured’s stock of the corporation,\(^{124}\) the insured decedent is deemed to indirectly hold the corporation’s incidents of ownership in the policy and the proceeds are then included in the insured decedent’s gross estate under Section 2042(2) as if the insured decedent had held the incidents of ownership directly.\(^{125}\) If some of the proceeds are paid to the corporation or paid in a manner that increases the value of the corporate stock, only the remaining proceeds would be included in the decedent’s gross estate under Section 2042(2).\(^{126}\) In applying these rules, if the corporation has only a

\(^{119}\) Cf. Estate of Tomerlin v. Comm’r, TC Memo. 1986-147; Rev. Rul. 76-113, 1976-2 CB 376 (not split dollar life insurance). Technically, this result is statutorily inappropriate; but it generally makes no difference to the decedent’s estate tax consequences. A similar discrepancy in treatment but not in consequences occurs with respect to recourse and nonrecourse mortgages under Section 2053(a)(4), discussed at ¶ 5.03[5], text accompanying notes 247–252.

\(^{120}\) See infra ¶ 4.14[9][b].

\(^{121}\) See supra ¶ 4.14[5].

\(^{122}\) Reg. § 20.2042-1(c)(6).

\(^{123}\) See Reg. § 20.2031-2(f); Estate of Huntsman v. Comm’r, 66 TC 861 (1976), acq. 1977-2 CB 1.

\(^{124}\) See Reg. § 20.2031-2(f).

\(^{125}\) Estate of Levy v. Comm’r, 70 TC 873 (1978); Dimen v. Comm’r, 72 TC 198 (1979), aff’d, 633 F2d 203 (2d Cir. 1980). In these cases involving split dollar arrangements, the insured decedent did not directly own incidents of ownership, but the corporation that the decedent controlled held incidents of ownership over the policy, part of which proceeds were paid to the corporation (no Section 2042(2)) and part of which were paid to a third party (Section 2042(2) inclusion). See also Rev. Rul. 82-145, 1982-2 CB 213 (corporate incident of ownership attributed to controlling shareholder except to extent proceeds paid to corporation).

\(^{126}\) Reg. § 20.2042-1(c)(6). For example, if an insured decedent directly held no incidents of ownership but controlled a corporation that held incidents of ownership, and the proceeds were paid in a manner that did not increase the value of the corporate stock, the proceeds would be included in the insured decedent’s gross estate under Section 2042(2) as a result of Regulations Section 20.2042-1(c)(6). If, in that situation, the corporation had a valid claim against the beneficiary to some portion of the proceeds, the proceeds included in the insured decedent’s gross estate under Section 2042(2) would be reduced by the amount of the corporation’s claim to the proceeds deductible under Section 2053(a)(4).
right of reimbursement for its economic interest in the policy, the right of re-


imbursement is not itself a Section 2042(2) incident of ownership held by the
corporation in the policy.\textsuperscript{127} If the ownership arrangement is held in part by a
partnership or a limited liability company rather than a corporation, similar re-
results occur.\textsuperscript{128}

[7] Amount to Be Included

[a] In General

If insurance proceeds are includible in a decedent’s gross estate, the
amount to be included is “the full amount receivable under the policy.”\textsuperscript{129} If
the estate or beneficiary can take a lump sum as proceeds of the policy, that is
the full amount receivable. If payments are to be made periodically in the form
of an annuity with no option to take a lump sum, the amount receivable is the
“sum used by the insurance company in determining the amount of the annu-
ity.”\textsuperscript{130} However, if the periodic payments are merely payments of interest on

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\textsuperscript{127} Rev. Rul. 76-274, 1976-2 CB 278, modified by Rev. Rul. 82-145, 1982-2 CB 213;
Priv. Ltr. Rul. 9651030 (Sept. 20, 1996); Priv. Ltr. Rul. 9808024 (Nov. 20, 1997). Thus,
if the insured and the insured’s controlled corporation held no incidents of ownership in
the policy, but the corporation had a right to recover a portion of the split dollar proceeds
from the beneficiary, the right of reimbursement would not be any incident of ownership
and there would be no Section 2042 inclusion in the insured’s gross estate; however, the
value of the insured’s stock included under Section 2033 would be increased as a result of
the corporation’s right of recovery.

\textsuperscript{128} Cf. Priv. Ltr. Rul. 9639053 (June 20, 1996); Priv. Ltr. Rul. 200925003 (Dec. 16,
2008) (if trust grantor/insured disposes of his general partnership interest in partnership
which entered into split dollar agreement with trust, trust grantor/insured would not hold
any incidents of ownership in the policy). See supra ¶ 4.14[5][b].

\textsuperscript{129} Reg. § 20.2042-1(a)(3). Compare the amounts to be included if the decedent
owned a policy on the life of another that was included in the decedent’s estate under
Section 2033. Reg. § 20.2031-8(a). See ¶¶ 4.02[3][h], 4.05[6]. Form 712, Life Insurance
Statement, must be completed by every life insurance company that issued a policy on the
life of the decedent, and filed by the estate’s executor with Form 706, United States Estate
(and Generation-Skipping Transfer) Tax Return.

\textsuperscript{130} Reg. § 20.2042-1(a)(3); Estate of Chisholm v. Comm’r, 37 BTA 167 (1938),
nonacq. 1938-2 CB 39.
the proceeds and not an annuity, the face amount of the policy is included. The amount to be included as insurance “proceeds” may include sums beyond the face amount of the policy if the beneficiary also receives additional amounts such as accumulated dividend additions or interest. However, includible proceeds do not include a mere return of prepaid premiums to one other than the decedent who purchased the policy; of course, if the decedent was entitled to the prepaid premiums and they are payable to the decedent’s estate, they are included in the decedent’s gross estate under Section 2033.

[b] Inclusion of Only a Portion of Proceeds

It is possible that only a portion of the proceeds of a policy will be included in the decedent’s gross estate. For example, if the decedent owned a paid-up policy on the decedent’s life in the face amount of $10,000 that was pledged as security for a $5,000 note on which the decedent was liable, and, subject to the decedent’s creditor’s rights, more than three years prior to death the decedent assigned all the rights in the policy to the beneficiary, only $5,000 of the proceeds should be included in the decedent’s gross estate. That amount of proceeds would be an amount “receivable by the executor” under Section 2042(1). It may be, additionally, that the pledge relationship constitutes an incident of ownership. This further thought suggests the possible inclusion of the entire proceeds, but a proportionate concept seems preferable. As the incident of ownership extends at most to half the date-of-death value of the policy, no more than that should be included under 2042(2).

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131 Cf. IRC §§ 101(c), 101(d).
132 Estate of Willis v. Comm’r, 28 BTA 152 (1933).
134 The estate would also likely be allowed a Section 2053 deduction of $5,000. See ¶ 5.03[4][a].
135 Reg. § 20.2042-1(b)(1); Estate of Matthews v. Comm’r, 3 TC 525 (1944), acq. 1944 CB 19; Bintliff v. United States, 462 F2d 403 (5th Cir. 1972).
136 Prichard v. United States, 397 F2d 60 (5th Cir. 1968).
138 The Service seems to adopt this proportionate approach with respect to split dollar life insurance in which the insured decedent held incidents of ownership but a portion of the policy was owned by the employer. Schwager v. Comm’r, 64 TC 781 (1975); Estate of Tomerlin v. Comm’r, 51 TCM (CCH) 831 (1986). Arguably, the decedent holds incidents of ownership over the entire policy, all of whose proceeds would be included in the decedent’s gross estate under Section 2042(2), reduced by the employer’s claim against the estate under Section 2053(a)(3). Cf. Reg. § 20.2042-1(c)(5) (providing a like approach to community property insurance); Reg. § 20.2036-1(a) (adopting a similar proportionate approach to certain lifetime transfers).
[8] Policy Purchased With Community Property Funds

The community property laws of some states effect a sharp difference in the estate tax treatment of the proceeds of life insurance. For example, an insurance policy on a husband’s life paid for out of community property funds is a community asset even if the proceeds are payable to the husband’s estate. As the surviving wife has a right to half such proceeds, only one half is includible in the husband’s estate upon his death, despite the usual consequences of Section 2042(1). And if the proceeds are payable to a third party but the decedent had an incident of ownership in the policy that would invoke Section 2042(2), again only one half of the proceeds is includible in the decedent’s estate despite the usual full inclusion consequences of Section 2042(2). The theory here is that the decedent has incidents of ownership in only one half of the policy. Regarding the other half, the decedent acts only as an agent for the decedent’s spouse. Of course, if the decedent’s spouse predeceases the decedent, half of the value of community property insurance on the decedent’s life will be included in the spouse’s estate under Section 2033.

Even if a policy is purchased with community property funds, it is possible for one spouse to make a gift of that spouse’s one half of the policy to the other spouse at the time of the acquisition. Whether there has been an effec-

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139 Questions can arise over whether the policy was acquired with community property funds. Daly v. United States, 1975-1 USTC ¶ 13,070 (D. Idaho 1975); Rev. Rul. 2003-40, 2003-1 CB 813. Cf. infra text accompanying note 146.

140 Reg. § 20.2042-1(b)(2). But see supra ¶ 4.14[3][c], note 32. See also Estate of Street v. Comm’r, 152 F3d 482 (5th Cir. 1998) (full proceeds included with court implying policy was not community property).

141 Reg. § 20.2042-1(c)(5). But cf. Estate of Wildenthal v. Comm’r, 29 TCM (CCH) 519 (1970); Rev. Rul. 80-242, 1980-2 CB 276 (both involving a separate property policy with premiums paid with community property where the only right of the surviving spouse may be to receive repayment of the amount of premiums paid from the surviving spouse’s share of community property).

