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Estate and Gift Tax Effects of Selling a Remainder: Have *D'Ambrosio*, *Wheeler* and *Magnin* Changed the Rules? *Ronald H. Jensen**

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I. INTRODUCTION

For over two-thirds of a century, federal estate tax law has expressly provided that property transferred by a decedent during his *lifetime* will nonetheless be subject to estate tax if he retains the right to the property's income for the remainder of his life.¹ This rule—now embodied in section 2036 of the Internal Revenue Code²—reflects Congress's belief that such transfers are inherently testamentary: the transferor continues to enjoy the "transferred" property for the rest of his life, while his beneficiary obtains the property only upon the transferor's death.³

During the same period, "bona fide sale[s] for an adequate and full consideration" have been excluded from the operation of this provision.⁴ The rationale for this exclusion is that a transfer of property for which the transferor

1. The first statutory provision expressly mandating this result was § 302(c) of the Revenue Act of 1926 as amended by the Joint Resolution of March 3, 1931. H.R.J. Res. 529, 71st Cong. (1931). Previously, the Government had argued for the same result under the general provision requiring inclusion in the decedent's gross estate of any property he transferred where the transfer was "intended to take effect in possession or enjoyment at or after his death." This language was contained in § 202(b) of the Revenue Act of 1916, ch. 463, 39 Stat. 756, 777-78 (1916), and was carried over in subsequent revenue acts. See, e.g., Revenue Act of 1918, ch. 18, § 402(c), 40 Stat. 1057, 1097 (1919); Revenue Act of 1921, ch. 136, § 402(c), 42 Stat. 227, 278 (1921); Revenue Act of 1924, ch. 234, § 302(c), 43 Stat. 253, 304 (1924); Revenue Act of 1926, ch. 27, § 302(c), 44 Stat. 9, 70 (1926). However, the Supreme Court ruled this language did not encompass a lifetime transfer of property in which the decedent retained a life estate in *May v. Heiner*, 281 U.S. 238 (1930), overruled in part by *Commissioner v. Estate of Church*, 335 U.S. 639 (1949), and in three decisions decided on the same day in 1931: *Burnet v. Northern Trust Co.*, 283 U.S. 782 (1931); *McCormick v. Burnet*, 283 U.S. 784 (1931); and *Morsman v. Burnet*, 283 U.S. 783-84 (1931). One day after the 1931 decisions were handed down, Congress enacted the Joint Resolution of March 3, 1931, legislatively overruling them and *May v. Heiner*. For the history of Congress's response to *May v. Heiner*, see *Commissioner v. Estate of Church*, 335 U.S. at 639-40.

2. Unless otherwise stated, all section references are to the Internal Revenue Code of 1986 as currently in effect. Section 2036(a) provides:

The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

- (1) the possession or enjoyment of, or the right to the income from, the property, or
- (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

3. See *Estate of Church v. Commissioner*, 335 U.S. 632, 646 (1949) ("[T]rusts reserving life estates with remainders over at grantors' deaths are . . . effective substitutes for wills.").

4. IRC § 2036(a) (parenthetical clause).

receives full value does not diminish the size of his estate, and thus there is no need to subject the transferred property to estate tax.⁵

An issue that has vexed courts, estate planners, and commentators is how to ascertain the adequacy of consideration when a property owner sells a remainder interest in the property and retains a life estate. For the exclusion to apply, must the consideration received for the remainder simply equal the value of the remainder or must it equal the value of the entire property? A substantial body of case law—developed largely in the context of the so-called “widow’s election”—holds the consideration must equal the full value of the property.⁶ However, the Third Circuit in *D’Ambrosio* in 1996⁷ and the Fifth Circuit in *Wheeler* in 1997⁸ held that consideration received in a simple sale of a remainder is adequate—and hence the exclusion applies—where the consideration merely equals the actuarial value of the remainder on the date of sale. More recently, the Ninth Circuit in *Magnin*, overruling one of its own decisions, adopted the *D’Ambrosio-Wheeler* test for “full consideration.”⁹ (This article will sometimes refer to *D’Ambrosio*, *Wheeler*, and *Magnin* collectively as the “*D’Ambrosio* trilogy”).