142 If a decedent’s spouse fails to assert the right to one half of the proceeds and they are paid to the decedent’s executor and ultimately to some third party, or if they are paid directly to a third party, then the spouse has made a gift of the spouse’s one half of the proceeds. Reg. § 25.2511-1(h)(9). Cf. Goodman v. Comm’r, 156 F2d 218 (2d Cir. 1946); Rev. Rul. 79-303, 1979-2 CB 332 (involving various ramifications in a simultaneous death situation).


144 Such a gift would not result in a taxable gift as it would fall within the exclusion of Section 2503(b) or qualify for the marital deduction of Section 2523. See Reg. § 25.2503-3(a); IRC § 2524. Additionally, any further premiums paid with community property funds, also likely intended as gifts, would similarly escape gift tax. IRC §§ 2503(b), 2523, 2524; Reg. § 25.2503-3(c), Ex. 6.
tive transfer of all ownership in the policy to one spouse depends on the effectiveness of the intended gift under local law, which varies somewhat from state to state with regard to the formalities required. In general, the signature of one spouse on the policy or policy application is an insufficient affirmative act to overcome the community property presumption. However, a specific “control clause” in the policy declaring that one spouse has or owns all incidents of ownership in the policy is generally sufficient to establish ownership of the policy in one spouse.

Suppose community property funds are used to purchase separate policies on the lives of each spouse but there is an attempt to make each spouse both sole owner and beneficiary of the policy on the life of the other. If the attempt to convert ownership of each policy from community property to separate property is ineffective, then when the first spouse dies, one half of the value of the proceeds is included in that spouse’s estate under Section 2042(2) and one half of the value of the policy on the survivor’s life is included in the survivor’s estate under Section 2033. If however, there is an effective conversion to separate property, then upon the death of the first spouse, none of the proceeds of the policy on the spouse’s life is included in the spouse’s estate under Section 2042, and only the full lifetime value of the policy on the survivor’s life is included under Section 2033.

If a husband and wife own a community property policy on the husband’s life and the wife predeceases the husband, leaving her interest in the policy to him at her death, and if he continues to pay premiums on the policy and to retain incidents of ownership in it until his death, then the full amount of the proceeds is included in the husband’s estate under Section 2042. However, if

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146 Freedman v. United States, 382 F2d 742 (5th Cir. 1967); Lutich v. United States, 1972-1 USTC ¶ 12,852 (ND Cal. 1972).

147 Bintliff v. United States, 462 F2d 403 (5th Cir. 1972); Parson v. United States, 460 F2d 228 (5th Cir. 1972); Kern v. United States, 491 F2d 436 (9th Cir. 1974).


150 But see Estate of Cavenaugh v. Comm’r, 51 F3d 597 (5th Cir. 1995) (only one half of proceeds of term policy included in survivor’s gross estate because under state law the predeceasing spouse’s death converted policy to a tenancy in common); Estate of Burris v. Comm’r, 82 TCM (CCH) 400 (2001), acq. 2003-1 CB xxi (including one half of proceeds in husband’s gross estate because the policy had been community property without considering aspects of the other half where proceeds paid to children).
the wife’s interest in the policy is bequeathed to a third person and thereafter the decedent pays all the premiums out of his own funds and retains incidents of ownership in the policy, the decedent and the third person own the policy as tenants-in-common. The portion of the proceeds includible in the decedent’s estate is determined with reference to his contribution to the cost of the policy. Included are the full proceeds less the amount that bears the same ratio to the total proceeds as the wife’s premium payments bear to the total premium payments. While it might seem that this rule improperly invokes the old payment-of-premiums test, it does not. Reference to premium payment is made only to determine the relative ownership interests of the tenants in common. If, after his wife’s death, one half of each of the decedent’s premium payments is an effective gift to the third-party joint owner, then only one half of the proceeds plus any premium gifts made within three years of the decedent’s death should be included in his gross estate.

[9] Relation of Section 2042 to Other Sections Defining “Gross Estate”

[a] The Transfer Sections Generally

As previously indicated, the provisions of Section 2042 are not exclusive. Of course, if the particular policy involved is held not to be an insurance policy, Section 2042 is not applicable at all and other sections necessarily take over the determination of what is included in the gross estate. Even if insurance is involved, other sections will be applied if they bring into the gross estate something more than what would come in under Section 2042.

Section 2037 might easily be applicable if the decedent had made a lifetime gratuitous transfer of a policy on the decedent’s life, but it is doubtful that the government will ever resort to that section. It contains a threefold test (transfer-survivorship-reversionary interest), and as the requirements of Section

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151 Scott v. Comm’r, 374 F2d 154 (9th Cir. 1967). See also Liebmann v. Hassett, 148 F2d 247 (1st Cir. 1945) (similar proportionate inclusion in Section 2035 joint payment-of-premiums context); Estate of Cervin v. Comm’r, 111 F3d 1252 (5th Cir. 1997) (one half of proportionate inclusion where some premiums paid by decedent deemed paid by third parties with decedent having a claim against third parties for premiums).

152 IRC § 811(g) (1939).

153 Form should not control, but the gift might be clearer if the decedent gives cash equal to one half of the premium to the third party and the third party directly pays the third party’s one half of the premium. Cf. Estate of Cervin v. Comm’r, 111 F3d 1252 (5th Cir. 1997) (one half of each premium was an account receivable of decedent against third-party joint owner). For a general discussion of community property life insurance, see Thurman, “Federal Estate and Gift Taxation of Community Property Life Insurance,” 9 Stan. L. Rev. 239 (1957).
2042 are met by satisfaction of the reversionary-interest test alone, it is difficult to see how resort to Section 2037 could produce a more onerous tax result than would follow from the application of Section 2042. For a similar reason, Section 2036 is not likely to be resorted to. If “insurance”\textsuperscript{154} is involved and the decedent has transferred the policy in such a way as to reserve an income interest in it,\textsuperscript{155} the decedent would have an incident of ownership that would activate Section 2042(2) without regard to Section 2036.\textsuperscript{156}

Likewise, a power to alter, amend, revoke, or terminate that would bring into play Section 2038 would also satisfy the incident-of-ownership test of Section 2042(2).\textsuperscript{157} Section 2039 is expressly made inapplicable to insurance, and Section 2040 applies only to property in which the decedent has an ownership interest with others at death. A power of appointment, such as might be taxed under Section 2041, is certainly an “incident of ownership,” although it is usually not treated as an interest in property.

[b] Near-Death Transfers

If the foregoing is correct, Section 2035(a), concerning transfers within three years of death, is the principal provision to stretch beyond the reach of Section 2042 to include amounts in a decedent’s gross estate with respect to insurance policies on the decedent’s life. If a transfer of a life insurance policy is within Section 2035(a), a question arises regarding the amount includible in the decedent’s gross estate. A partial answer is the uniform date-of-death (or alternate valuation date) rule,\textsuperscript{158} which runs through all the sections defining “gross estate.” In the case of life insurance, its value takes account of the fact of the decedent’s death. Thus, if a paid-up insurance policy was transferred by the decedent within three years of death, the full proceeds will be included in

\textsuperscript{156} It is not unlikely that Section 2036 will bring the value of an insurance policy on another’s life into a decedent’s gross estate. Such a result would be obvious if a third-party owner transferred a policy to a trust retaining income interests. A sneakier application of Section 2036 may arise out of a surviving beneficiary’s election of a settlement option of income from proceeds for life, then proceeds to others. Compare Estate of Pyle v. Comm’r, 313 F2d 328 (3d Cir. 1963) (Section 2036 applied even though the decedent elected option before insured’s death), with National City Bank of Cleveland v. United States, 371 F2d 13 (6th Cir. 1966) (Section 2036 held not applicable for lack of transfer by decedent where, while owner, she merely passively accepted income from proceeds for life and suffered proceeds to be paid to others at her death).
\textsuperscript{157} See supra text accompanying notes 154–156; compare Estate of Skifter v. Comm’r, 468 F2d 699 (2d Cir. 1972), with Terriberry v. United States, 517 F2d 286 (5th Cir. 1975), cert. denied, 424 US 977 (1976).
\textsuperscript{158} IRC §§ 2031(a), 2032(a).
the decedent’s gross estate; and the amount included is increased by the amount of gift tax paid.

Section 2035(a) applies only where the decedent actually held and transferred Section 2042 incidents of ownership. Cases involving transfers after the amendment of Section 2035 in 1981 have refused to impute indirect acquisition of a policy to a decedent where the decedent did not actually hold inci-

\[\text{Ref. Rul. 71-497, 1971-2 CB 329, Situation 2. As in other circumstances, a full and adequate consideration for the transfer of the policy will of course defeat the application of Section 2035(a). But a transfer for an amount equal to the cash surrender value of the policy clearly will not invoke this exclusionary rule. Estate of Pritchard v. Comm’r, 4 TC 204 (1944). In limited circumstances, the state of the insured’s health may bear on what consideration will be adequate. Cf. Estate of Jennings v. Comm’r, 10 TC 323 (1948). Partial consideration will of course effect a reduction in the amount included in the gross estate. See discussion of IRC § 2043(a) at ¶ 4.15[2], and discussion of IRC § 2035(a) at ¶ 4.07[2][b][i].
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\[\text{IRC § 2035(b).
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\[\text{Estate of Headrick v. Comm’r, 93 TC 171 (1989), aff’d, 918 F2d 1263 (6th Cir. 1989); Leder v. Comm’r, 893 F2d 237 (10th Cir. 1989); Estate of Perry v. Comm’r, 927 F2d 209 (5th Cir. 1991); Estate of Chapman v. Comm’r, 56 TCM (CCH) 1451 (1989). All the above cases found Section 2035(a) inapplicable. In a follow-up development, in Perry, the Fifth Circuit has held that the estate was entitled to recover attorney fees for the cost of the appeal. Estate of Perry v. Comm’r, 931 F2d 1044 (5th Cir. 1991). These cases, along with various other planning aspects of life insurance trusts, are discussed in a short but excellent planning article by Aucutt & Hughes, “Irrevocable Life Insurance Trusts Still Have Planning Possibilities After TAMRA,” 71 J. Tax’n 258 (1989). See also Lien, “Exclusion of Life Insurance Proceeds From the Value of the Decedent’s Gross Estate: Estate of Perry v. Commissioner,” 46 Tax Law. 295 (1992).
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dents over the policy,\textsuperscript{162} casting doubt on some cases arising under Section 2035 prior to its amendment in 1981.\textsuperscript{163}

Suppose a policy is incompletely transferred by $D$. $D$ might transfer a policy to another but continue under its terms to have the power to have the proceeds paid to $D$’s estate if all of the beneficiaries predecease $D$, or $D$ might retain the power to change the beneficiaries. These, of course, are incidents of ownership that would cause the proceeds to be included in $D$’s gross estate under Section 2042(2). But now assume that $D$ finally relinquishes all such powers within three years of $D$’s death. The only logical conclusion is that the proceeds should still be included, and that is the Treasury’s position.\textsuperscript{164} The statute has been tidied up to support the result,\textsuperscript{165} as the incidents-of-ownership test of Section 2042 would be largely a mockery if it could be defeated by

\begin{itemize}
\item \textsuperscript{162} For example, in Headrick v. Comm’r, 918 F2d 1263 (6th Cir. 1990), a trustee, under no requirement to do so, purchased a life insurance policy on the decedent’s life with funds provided by the decedent, and in Leder v. Comm’r, 893 F2d 237 (10th Cir. 1989), the decedent’s spouse applied for a policy on the decedent’s life, and the decedent’s wholly owned corporation paid the premiums on the policy. Neither case included the proceeds in the decedent’s gross estate under Section 2035(a). See TAM 9323002 (Feb. 24, 1993). See also Priv. Ltr. Ruls. 200947006 (July 20, 2009), 200948001 (July 20, 2009), 200949004 (July 20, 2009) (all holding proceeds of policies to be paid to partnership at taxpayer’s death will not be included in taxpayer’s gross estate under Section 2035 following proposed transactions by which two family trusts will take ownership of partnership, which will then own and be the designated beneficiary of the policies since, before and after the proposed transactions, taxpayer will not possess any incidents of ownership). See also Priv. Ltr. Rul. 9651004 (Aug. 26, 1996) (proceeds of a life insurance policy transferred more than three years prior to decedent’s death were not includible in decedent’s gross estate under Section 2035(a)).
\item \textsuperscript{163} Earlier cases under Section 2035, prior to its 1981 amendment (see ¶ 4.07[1]), found a constructive Section 2035 transfer or an agency relationship to pull the proceeds into a decedent’s gross estate under the Section 2035(a) transfer requirement. See Bel v. United States, 452 F2d 683 (5th Cir. 1971), cert. denied, 406 US 919 (1972) (decedent took out a policy naming children as beneficiaries and owners and paying premiums); Detroit Bank & Trust Co. v. United States, 467 F2d 964 (6th Cir. 1972), cert. denied, 410 US 929 (1973) (policy was taken out by the trust but decedent paid the only premium); First Nat’l Bank of Ore. v. United States, 488 F2d 575 (9th Cir. 1973) (decedent’s wife purchased policy on his life but decedent paid the premiums). See also Rev. Rul. 71-497, 1971-2 CB 329, Situation 2. The more recent cases require Section 2042 ownership prior to applying current Section 2035(a). Although Bel may still be followed, because the decedent can be viewed as owning the policy, and Headrick is distinguishable from Detroit Trust because there was no requirement for the trust to purchase the policy, Leder is directly contrary to First National Bank of Oregon, leaving these three cases in varying degrees of authority under current Section 2035(a).
\item \textsuperscript{164} Reg. § 20.2042-1(a)(2).
\item \textsuperscript{165} See IRC § 2035(a)(2); ¶ 4.07[2][a][ii].
\end{itemize}
last-minute, death-motivated relinquishment of proscribed incidents.\textsuperscript{166} The foregoing lifetime transfer discussion deals with paid-up policies. More often, premiums remain payable after a transfer. The four principal possibilities are as follows:

1. The decedent transfers the policy more than three years before death and the beneficiary pays all the premiums that subsequently come due. Nothing is included in the decedent’s estate.\textsuperscript{167}

2. The decedent’s transfer is within three years of death, but again the beneficiary pays all post-transfer premiums. A part of the proceeds is includible in the decedent’s gross estate.\textsuperscript{168} The includible part of the proceeds is determined by subtracting from the full proceeds a portion of that amount commensurate with the portion of the premiums paid by the beneficiary.\textsuperscript{169}

3. The decedent’s transfer is within three years of death, and the decedent pays all the premiums that subsequently come due. The entire proceeds are includible in the decedent’s gross estate.\textsuperscript{170}

4. The decedent’s transfer is made more than three years before death, but the decedent continues to pay all post-transfer premiums. The proceeds and the premiums are entirely excluded from the decedent’s gross estate.\textsuperscript{171}

\textsuperscript{166} Cf. United States v. Allen, 293 F2d 916 (10th Cir.), cert. denied, 368 US 944 (1961). But see, e.g., Estate of Sullivan v. Comm’r, 175 F2d 657 (9th Cir. 1949); \textsuperscript{168} 4.08[8][b], 4.12[9].

\textsuperscript{167} The decedent has no Section 2042(2) incidents at death, the transfer of the policy is outside the three-year rule of Section 2035(a), and the premium payments cannot be attributed to the decedent.

\textsuperscript{168} Full inclusion might be expected here, since the decedent transferred the policy, the proceeds of which are paid at death. However, there is authority, long accepted as controlling, for treating the beneficiary’s premium payments as in the nature of an improvement or betterment in something acquired from another. Liebmann v. Hassett, 148 F2d 247 (1st Cir. 1945); Cf. Rev. Rul. 67-463, 1967-2 CB 327. This is appropriate; the policy has become the property of the beneficiary that the beneficiary must “improve” if it is to retain its economic potential.

\textsuperscript{169} Liebmann v. Hassett, 148 F2d 247 (1st Cir. 1945).

\textsuperscript{170} The settled view seems to be that there is no basis for any reduction such as is recognized in the second situation just discussed. It could, however, be argued that the transfer of the policy is a complete transfer of an incomplete thing. Thereafter, the decedent’s premium payments are not a further transfer of parts of the policy. Thus, the decedent’s premium payments might be viewed the same as cash gifts to the beneficiary and subsequent premium payments by the beneficiary. If this view were taken, the part of the proceeds includible would be determined the same as in the second situation above, but to that would be added the amount of the post-transfer premiums paid by the decedent.

\textsuperscript{171} If the decedent’s premium payments within three years of death “engendered the entire right, title, and interest which” beneficiaries had in the policy, the entire proceeds may be includible. See Bel v. United States, 452 F2d 683, 690 (5th Cir.), cert. denied, 406
[10] Background of the Section

No attempt is made here to trace the full history of Section 2042, but some of the highlights may be mentioned. The first federal estate tax statute did not deal expressly with insurance. Nevertheless, it was held that insurance proceeds paid to the decedent’s estate could be taxed as property owned by the decedent. In 1918, in adding an insurance provision, Congress specifically taxed insurance receivable by the executor and also went after a tax on the proceeds of insurance policies “taken out by the decedent on his own life,” even if the proceeds were payable to other named beneficiaries. Seemingly a simple rule, this triggered a confusing series of administrative attempts to give meaning to the quoted language, which terminated in 1941 with a determination that the statute raised the question whether or to what extent the decedent had paid the premiums on the policy. If the decedent had paid half the premiums, then one half of the policy was “taken out” by the decedent and half the proceeds were in the decedent’s estate, and so forth. But the rule was not given full retrospective effect. Premiums the decedent had paid on or before January 10, 1941, were to be disregarded in applying this test, if, on that date, the decedent had no incidents of ownership in the policy.

From 1918 to 1942, the rule on includability of insurance proceeds payable to others was mitigated by a $40,000 exemption for such proceeds, which specific insurance exemption was not dropped from the statute until Congress undertook a general revision of the section in 1942. It was this insurance exemption that prompted the estate to argue in Helvering v. Le Gierse that an insurance policy should be recognized as such even though it was taken out in combination with an annuity policy.

In 1942, Congress incorporated the Treasury’s payment-of-premium test into the statute, including the rule that premiums paid by the decedent on or before January 10, 1941 were to be disregarded if, after that date, the decedent had no incidents of ownership in the policy. Thus, a complete and irrevocable assignment before 1941 of a policy fully paid before that date would place

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US 919 (1972). But see supra ¶ 4.14[7][b], note 138. Cf. Leder v. Comm’r, 893 F2d 237 (10th Cir. 1989). See also Goodnow v. United States, 302 F2d 516 (Ct. Cl. 1962) (the life beneficiary of a trust who paid premiums on policies owned by the trust was not for that reason deemed to be a settlor of the trust so as to make applicable Section 2036 to include trust assets in the life beneficiary’s estate at death).