This issue is of more than academic interest. If the holdings of the *D’Ambrosio* trilogy are correct, existing case law regarding the widow’s election (hereinafter “spousal election”) is arguably wrong. If so, estate tax planners will have acquired a valuable tool, albeit one subject to serious *income* tax risks, that would apparently enable a *couple to pass one-half or more of their combined property to the next generation free of any gift or estate tax* in many cases and to enjoy significant transfer tax savings in virtually every case.¹⁰

5. In *Estate of Frothingham v. Commissioner*, 60 T.C. 211, 215 (1973), the court stated:

Thus, where the transferred property is replaced by other property of equal value received in exchange, there is no reason to impose an estate tax in respect of the transferred property, for it is reasonable to assume that the property acquired in exchange will find its way into the decedent’s gross estate at his death unless consumed . . . in much the same manner as would the transferred property itself had the transfer not taken place.

6. See, e.g., *Pittman v. United States*, 878 F. Supp. 833 (E.D.N.C. 1994); *Wheeler v. United States*, 77 A.F.T.R. ¶¶ 96-612 to 96-613 (W. D. Tex. 1996), rev’d, 116 F.3d 749 (5th Cir. 1997); *D’Ambrosio v. Commissioner*, 105 T.C. 252 (1995), rev’d, 101 F.3d 309 (3d Cir. 1996), cert. denied, 520 U.S. 1230 (1997); *Gradow v. United States*, 11 Cl. Ct. 808 (1987), aff’d, 897 F.2d 516 (Fed. Cir. 1990); *United States v. Past*, 347 F.2d 7 (9th Cir. 1965); *Estate of Gregory v. Commissioner*, 39 T.C. 1012 (1963).

7. *D’Ambrosio v. Commissioner*, 101 F.3d 309 (3d Cir. 1996), cert. denied, 520 U.S. 1230 (1997).

8. *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997).

9. *Estate of Magnin v. Commissioner*, 184 F.3d 1074 (9th Cir. 1999).

10. See *infra* Part IV for a discussion of possible tax advantages of spousal election wills.

Part II of this article traces the evolving judicial interpretation of the “adequate and full consideration” exclusion found in section 2036. Part III examines the proper application of the “adequate and full consideration” exclusion to simple sales of remainders such as those involved in *D’Ambrosio* and *Wheeler* and concludes that the holdings in those cases are indisputably correct. It then analyzes the possible planning opportunities these decisions offer, particularly in light of section 2702.

Part IV examines the effect of the *D’Ambrosio* trilogy on spousal elections. This Part outlines the potential gift and estate tax savings this device affords and then considers how such elections should be analyzed for purposes of the “adequate and full consideration” exclusion. It concludes that spousal elections in virtually every case should be governed by the reciprocal trust doctrine. Under this approach, spousal elections do not constitute sales of remainders, and hence the holdings of the *D’Ambrosio* trilogy should not apply. Indeed, in many cases, the existing position of the Internal Revenue Service and the courts produces excessively generous results to taxpayers. However, in the relatively few cases where the reciprocal trust doctrine should not apply, the current treatment of spousal elections should change to conform to the holdings in *D’Ambrosio*, *Wheeler*, and *Magnin*.

II. JUDICIAL INTERPRETATION OF “ADEQUATE AND FULL CONSIDERATION”

Spousal elections have played a central role in molding judicial interpretation of the phrase “adequate and full consideration.” These elections originated in community property states where each spouse possesses a current, vested one-half interest in all property acquired by the couple during marriage.¹¹ In a spousal election will, the deceased spouse attempts to dispose of *both* his share *and* the surviving spouse’s share of the community property. Since the deceased spouse can only dispose of his share of the community property, state courts hold that such wills impose an election on the surviving spouse: she must either allow her share of the community property to pass under the decedent’s will, in which case she receives the benefits provided for her in the will, or else retain her share of the community property, in which event she forfeits all such benefits.¹²

Following convention—and actuarial experience—this article assumes that husband *H* dies first survived by his wife *W*. Unless otherwise indicated, the following facts apply: *H*’s will purports to leave all the community property in trust, with income payable to *W* for her life and principal payable upon her death

11. See generally Roger A. Cunningham et al., *The Law of Property* §§ 5.14 - .16 (2d ed. 1993) (overview of state community property laws).