175 TD 5032, 1941-1 CB 427.
176 Helvering v. Le Gierse, 312 US 531 (1941).
the insurance outside the estate as far as the payment-of-premium test was concerned. It was this rule that prompted the taxpayer estate to argue in *Bohnen v. Harrison* that an insurance policy should be recognized as such even though taken out in combination with an annuity policy.

In the 1942 revision, Congress added an alternative incidents-of-ownership test. Thus, from 1942 to 1954, insurance payable to others was included in the gross estate if the decedent had paid the premiums or if the decedent had any incidents of ownership in the policy at death. It is the incidents-of-ownership test, with some modifications, that survives as the sole test in the 1986 (and 1954) Code. The present provision is discussed above without precise reference to how it differs from the incidents-of-ownership test in the 1939 Code, but of course the differences are of importance in the case of decedents dying prior to August 17, 1954, on which date in general the 1954 Code became effective.

The insurance section has survived a number of constitutional squalls. It was sustained by the Supreme Court against constitutional attack in 1929, after having lost a round with regard to an attempted retroactive application in 1925. A serious constitutional shadow that was later thrown over the old payment-of-premium test has been removed. There are few grounds upon which the section in its present form is open to serious constitutional challenge.

### 4.15 SECTION 2043. TRANSFERS FOR INSUFFICIENT CONSIDERATION

Section 2043 is divided into two parts. The first, Section 2043(a), contains an affirmative rule specifying the estate tax effect of a receipt by the decedent of partial consideration in connection with an inter vivos transaction giving rise to estate tax liability under Sections 2035 through 2038 and Section 2041. In brief, the section provides that a transfer includible under one of those sections will be exempted to the extent of the consideration received by the decedent.

The second part, Section 2043(b), contains generally a negative rule specifying certain advantages that may accrue to a decedent that cannot be treated as consideration to any extent for estate tax purposes. It applies to both claims against the gross estate and inter vivos transfers included in the gross estate.

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178 *Bohnen v. Harrison*, 199 F2d 492 (7th Cir. 1952), aff’d per curiam (by an equally divided court), 345 US 946, reh’g denied, 345 US 978 (1953).
An understanding of this Section 2043(b) restriction is necessary before considering Section 2043(a), and accordingly, the discussion will begin with the negative rule.


Section 2043(b)(1) provides that relinquishment or promised relinquishment of dower or curtesy or their statutory equivalents is not consideration in money or money’s worth for estate tax purposes.¹

An initial objective of Section 2043(b)(1) was to eliminate a form of estate tax avoidance that did not involve a lifetime transfer, specifically the contractual conversion of the wife’s dower rights into a deductible claim against the estate. For example, if a husband died leaving an estate of $3 million and under state law the surviving spouse was entitled to one third, ($1 million), as dower, this would not reduce the gross estate.² But without Section 2043(b)(1), the husband’s estate would be entitled to a deduction of $1 million³ if the surviving spouse and the decedent had entered into a contract by which she was to receive that amount from his estate in consideration for a waiver of her dower rights.⁴ Although it was probably not initially intended, the Supreme Court has read Section 2043(b)(1) into the gift tax where it plays a role in determining whether lifetime interspousal transfers are gifts.⁵

The rule of Section 2043(b)(1) is closely related to the estate tax and gift tax marital deductions.⁶ Prior to the Economic Recovery Tax Act of 1981⁷ when there was a ceiling on those deductions, Section 2043(b)(1) played a more active role.⁸ Now, however, there is an unlimited marital deduction for

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¹ The predecessor of present Section 2043(b) was enacted in 1926 and amended by the Revenue Act of 1932. Revenue Act of 1926, Pub. L. No. 69-20, § 302(i), 44 Stat. 9, 71 (1926); Revenue Act of 1932, Pub. L. No. 72-154, § 804, 47 Stat. 169, 280 (1932). From that time on, it has been quite clear that a lifetime transfer is not saved from estate tax merely because it was made in exchange for the relinquishment of dower or curtesy rights or any statutory rights that are similar in purpose and effect.

² IRC § 2034.

³ IRC § 2053(a)(3). If Section 2043(b)(1) presented no obstacle, such a claim could pass muster under Section 2053(c)(1)(A). See ¶ 5.03[4][a][i].


⁵ Merrill v. Fahs, 324 US 308 (1945). See ¶ 10.02[5][d].

⁶ See ¶¶ 5.06, 11.03.


⁸ But for Section 2043(b)(1), the estate in the hypothetical could conceivably argue for a deduction under Section 2053 in addition to the maximum marital deduction. If the husband left all his property to his surviving spouse, the result would have been a $2 mil-
most interspousal transfers either at death\(^9\) or during life.\(^{10}\) Thus, in the preceding hypothetical, if the husband leaves all his property to his surviving spouse, the husband’s estate can receive a full $3 million deduction. The deduction, however, is under Section 2056. Section 2043(b)(1) still precludes a deduction of the claim under Section 2053 because the claim is founded on a promise or agreement that is not supported by consideration.

In view of the unlimited marital deduction, is Section 2043(b)(1) to be relegated to the scrap heap? Almost, but not quite. In a few situations, in which interspousal transfers do not qualify for a Section 2056 deduction,\(^{11}\) the Section 2043(b)(1) preclusion of consideration for the transfer remains important.\(^{12}\) Section 2043(b)(1) also has an impact in the divorce area with respect to post-divorce payments. If, in a divorce agreement, a spouse relinquishes the types of marital rights within the scope of Section 2043(b)(1), there may not be consideration for the transfer.\(^{13}\) Despite some overlap in the interspousal and divorce negative consideration rules, there are sufficient differences to treat the two sets of negative rules separately.\(^{14}\)

[a] The Negative Rule in a Marital Situation

The marital rights that are disqualified as consideration for estate tax purposes are explicit. In part, Section 2043(b)(1) echoes the provisions of Section


\(^{11}\) See the terminable interest rule and the exceptions to the rule. IRC § 2056(b), discussed at ¶¶ 5.06[7], 5.06[8]. See especially ¶ 5.06[7][b], text accompanying notes 176–181. Cf. ¶ 5.06[3][b]. The transfers may be either inter vivos transfers included in the decedent’s gross estate under Sections 2035, 2036, 2037, 2038, and 2041 or testamentary transfers.

\(^{12}\) For example, if H gratuitously transfers property to his children, reserving a twenty-year leasehold in the property, and then contracts with W that he will leave her the twenty-year leasehold in his will in exchange for her promised relinquishment of dower, the value of H’s interest in the leasehold is included in his gross estate under Section 2036. Are there any deductions? In the absence of a QTIP election under Section 2056(b)(7), a marital deduction under Section 2056 is foreclosed by the Section 2056(b)(1) terminable interest rule. See supra note 11. And a deduction under Section 2053 is precluded by Section 2043(b)(1). If not for Section 2043(b)(1), W’s nondeductible dower interests would have been contractually converted into a deductible claim against the estate under Section 2053.

\(^{13}\) See infra ¶ 4.15[1][b].

\(^{14}\) See infra ¶¶ 4.15[1][a], 4.15[1][b].
2034 in its reference to dower or curtesy and their statutory substitutes. The meaning of these terms, indicated in the comments on Section 2034, is not further developed here, but it is not mere coincidence that these expressions are parallel, and their relationship should be made clear.

Now it will be seen, however, that Section 2043(b)(1) not only excludes dower, curtesy, or statutory equivalents, but it also goes on to disqualify as consideration “other marital rights in the decedent’s property or estate.” The question is: What further disqualification arises from this additional phrase? The answers come more readily if it is borne in mind that the disqualification aims at preventing the same kind of distortion that would result if dower and similar rights were treated as consideration.

One spouse’s transfer may be at least in part in exchange for a relinquishment of the other partner’s right to a share of the first spouse’s estate at death under the laws of intestate succession. This right of the other spouse is disqualified by Section 2043(b)(1) as an “other” marital right. It is an inchoate right “in the decedent’s property or estate” that, like dower, even if asserted at death in a case of intestacy, will have no impact on the decedent spouse’s gross estate. Therefore, for the same reasons as apply to dower, the right cannot be accorded estate tax recognition as consideration without serious distortion of estate tax liability.

Other types of marital rights are not disqualified. For example, the interest a spouse has in community property is not a dower or curtesy interest, a statutory substitute therefore, or an “other” marital right within Section 2043(b)(1). In fact, one spouse’s community property interest is that spouse’s property, not an interest in the property of the other spouse. Thus, if a wife transfers some of her non-community property to her husband in exchange for his interest of like value in community property, the exchange is for full consideration and is unaffected by Section 2043(b)(1). No distortion results because the husband’s community property acquired by the wife in the exchange

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15 See ¶ 4.06.


17 There is general agreement that “inheritance rights” are disqualified as consideration (cf. McMurtry v. Comm’r, 203 F2d 659 (1st Cir. 1953) (decided under the gift tax)), and the conclusion saves estate tax concern about what the value of the rights might be. But cf. United States v. Davis, 370 US 65 (1962).

18 See Estate of Waters v. Comm’r, 48 F3d 838 (4th Cir. 1995) (under North Carolina equitable distribution statute, common-law marital rights were converted to community property rights on divorce).
would not, but for the exchange, have been a part of her gross estate.\textsuperscript{19} It replaces the property transferred, and the transfer therefore causes no artificial tax-free diminution of her gross estate.\textsuperscript{20}

In a similar vein, a spouse’s relinquishment of the spouse’s right to support can be consideration.\textsuperscript{21} If tunnel vision focuses only on the phrase “other marital rights,” there will be trouble because a spouse’s right to support is rather clearly a marital right other than a right such as dower. But if the whole phrase “other marital rights in the decedent’s property or estate” is read, it will come closer to the correct conclusion because support rights are not rights in a spouse’s property. Support rights are measured by a spouse’s income and manner of living rather than by one’s wealth or estate.\textsuperscript{22} This close but proper reading of Section 2043(b)(1) to exclude support rights from the proscription of that provision has not invariably been followed,\textsuperscript{23} but it has long been accepted by the Treasury.\textsuperscript{24} The exclusion of support rights from the Section 2043(b)(1) proscription finds other collateral support. If the ejusdem generis canon of construction is applied,\textsuperscript{25} and if the phrase “other marital rights in the decedent’s property or estate” is properly read in the context of all of Section 2043(b)(1), the phrase “other marital rights” must mean rights such as dower, curtesy, and their statutory substitutes. But, as indicated, support rights are not like dower and similar property rights. Moreover, it is relevant to ask whether distortion will result from treating a relinquishment of support rights as consideration. If there is no settlement of support rights by way of a lifetime transfer, one spouse’s lifetime payments for support during life do effect a natural shrinkage in that spouse’s estate with an attending reduction of estate tax lia-

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\item \textsuperscript{19} Cf. Carli v. Comm’r, 84 TC 649 (1985) (interest in property received in relinquishment of community property rights under an antenuptial agreement is supported by adequate and full consideration); \textsuperscript{¶} 4.05[2][a].
\item \textsuperscript{20} Cf. \textsuperscript{¶} 4.08[7][c], discussing the community property widow’s election.
\item \textsuperscript{21} But see Bowes v. United States, 77-2 USTC \textsuperscript{¶} 13,212 (ND Ill. 1977), aff’d, 593 F2d 272 (7th Cir. 1979) (a purported relinquishment of support rights in a state that holds any such agreement void as against public policy did not constitute consideration).
\item \textsuperscript{22} Cf. Bernatschke v. United States, 364 F2d 400 (Ct. Cl. 1966) (differentiating a property settlement from an alimony arrangement for purposes of determining whether Section 71 or Section 72 determined the income tax consequences of annuity payments received by a divorced wife prior to the 1984 amendment of Section 71).
\item \textsuperscript{23} Estate of Meyer v. Comm’r, 110 F2d 367 (2d Cir.), cert. denied, 310 US 651 (1940).
\item \textsuperscript{24} Rev. Rul. 68-379, 1968-2 CB 414, superseding ET 19, 1946-2 CB 166, which expressed the same principle. But compare Sherman, Jr. v. United States, 462 F2d 577 (5th Cir. 1972), and Estate of Iversen v. Comm’r, 552 F2d 977 (3d Cir. 1977) (lifetime support rights were consideration even if payments extended beyond husband’s death), with Estate of Ellman v. Comm’r, 59 TC 367 (1972) (post-death support rights are “marital rights” proscribed by Section 2043(b)). See also Sherman v. United States, 492 F2d 1045 (5th Cir. 1974) (determining the amount of deduction in the \textit{Sherman} case).
\item \textsuperscript{25} See Estate of Glen v. Comm’r, 45 TC 323, 340 (1966).
\end{itemize}
bility. Presumably, if the obligation is discharged all at once by a lifetime transfer, only a corresponding shrinkage and tax reduction occur, which is unlike the artificial diminution that would attend a transfer for a relinquishment of dower rights. Thus, technical and policy reasons exist to differentiate support rights from dower for purposes of Section 2043(b)(1). 26

[i] Claims. Testamentary transfers that qualify for the marital deduction under the unlimited marital deduction are permitted a Section 2056 deduction regardless of the nature of the property being transferred. But other testamentary transfers to a surviving spouse that do not qualify for a Section 2056 deduction27 are deductible only if they are Section 2053 claims, which must then be founded on consideration as defined in Section 2043(b)(1). Thus, a surviving spouse’s claim for statutory marital property rights generally would not be deductible under Section 2053, while a claim for liquidated support rights or community property rights would be deductible. 28

[ii] Gross estate inclusion of lifetime transfers. The negative rule can apply to married couples in another context. A lifetime transfer that was testamentary in nature can generate gross estate inclusion under Sections 2035 through 2038 and 2041. 29 The transfer may be saved (or partly saved) from adverse estate tax consequences by recognized consideration passing to the transferor at the time of the transfer. Whether it is so saved requires an accurate identification of each right relinquished by the transferee that is tested against the Section 2043(b)(1) restrictions. 30 Any relinquished rights that qualify as consideration then must be valued. In the gross estate, the inter vivos transfer is either fully taxable, fully excluded (under the parenthetical exception to the transfer provisions), or partially taxable under the rules of Section 2043(a). 31

26 A transfer in exchange for the relinquishment of a child’s right to support runs into no difficulty under Section 2043(b). It is a “filial” right, not a “marital” right, and besides, the policy reasons that support the relinquishment of a wife’s support rights as consideration apply alike to the support right of children. McDonald Trust v. Comm’r, 19 TC 672 (1953), aff’d sub nom. Chase Nat’l Bank v. Comm’r, 225 F2d 621 (8th Cir. 1955).

27 See supra ¶ 4.15[1], text accompanying note 11.

28 See supra text accompanying notes 18–26.

29 Much of the gross estate inclusion will, because of the unlimited marital deduction, result in a wash. However, see supra ¶ 4.15[1], text accompanying notes 11, 12.

30 See, e.g., Estate of Waters v. Comm’r, 48 F3d 838 (4th Cir. 1995) (no recognized consideration for Section 2035 transfer, but other consideration for Section 2053 claims). The identification carries its own share of difficulties. In Estate of Glen v. Comm’r, 45 TC 323, 341 (1966), the court limits “other marital rights” to “inheritance rights,” differentiating rights that would arise “immediately upon divorce.” The rejection of this approach by Tannenwald, J., dissenting, id. at 349, is persuasive.

31 See Comm’r v. Estate of Nelson, 396 F2d 519 (2d Cir. 1968); Estate of Scholl v. Comm’r, 88 TC 1265 (1987); Rev. Rul. 71-67, 1971-1 CB 271. The consideration is to be
Thus, if a surviving spouse’s dower and similar marital rights do not reduce the decedent’s gross estate at death, their relinquishment during life should not, as consideration, save a lifetime transfer from gross estate inclusion under Sections 2035 through 2038 or Section 2041. For example, suppose D, about to die, transferred an insurance policy to S, D’s spouse, in exchange for S’s relinquishment of S’s marital rights having a value equal to the value of the policy. If there were no such transfer, as a result of Section 2034, S’s marital rights would have been part of D’s gross estate. To treat the transfer of the policy as being made for consideration so as to defeat an inclusion of the transferred insurance policy under Section 2035(a) would result in an obvious distortion, for nothing taxable would have replaced the policy that was transferred. A similar result would occur if D transferred a remainder interest in a trust to S in return for S’s relinquishment of marital rights with D retaining a life estate in the trust. Because D did not receive money or money’s worth consideration for the transfer, § 2036(a)(1) would include the trust corpus in D’s gross estate. If D’s transfer had been in return for S’s community property or a relinquishment of S’s support right equal in value to the value of the remainder interest, Section 2036(a)(1) would likely be inapplicable. If money or money’s worth consideration were transferred but its value was less than the value of the transferred remainder, Section 2036(a)(1) would apply, but the amount included in the gross estate would be reduced by the dollar amount of consideration received at the time of the transfer.

[b] The Negative Rule in a Divorce Situation

The picture becomes a bit more clouded when at the time of the decedent’s death the spouses are divorced. Divorce, of course, eliminates the possibility of a marital deduction. In general, the Section 2043(b) rule continues to apply to deny consideration status to “dower or curtesy, or...other marital rights,” terms that have the same meaning as in the marital situation previously discussed. However, in some circumstances, rights that constituted mere marital rights in the decedent’s property and are not treated as consideration under

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32 IRC § 2043(b)(1).
33 Puchner v. United States, 274 F. Supp. 704 (ED Wis. 1967) (marital rights were not valid consideration, although other property transferred was valid consideration).
34 See ¶ 4.08[1][a].
35 IRC § 2043(a). See infra ¶ 4.15[2], especially text accompanying notes 67–70.
36 IRC § 2056(a). However, no particular conceptual difficulties arise with regard to an interspousal transfer effected in connection with mere separation unaccompanied by judicial proceedings. The results parallel those in the other marital situations previously discussed. See supra ¶ 4.15[1][a].

Section 2043
Section 2043(b) may be elevated by case law or by the statute to rights that are in essence founded on consideration. Confusion in this area has also developed out of a merging of issues that are only loosely related: the deductibility of claims under Section 2053 and the taxability of lifetime transfers under the provisions defining the gross estate.

[i] Claims. In the claims area, recall that consideration must be shown to support a deduction only if a claim is founded on a promise or agreement; if the claim arises in another way, it is deductible without regard to consideration. Thus, a claim based on a divorce decree that does not merely enforce the agreement of the parties is deductible without reaching any question of consideration. It is not suggested that a claim against the estate becomes deductible without regard to consideration just because a court has rendered a judgment for the creditor. If A has merely made an enforceable promise to pay B, A’s child, $11,000, the claim is not deductible without a showing of consideration for A’s promise, even if B gets a judgment enforcing B’s claim against A’s estate after A’s death. Such a judgment does not alter the fact that the claim is “founded on” A’s promise.