12. See, e.g., *In re Smith’s Estate*, 40 P. 1037 (Cal.1895); *Graser v. Graser*, 215 S.W.2d 867 (Tex. 1948); *Dakan v. Dakan*, 83 S.W.2d 620 (Tex. 1935).

to their child *C*. *W* chooses to let her share of the community property pass to the trust created under *H*'s will. For purposes of clarity, the trust that *W*'s share of the community property passes into will be referred to as *W Trust*, and the trust that *H*'s property passes into will be referred to as *H Trust*.

When *W* elects to allow her share of the community property to pass under *H*'s will, she in effect "transfers" her property to *W Trust*. Since she "retains" a life estate in that trust, the trust will be included in her gross estate pursuant to section 2036, unless *W*'s election constitutes "a bona fide sale for an adequate and full consideration."¹³ The "consideration" *W* receives for making the election is seemingly her life estate in *H Trust*. The question confronting the courts was how to determine whether this "consideration" was "adequate and full." Should this consideration (i.e., *W*'s life estate in *H Trust*) be measured against the full value of her property that passes into *W Trust* or merely the value of the remainder that *W* gives *C* in her share of the property?

In the early cases, the courts apparently found the answer self-evident, holding without discussion that the value of *W*'s life estate is "adequate" consideration only if it equals the full value of the property transferred to *W Trust*.¹⁴ The courts seemed to have thought along these lines: *W* has transferred her *entire* share of the community property to the testamentary trust established under *H*'s will; therefore, the consideration received for this transfer is adequate only if it equals the value of the property transferred.¹⁵ What this approach overlooks is that while *W* transferred title to her entire share of the community property, *economically* she transferred only a remainder interest since she continued to enjoy the economic benefit of her retained life estate.¹⁶

13. IRC § 2036(a)(1).

14. *United States v. Past*, 347 F.2d 7 (9th Cir. 1965) (divorce settlement); *Estate of Gregory v. Commissioner*, 39 T.C. 1012 (1963). Some early cases found the consideration inadequate without specifying the appropriate measure. See, e.g., *United States v. Gordon*, 406 F.2d 332 (5th Cir. 1969); *Estate of Vardell v. Commissioner*, 307 F.2d 688 (5th Cir. 1962). In these cases, the value of *W*'s life estate in *H Trust* was less than either the remainder in *W Trust* or the total value of *W Trust*; hence, there was no need to specify the appropriate yardstick in determining the adequacy of consideration. Thus in *Vardell*, the value of *W*'s legal life estate in *H*'s property was approximately \$454,000, less than either the value of remainder in *W*'s property (approximately \$684,000) or the total value of such property (approximately \$1,241,000). *Estate of Vardell*, 35 T.C. 50, 53 (1960), rev'd on other grounds, 307 F.2d 688 (5th Cir. 1965). This was also true in *Gordon*, 406 F.2d at 335 (value of *W*'s life interest in *H*'s share (approximately \$18,500) was less than the value of the remainder in her share (about \$34,800) or the total value of her share (about \$53,300)).

15. *Past*, 347 F.2d at 13-14 (wife's life estate worth \$143,346 "from her husband's contribution" was less than the \$243,989 "decendent contributed to trust"); *Estate of Gregory*, 39 T.C. at 1017 (wife's life estate worth \$60,635 in portion of trust contributed by husband is "clearly not adequate and full consideration" for the \$65,925 contributed by wife to trust).