In a divorce setting, however, a decree may do more than merely enforce a prior agreement of the parties. If the divorce court under local law or as a result of an agreement being conditioned upon court approval has the power to determine on its own a settlement of property rights and even to vary the terms of any prior settlement agreement made by the parties, any indebtedness arising out of the court decree, even if there was a prior agreement, is not considered to be founded upon a promise or agreement but, rather, upon the court decree, and it is therefore deductible without regard to consideration. This is true regardless of whether the claim is by the decedent’s spouse or some third

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37 IRC § 2053(c)(1)(A). If there is consideration, the claim is deductible. Compare Estate of Kosow v. Comm’r, 45 F3d 1524 (11th Cir. 1995) (deduction allowed because consideration in the form of former spouse’s reduction of support payments), with TAM 200011008 (Nov. 30, 1999) (no deduction because no proof of reduction of former spouse’s support payments).


person, such as a child, who is a beneficiary under the agreement.\footnote{41} If, however, the spouse’s rights are not reduced or relinquished in return for a transfer to such third person, then, even though the agreement including the transfer to the third person is approved by a court decree, no deduction for the third person’s claims is allowed under Section 2053.\footnote{42}

On the other hand, if a Section 2053 claim arising out of a divorce is founded on a property settlement agreement (i.e., on a promise), rather than on the divorce decree itself, whether there was consideration becomes significant and generally depends on avoiding Section 2043(b).\footnote{43} However, in 1954, Congress enacted Section 2516, a gift tax amnesty rule, which provides that some transfers pursuant to an agreement are invariably to be treated as made for adequate consideration for gift tax purposes.\footnote{44} That section provides that any transfer of property pursuant to a written separation agreement is deemed made for a full consideration for gift tax purposes if a divorce occurs within the three-year period beginning one year before the agreement is made.\footnote{45}

In 1954, Congress did not enact an estate tax section analogous to the special gift tax amnesty rule, and it was criticized for failing to do so.\footnote{46} In response, in 1984 legislation, Congress finally took some action by enacting Section 2043(b)(2).\footnote{47} It expressly adopts the Section 2516 rule for estate tax purposes but only to provide adequate and full consideration for Section 2053 claims, not for lifetime transfers.\footnote{48} Thus, after 1984, claims against the estate

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\item[41] Leopold v. United States, 510 F2d 617 (9th Cir. 1975). Of course, such an agreement could result in a gift by the spouse.
\item[43] IRC § 2053(c)(1)(A).
\item[44] See \¶ 10.06.
\item[45] IRC § 2516.
\item[48] Estate of Kahanic v. Comm’r, 103 TCM (CCH) 1434 (2012); Priv. Ltr. Rul. 200709014 (Nov. 16, 2006). Where a decedent transfers property to a trust to satisfy marital and property rights retaining a life interest that satisfies the requirements of Section 2516, the transferred property is includible in decedent’s gross estate under Section 2036 without any reduction for consideration in money or money’s worth because Section 2043(b)(2) applies only for purposes of Section 2053, not Section 2036. However, a deduction has been allowed under these circumstances under Section 2053(a) for the full value of the property passing to the former spouse. TAM 9826002 (Mar. 23, 1998). Section 2043(b)(2) should have been made applicable to the lifetime transfer provisions, Sec-
\end{footnotes}
are deductible if they are either founded on a consideration in money or money’s worth or founded on a divorce decree, or if they meet the Section 2516 requirements.

[ii] Gross estate inclusion of lifetime transfers. A fair reading of the lifetime transfer provisions of Sections 2035 through 2038 and 2041 is that, absent qualified consideration, they prescribe gross estate inclusion in various circumstances whether the transfer was based on a promise or agreement or arose in some other manner. Thus, even if a transfer is directed by a judicial decree that does not merely enforce an agreement of the parties, the statute on its face still requires a showing of recognized consideration in order to avoid gross estate inclusion.

A development under the gift tax has raised a question of whether the estate tax transfer provisions should be construed in this manner. In Harris v. Commissioner, the Supreme Court held that a wife’s lifetime transfer to her husband, found to rest on a divorce decree, was free from gift tax without any showing of consideration. The inference to be drawn from the opinion is that consideration must be shown to avoid gift tax only if a transfer involving a relinquishment of marital rights is founded on a promise or agreement, although the court does not expressly say so. Is gross estate inclusion under the estate tax lifetime transfer sections similarly limited so that they too become inoperative if the transfer was either for recognized consideration or made pursuant to a divorce decree (i.e., not founded on a promise or agreement)? The Tax Court has seemed to say so. But other courts have disagreed. In United States v. Past, the court refused to assume full recognized consideration for a transfer pursuant to a divorce decree to negate the effect of Section 2036 or Section 2038. As a matter of literal statutory interpretation, the Past rule...
seems preferable to that of the Tax Court. Despite *Harris*, nothing in either the estate tax or the gift tax sections purports ever to waive the requirement of consideration in the case of lifetime transfers.

In the meantime, however, if there is to be a waiver of the consideration test under the gift tax for some divorce transfers, it is anomalous not to recognize a similar waiver for estate tax purposes. Thus, as the estate tax and gift tax are in pari materia, it is not illogical for the Tax Court to suggest an estate tax treatment of lifetime transfers consistent with the gift tax treatment directed by *Harris*. Even if the *Harris* decision is questionable, the Supreme Court has the right to be wrong and, once it has fixed the gift tax philosophy, the same approach should be taken to like questions under the estate tax. In effect, therefore, the “founded on a promise or agreement” concept should be read into the estate tax lifetime transfer sections, just as it has been read into the gift tax, and a transfer pursuant to the independent determination of a divorce court should be relieved of gross estate inclusion. As the Tax Court decisions indicate, this elimination of the estate tax/gift tax anomaly seems to be within the reach of the judiciary.

In a similar vein, Congress chose not to write Section 2516 gift tax consideration into the estate tax other than for purposes of deduction of claims under Section 2053. Section 2516 does not provide consideration for the lifetime transfer provisions under the estate tax, a result that seems inappropriate.

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56 Merrill v. Fahs, 324 US 308 (1945); Estate of Sanford v. Comm’r, 308 US 39, 44 (1939).
57 See Jackson, J., concurring in Brown v. Allen, 344 US 443, 540 (1953): “We are not final because we are infallible, but we are infallible only because we are final.”
58 But see Tannenwald, J., dissenting in Estate of Glen v. Comm’r, 45 TC 323, 352 (1966): “I do not believe that...we should pull ourselves up by our own bootstraps by accepting the importance of one provision of the estate tax into the gift tax via *Harris* and then reimporting that provision back into the estate tax—indeed, into another provision of the estate tax.”
59 IRC § 2043(b)(2). If property is included in a decedent spouse’s gross estate under Section 2035, Section 2036, Section 2037, or Section 2038 and the surviving former spouse has marital and property rights to such property after the decedent’s death that satisfied the requirements of Section 2516, the Service treats such rights as a claim against the estate deductible under Section 2053 because Section 2043(b)(2) applies. TAM 9826002 (Mar. 23, 1998) (since surviving former spouse had rights to full value of the property at decedent’s spouse’s death, the full value of the corpus was deductible under Section 2053). See supra note 48.
60 See IRC § 2043(b)(2).
61 Congress should have made Section 2043(b)(2) applicable to the lifetime transfer provisions, Sections 2035, 2036, 2037, and 2038, as well as Section 2053. If it had done

The sections providing for estate tax liability with respect to certain inter vivos transfers uniformly provide an exception for “a bona fide sale for adequate and full consideration in money or money’s worth.” Section 2043(a) deals with transactions where there is some consideration in money or money’s worth, but there is not a bona fide sale for adequate and full consideration. Although the flat exception of the various sections is not applicable, the partial consideration is to be taken into account. The rule provided is that the value of the consideration received by the decedent can be subtracted from the applicable valuation date value of the property included in the gross estate.

The rule and its rationale are easy to understand, although the application of the rule may be difficult and complicated. If the property interest transferred by the decedent was replaced by something of money value, to the extent of such value there has been no reduction of the decedent’s estate, regardless of motive or the form in which the transaction was carried out. Thus, the estate should not be taxed in the same way as if the transfer had been wholly gratuitous. It is important to note that the statute takes into account only a consideration in money or money’s worth. This absolute rejection of the concept of consideration as known to the law of contracts is consistent with the purpose of the statute. A promise to marry may be a consideration for contract or other purposes, but a transfer for such a promise could reduce the gross estate, because the promise has no monetary value and in no way re-

so, the value of the consideration would be measured at the time of the inter vivos transfer. If the Service’s position in TAM 9826002 (Mar. 23, 1998) is followed, the issue frequently is mooted. For example, if Decedent retains a life estate with a remainder to surviving former Spouse (founded on Section 2516 consideration), the property is included in Decedent’s gross estate under Section 2036(a) but is fully deductible as a claim under Section 2053. However, if Decedent created a similar trust with a secondary life estate in former Spouse (which satisfied the requirements of Section 2516) and a remainder to Children, and former Spouse predeceased Decedent, the full corpus would be included in Decedent’s gross estate with no reduction for the value of the former Spouse’s interest at the time of the transfer.

62 The present requirement of “adequate and full” consideration to bring into play the flat exception of the various sections is appropriately stricter than its predecessors. Its origin is the Revenue Act of 1926, Pub. L. No. 69-20, § 302(i), 44 Stat. 9, 71 (1926), by which Congress replaced the earlier requirement of a “fair” consideration. See, e.g., Revenue Act of 1918, Pub. L. No. 65-254, § 402(c), 40 Stat. 1057, 1097 (1918).

It is sometimes unclear what constitutes “a bona fide sale for adequate and full consideration in money or money’s worth.” See infra text accompanying note 66; ¶ 4.08[1][a].

places the value of the property transferred. Accordingly, such a promise is not consideration for estate tax purposes. For the same reason, a monetary detriment to the transferee without corresponding monetary advantage to the decedent transferor is not taken into account. However, consideration that is recognized under Section 2043(a) need not be in the form of money or physical property received by the decedent. A promise to pay money in the future generally is consideration “reducible to a money value.”

If the decedent received property or money in connection with a transfer otherwise fully subject to estate tax, the amount of money received or the value of the property at the time of receipt is the amount to be subtracted under Section 2043(a). This is the settled approach despite the fact that if a sale was for half price, it might appear that only 50 percent of the date-of-death value of the property should be included in the gross estate. Increases or decreases in the value of the property transferred by the decedent, after the date of the transfer, are fully, not just partially, reflected in the gross estate, whereas under the rule, the value of the consideration is determined at the time of the transfer.

For example, assume parent makes a transfer in trust retaining a life interest in the trust and designating parent’s children as remainderpersons. At the time of the transfer, the corpus is worth $200,000 and the remainder is worth $100,000. The children pay parent $50,000 for their remainder interest. If the value of the remainder is $200,000 at parent’s death, $150,000 will be included in parent’s gross estate. If the value of the remainder is $50,000 at the decedent’s death, nothing will be included in the gross estate.

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66 Reg. § 20.2043-1(a). But see infra text accompanying note 75.
67 Reg. § 20.2043-1(a); Estate of Magnin v. Comm’r, 184 F3d 1074 (9th Cir. 1999); Schoenheit v. Lucas, 44 F2d 476, 490 (4th Cir. 1930).
70 Where reference is made to a remainder following a life estate and the life tenant is dead, the value of the remainder equals the value of the corpus of the trust. Thus, the Section 2043(a) rule still comes into play in those instances.
If the decedent has made a transfer in exchange for a release from recognized legal obligations that have an ascertainable monetary value, the transfer is for consideration to the extent of such value. In one case, the decedent, upon separation from his wife, created a trust in part for the support of his children during their minority in connection with the execution of a separation agreement and subsequent divorce. Notwithstanding his retention of a power to alter the trust, exercisable in conjunction with his divorced wife, less than the entire value of the trust was included in his estate. The court found the value of the support obligation at the time the trust was created to be $30,000. This amount was subtracted from the date-of-death value of the trust corpus as consideration in money’s worth for the transfer. A good way to appraise this is that, except for creation of the trust and viewed as of the date of transfer, the decedent’s estate would in any event have been reduced by $30,000 by way of payments that he would have had to make for support of his children. Thus, only the excess in value of what he transferred tended to result in an artificial reduction of his estate.

The most difficult question in applying the rule of Section 2043(a) is how to measure the consideration for the transfer when it is something less than “adequate and full” and is received by the decedent, especially in the form of an interest in property that is something less than outright ownership. The Commissioner frequently has been successful in contending that promissory notes given by a transferee were not bona fide obligations contracted for consideration. Again, the consideration is to be valued at the time of the transfer.

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72 See IRC § 2038; ¶ 4.10.

73 A provision in proposed regulations, Proposed Regulations Section 20.2043-1(b) (Notice of Proposed Rules, 21 Fed. Reg. 7850, 7886 (1956)), that in such circumstances the amount to be subtracted from the date-of-death value of the property is the date-of-death value of a child’s continuing right to support, was appropriately omitted from the final regulations. See also Comm’r v. Estate of Nelson, 396 F2d 519 (2d Cir. 1968).

74 Greene v. United States, 237 F2d 848 (7th Cir. 1956) (agreement to make up income deficiencies might constitute a partial consideration where there was a transfer in consideration of a promise to pay over the net income from the property, but not less than $1,500 annually). Cf. ¶ 4.08[1][a].

75 Estate of Maxwell v. Comm’r, 3 F3d 591 (2d Cir. 1993) (interest-bearing note given by children that was annually reduced in the amount of the annual exclusion and relieved by will was not a bona fide sale under Section 2036); Estate of Musgrove v. Comm’r, 33 Fed. Cl. 657 (1995). Maxwell is discussed at ¶ 4.08[6][c], text accompanying notes 133–134. Cf. Estate of Flandreau v. Comm’r, 63 TC (CCH) 2512 (1992), aff’d, 994 F2d 91 (2d Cir. 1993) (non-interest-bearing notes given to children not due until death or decedent reached age 95 were not valid Section 2053 claims against the estate).
not at the time of death, even though the property includible in the estate is to be valued at the time of the decedent’s death.

### ¶ 4.16 SECTION 2044. CERTAIN PROPERTY FOR WHICH A MARITAL DEDUCTION WAS PREVIOUSLY ALLOWED

Sometimes a section makes little or no sense without an understanding of other provisions related to it. Section 2044 is such a section. It must be examined with Sections 2056(b)(7), 2523(f), and 2207A to comprehend its message.

Generally, interspousal transfers of property are not subject to estate or gift tax. However, when property previously transferred between spouses without estate or gift tax consequences moves outside the marital unit, it is then subject to tax. Under Sections 2523(f) and 2056(b)(7), Congress allows a marital deduction to a transferor spouse or transferor spouse’s estate for the total value of a gift or bequest of property to a transferee spouse, even though the transferee receives only an interest (“a qualifying income interest”) for the transferee’s life and all other interests in the property (including the remainder) pass to third parties. Under both of these sections, all interests in the property are treated as if they were transferred outright to the transferee spouse in the determination of the amount of the marital deduction allowed to the transferor spouse or transferor spouse’s estate.

This is where Section 2044 enters the picture. If the transferee spouse makes no inter vivos disposition of any part of the qualifying income interest

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76 United States v. Righter, 400 F2d 344 (8th Cir. 1958); Estate of Vardell v. Comm’r, 307 F2d 688, 693 (5th Cir. 1962).

77 Estate of Gregory v. Comm’r, 39 TC 1012 (1963). These rules are applied in a community property widow’s election context. See ¶ 4.08[7][c].


2 IRC §§ 2056(b)(7), 2523(f). Both of these qualifying terminable interest property (QTIP) Sections are exceptions to the terminable interest rules of the estate tax and gift tax marital deduction provisions. See ¶ 5.06[8][d], 11.03[4][c].

3 See ¶ 10.08.

4 See ¶ 8.07.


6 A more specific discussion of these requirements appears at ¶ 5.06[8][d].

7 The sections present exceptions to the terminable interest rules of the estate tax and gift tax marital deduction provisions. See ¶¶ 5.06[7], 11.03[3].

during the transferee’s life. Section 2044(a) includes the full value of the property in which the transferee had the qualifying income interest in the transferee’s gross estate. Because the transferee spouse is deceased, the qualifying income interest has expired and all interests subsequent to transferee’s life estate are included in the transferee’s gross estate, but, of course, these interests constitute all interests in the property.

If the transferor spouse’s executor elected to treat only a portion of the transferred property as qualified income property, only that portion of the property is included in the transferee spouse’s gross estate under Section

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9 IRC § 2044(b)(2).

10 See Reg. §§ 20.2044-1(a), 20.2044-1(d), 20.2044-1(e), Ex. 1. The full value of the property is included even if the transferor spouse’s transfer qualified for a Section 2503(b) annual exclusion. Reg. § 20.2044-1(a). Where a trust has been severed to make an election as to part of the property, referred to as a partial QTIP election (see Reg. §§ 20.2056(b)-7(b)(2)(ii), 25.2523(f)-1(b)(3)(ii)); ¶ 5.06[8][d], text accompanying notes 376–381), only the value of the property in the QTIP severed trust is included. Reg. § 20.2044-1(d)(4). Cf. Estate of Miller v. Comm’r, 97 TCM (CCH) 1602 (2009) (property included even though income never distributed to surviving spouse); Estate of Black v. Comm’r, 133 TC 340 (2009) (QTIP trust included even though trust was not funded when surviving spouse died).

Cf. Rev. Rul. 98-8, 1998-1 CB 541, discussed at ¶ 10.08[2], text accompanying note 41 (involving transferee spouse’s lifetime “purchase” of the remainder); Rev. Proc. 2001-38, 2001-1 CB 1335, discussed at ¶ 5.06[8][d], note 384.

11 See ¶ 4.05[5][b]. It is presumed that a marital deduction was “allowed” for purposes of Section 2044 if a marital deduction was taken on the return reporting the transfer creating the qualifying income interest. Reg. § 20.2044-1(c). To avoid Section 2044 inclusion, the transferee’s executor must establish that a marital deduction was not taken. This may be accomplished by producing the return on which no election was made, by establishing that no return was required to be filed by the transferor, or by indicating that the transfer occurred before the effective date of Section 2056(b)(7) or Section 2523(f). Id. See Estate of Soberdash v. Comm’r, 74 TCM (CCH) 295 (1997) (mismanagement of trust funds did not justify noninclusion under Section 2044).

Cf. Estate of Letts v. Comm’r, 109 TC 290 (1997) (duty of consistency required inclusion of property in surviving spouse’s gross estate (not necessarily under Section 2044) where decedent’s estate took a marital deduction for the terminable interest property but no QTIP election was made); TAM 20040718 (July 8, 2003) (painting for which a marital deduction was erroneously claimed includible in decedent’s gross estate pursuant to the doctrine of duty of consistency); Estate of Buder v. United States, 436 F3d 936 (8th Cir. 2006) (equitable recoupment applied to reduce refund to surviving spouse where property improperly treated as QTIP property in predeceased spouse’s estate).