16. Cf. Regs. § 25.2512-5(d)(2) ("When the donor transfers property in trust or otherwise and retains an interest therein, generally, the value of the gift is the value of the

The courts in these cases permitted *W's* estate, pursuant to section 2043(a),¹⁷ to offset *W's* gross estate by the consideration she received for making the election, that is, the value of her life estate in *H Trust*.¹⁸ The IRS as well as the courts now uniformly allow this offset.¹⁹ Note, however, that this relief is severely limited and much less beneficial than the "adequate and full consideration" exclusion. When the exclusion applies, *W Trust* is completely eliminated from *W's* gross estate. In contrast, the section 2043(a) offset merely reduces *W's* gross estate by the value of her life estate in *H Trust* leaving the balance of *W Trust* taxable. Moreover, the courts have limited the amount of the offset to the value of *W's* life estate *as of the election date*.²⁰ Thus, while the amount included in *W's* gross estate under section 2036(a) will increase to reflect any appreciation in the value of *W Trust* occurring between *W's* election and her death, the offset under section 2043(a) remains fixed.²¹

property transferred less the value of the donor's retained interest."); Regs. § 25.2702-1(b) ("The amount of the gift, if any, is then determined by subtracting the value of the interests retained by the transferor or any applicable family member from the value of the transferred property.").

17. Section 2043(a) provides:

If any one of the transfers, trusts, interests, rights, or powers enumerated and described in sections 2035 to 2038, inclusive, and section 2041 is made, created, exercised, or relinquished for a consideration in money or money's worth, but is not a bona fide sale for an adequate and full consideration in money or money's worth, there shall be included in the gross estate only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent.

18. See, e.g., *Past*, 347 F.2d at 14; *Estate of Vardell*, 307 F.2d at 693; *Estate of Gregory*, 39 T.C. at 1019-20.

19. In litigation involving spousal elections, the IRS has conceded that the surviving spouse's estate is entitled to a § 2043 offset equal to the value of the life estate she received in the deceased spouse's property valued on the date of its receipt. See, e.g., *Gradow v. United States*, 11 Cl. Ct. 808, 809-10 (1987), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990); *Estate of Gregory*, 39 T.C. at 1020 (IRS conceded issue on brief). The IRS also allows a § 2043 offset in simple sale-of-remainder cases equal to the amount of consideration the decedent received valued on the date of the sale. See, e.g., *Wheeler v. United States*, 116 F.3d 749, 753 (5th Cir. 1997); *D'Ambrosio v. Commissioner*, 101 F.3d 309, 311 & n.1 (3d Cir. 1996), *cert. denied*, 117 S. Ct. 1822 (1997).

20. See, e.g., *Estate of Magnin v. Commissioner*, 184 F.3d 1074, 1082 (1999); *United States v. Righter*, 400 F.2d 344 (8th Cir. 1968); *Estate of Gregory*, 39 T.C. at 1021 (for purposes of § 2043(a), "relevant value of her life estate in [husband's] property was the value at the time of transfer"); Regs. § 20.2043-1.

21. Conversely, the § 2043(a) offset is not reduced when the value of the transferred property decreases in value between the date of transfer and the transferor's death.

The propriety of freezing the § 2043(a) offset at the consideration's value on the date of its receipt is challenged in Charles L. B. Lowndes, *Consideration and the Federal Estate and Gift Taxes: Transfers for Partial Consideration, Relinquishment of Marital Rights, Family*

The courts in the early cases may have failed to thoroughly analyze whether the consideration received was to be measured against the value of the remainder interest or the value of the fee in the transferred property because the facts in those cases showed the consideration was inadequate regardless of which measure was used.²² This was not true in *Gradow*,²³ where the Court of Claims for the purpose of deciding a motion for summary judgment assumed that the value of *W's* life estate in *H Trust* exceeded the value of the remainder interest