12 Any undistributed income earned during the term of the qualifying income interest, “stub income,” is included in the transferee spouse’s gross estate under Section 2044 (if not included under another section), even though it is in fact paid to a third party. Reg. § 20.2044-1(d)(2). See ¶ 5.06[8][d], notes 321–323. This is the case even if no income distributions were ever made from the marital trust. Estate of Miller v. Comm’r, 97 TCM (CCH) 1602 (2009).
2044. The included share is also reduced if it is established that principal distributions to the transferee spouse have been made pursuant to the trust instrument from the qualified terminable interest share during the term of the qualified income interest. On the other hand, if the transferee spouse makes a lifetime disposition of any portion of the qualifying income interest in the property, Section 2044 is inapplicable. Although Section 2044 is inapplicable, if the transferee spouse makes a disposition of only a portion of the qualifying income interest, the Treasury contends that Section 2036(a)(1) applies and requires inclusion in the transferee’s gross estate of the portion of corpus producing the retained portion of the qualifying income interest.

Property included in the gross estate under Section 2044 is treated as passing from the transferee spouse to the persons who receive the property on the spouse’s death. Thus, if the property passes to charity or if the transferee spouse has remarried and the property passes to the new spouse, the transferee spouse’s estate qualifies for a Section 2055 or Section 2056 deduction. The tax imposed on the property included under Section 2044 may qualify for estate tax installment payment under Section 6166.

In general, an interest in property included in a decedent’s gross estate under one Code section is aggregated with an interest in the same property included in the gross estate under another Code section in ascertaining the value of the interests for federal estate tax purposes. However, a series of cases have held that property includible in the transferee spouse’s gross estate under Section 2044 is valued without aggregating that property with similar property includible in that spouse’s gross estate under other gross estate inclusion provisions.

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13 Reg. §§ 20.2044-1(d)(1), 20.2044-1(e), Exs. 2, 3. See TAM 9446001 (Nov. 18, 1994) (election of a dollar amount equal to the value of surviving spouse’s income interest treated as an election of a fraction of the entire property); Reg. § 20.2044-1(e), Ex. 8 (Section 2044 inclusion of portion of trust where surviving spouse died before QTIP election on spouse’s return). Cf. Estate of Soberdash v. Comm’r, 74 TCM (CCH) 295 (1997); Reg. § 20.2044-1(e), Ex. 7 (where the QTIP election involves an annuity and the transfer was made prior to October 24, 1992).

14 Reg. § 20.2044-1(d)(3). The executor of the transferee spouse’s estate must establish the fair market value of the trust assets at the time of each distribution as a prerequisite to the reduction in the amount of Section 2044 inclusion. Reg. § 20.2044-1(e), Ex. 4.

15 IRC § 2044(b)(2). Section 2519 of the gift tax statute treats all third-party interests in the property as being transferred inter vivos by the transferee spouse. See ¶ 10.08[1].

16 Reg. § 25.2519-1(a). See Reg. §§ 20.2044-1(e), Ex. 5, 25.2519-1(g), Exs. 4, 5. See also ¶ 10.08[1][a], note 15 (questioning the propriety of the Treasury’s contention).

17 IRC § 2044(c). See Reg. §§ 20.2044-1(b), 20.2044-1(e), Ex. 6.

18 Reg. § 20.2044-1(b). See ¶ 2.02[3][c].

19 IRC §§ 2031, 2032, 2032A. Cf. Reg. § 20.2044-1(b); IRC § 1014, especially IRC § 1014(b)(10).
sions,20 and the Service has acquiesced in one of those decisions.21 While these decisions are favorable to the surviving spouse’s estate, they generate additional questions,22 and one must not turn a blind eye to the tax consequences of these decisions on the predeceasing spouse’s estate.23

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20 Estate of Bonner v. United States, 84 F3d 196 (5th Cir. 1996) (undivided interests in assets (a boat and land) owned outright by a decedent and by a trust included in the decedent’s gross under Section 2044 were not aggregated into 100 percent ownership in the decedent’s gross estate, but were instead separately valued as fractional interests in property); Estate of Mellinger v. Comm’r, 112 TC 26 (1999), acq. 1999-2 CB xvi (stock of publicly but thinly traded Frederick’s of Hollywood held in a trust included in transferee spouse’s gross estate under Section 2044 was not aggregated with stock held in transferee spouse’s revocable trust, even though the aggregated stock would have constituted a majority controlling ownership block); Estate of Nowell v. Comm’r, 77 TCM (CCH) 1239 (1999) (a partnership interest held in a trust included under Section 2044 and a partnership interest held in a revocable trust were not aggregated in the transferee spouse’s gross estate for valuation purposes); Estate of Lopes v. Comm’r, 78 TCM (CCH) 46 (1999) (interest in real estate in a trust included under Section 2044 not aggregated with interest in real estate held in transferee spouse’s revocable trust for valuation purposes). See ¶ 4.02[4][b], text accompanying notes 157, 158. See also Bogdanski, “The Outer Limits of Minority Discounts,” 23 Est. Plan. 496 (1999); Elliot, “A New Bright Line: Fractional Interest Discount Permitted for Property Interests Held by QTIP Trust and Decedent Outright,” 13 J. P’ship Tax’n 358 (1997).


22 A principal rationale behind the court’s lack of aggregation of the interests appears to be the fact that the surviving spouse had no control over the ultimate disposition of the assets in the qualified terminable interest trust. See Estate of Bonner v. Comm’r, 84 F3d 196, 199 (5th Cir. 1996) (“the assets…in fact were controlled at every step by [the predeceasing spouse]”; Estate of Mellinger v. Comm’r, 112 TC 26, 36 (1999), acq. 1999-2 CB xvi (“at no time did the decedent [surviving spouse] possess, control, or have any power of disposition over the [corpus] in the QTIP trust”). If this is the basis of the decisions, then the results should not be expanded to avoid aggregation of property included under other gross estate inclusion sections such as Section 2036, Section 2038, or Section 2041. See FSA 200119013 (Feb. 6, 2001) (stock included in decedent’s gross estate under Section 2041 as a result of a predeceasing spouse’s Section 2056(b)(5) marital deduction aggregated with stock included under Section 2033). The rationale also raises the issue of whether the Bonner line of cases would apply if the surviving spouse were given directly or indirectly a general power of appointment over the qualified terminable interest corpus or even a nongeneral power of appointment over such corpus. Cf ¶ 5.06[8][f].

23 Courts have recognized that discounts and premiums may be taken into account in determining the amount of a deduction under the estate tax deduction sections. See Estate of Chenoweth v. Comm’r, 88 TC 1577 (1987) (control premium allowed for gift to surviving spouse); Ahmanson Found. v. United States, 674 F2d 761 (9th Cir. 1981) (stock given by decedent to charity discounted from its value in decedent’s gross estate); Estate of Di Santo v. Comm’r, 78 TCM (CCH) 1220 (1999) (surviving spouse’s valid partial disclaimer of marital bequest converted the bequest to a minority interest with the result that the marital deduction was reduced by an amount greater than the disclaimed portion of the bequest). See ¶ 4.02[4]; ¶ 5.06[5], text accompanying notes 91–94.
4.17 SECTION 2045. PRIOR INTERESTS

Section 2045 contains the general rule concerning the time at which a transaction must have occurred to result in estate tax liability under Sections 2034 through 2042. The rule states that it makes no difference when the transaction took place, unless a critical date for applicability is specifically provided by law.

By its own terms, Section 2035 does not apply to transfers that occur more than three years prior to death.1 Section 2037 is expressly inapplicable to transfers made on or before September 7, 1916; moreover, by its express terms, it provides different rules for transfers made before October 8, 1949, and transfers made on or after that date.2 Specific critical dates or periods of broad or narrow importance appear in or for all the Sections from 2035 through 2041 and 2044; Sections 2034 and 2042 contain no critical dates.

The provisions of Section 2045 should not be confused with the matter of the effective date of the 1986 Code or amendments to it. When considering the possible application of Sections 2034 through 2042, two questions of timing may arise: (1) When did the transaction take place? and (2) When did the decedent die? In general, the estate tax provisions of the 1986 Code are applicable to estates of decedents who died after August 16, 1954, the date of the enactment of the 1954 Code.3 Even this rule is not entirely free from exception, however. For example, treaty obligations in effect when the 1954 Code was enacted are excepted from contrary provisions in the 1954 Code.4 Section 2039, concerning annuities, which had no direct counterpart in prior law, is generally applicable to estates of decedents who died after December 31, 1953, and in other circumstances only to estates of decedents who died after December 31, 1957, 1962, 1965, 1970, 1972, 1976, 1981, 1984, 1986, or 1987. Recent Revenue Acts have added substantially to instances in which a provision is limited to estates of decedents dying after a critical date.5 These comments are not extended here, as critical dates are noted in the discussion of the various sections defining “gross estate.”

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1 IRC §§ 2035(a)(1), 2035(b).
2 IRC § 2037(a).
3 IRC § 7851(a)(2)(A).
4 IRC § 7852(d)(2).
5 The only change in Section 2045 made by the Tax Reform Act of 1976 was to substitute the introductory phrase “Except as otherwise specifically provided by law” for “Except as specifically provided therein.” See Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(c)(1)(m), 90 Stat. 1520, 1853 (1976), reprinted in 1976-3 CB (Vol. 1), 329. Thus, critical times for transactions may be expressed in statutes not incorporated into the Code.
4.18 SECTION 2046. DISCLAIMERS

Section 2046 is simply a cross reference to the uniform disclaimer rule of Section 2518, which is applicable to the estate tax provisions. A detailed discussion of the disclaimer rule appears in Chapter 10.¹

¹ See ¶ 10.07.