Annuities, the Widow's Election, and Reciprocal Trusts, 35 Geo. Wash. L. Rev. 50, 56-60 (1966). Professor Lowndes advocates a "proportional rule" under which the § 2043(a) offset would equal the transferred property's date-of-death value multiplied by a fraction, the numerator of which is the consideration received and the denominator of which is the value of the property, with both the consideration and the property being valued on the date of transfer. See *id.*; see also Dodge et al., 50-5th T.M., Transfers with Retained Interests and Powers, at A-86 to A-87 (1992) (each endorsing proportional approach) and Keith E. Morrison, The Widow's Election: The Issue of Consideration, 44 Tex. L. Rev. 223, 242-44 (1965). Judge Learned Hand's decision in *Helvering v. United States Trust Co.*, 111 F.2d 576 (2d Cir. 1940) appears to be the only judicial endorsement of this approach. The Tax Court rebuffed the taxpayer's attempt to use a proportional approach in *Estate of Magnin v. Commissioner*, 71 T.C. Memo (CCH) 1856, 69 T.C. Memo (RIA) ¶ 96,025 at 248 (1996); *aff'd*, 184 F.3d 1074 (9th Cir. 1999), stating "it is well settled that the consideration received is to be valued at the time of the transfer."

22. In *Estate of Gregory v. Commissioner*, 39 T.C. 1012 (1963), *W's* life estate in *H Trust* was worth only \$12,000, while the total value of the property *W* allowed to pass into *W Trust* was \$66,000, and the remainder interest in *W Trust* was \$53,000. See *id.* at 1017. Thus, the consideration received (i.e., *W's* life estate in *H Trust*) was inadequate whether measured against the full amount of property *W* allowed to pass into *W Trust* or the remainder interest in that trust. (The value of remainder was determined by taking the factor for determining *W's* life estate, 0.1967, see *id.* at 1015, determining its reciprocal, 0.8033, and multiplying the reciprocal by the value of the amount *W* contributed to *W Trust*, \$66,000, see *id.* at 1017. All figures in this footnote are rounded to the nearest \$1,000.)

Under the figures used by the majority in *United States v. Past*, 347 F.2d 7 (9th Cir. 1965), the test employed to determine adequacy of consideration would make a difference. Under its figures, *W's* life estate in *H's* contribution, \$143,000, see *id.* at 14 n.7, was greater than the value of the remainder interest in the property she contributed, \$101,000 (i.e., contribution of \$244,000 less her life estate therein, \$143,000), but less than the full amount of her property contribution, \$244,000, see *id.* at 14. However, as Judge Ely pointed out in dissent, the majority overvalued *H's* contribution to the trust. Since *H's* total interest in the community was worth \$401,000, and since he received \$294,000 outright in the settlement, his maximum contribution to the trust was \$107,000 (\$401,000 - \$294,000), making *W's* contribution \$380,000. See *id.* at 16. Using these figures and the Government's actuarial tables, Judge Ely computed the value of *W's* life estate in *H's* contribution at \$63,000 and the remainder interest in *W's* contribution at \$157,000. See *id.* at 17 n.2. Thus, the consideration *W* received (i.e., her life estate in *H's* contribution, having a value of \$63,000) was inadequate whether measured against *W's* contribution to the trust (\$380,000) or the value of the remainder in her contribution (\$157,000).

23. *Gradow v. United States*, 11 Cl. Ct. 808 (1987), *aff'd*, 897 F.2d 516 (Fed Cir. 1990).

in *W Trust* but was less than the value of the fee interest in that trust.²⁴ Despite this factual difference, the court reiterated the holding of the prior cases that consideration in a spousal election is adequate only if the life estate *W* receives in *H Trust* equals or exceeds the value of the entire property placed in *W Trust*.²⁵

The *Gradow* court offered two justifications for its holding, one based on the statute's language and the other on its policy. The court referred to the introductory language of section 2036(a): "The gross estate shall include . . . all property . . . of which decedent has at any time made a transfer." It then asserted that "[f]undamental principles of grammar dictate that the parenthetical expression which then follows—'(except in the case of a bona fide sale . . .)'—refers to a transfer of the same property, i.e., the one-half of the community property she placed into trust."²⁶ In other words, the requirement of "adequate and full consideration," which is found in the parenthetical expression, refers back to "all property" transferred by the decedent. Hence, adequacy of consideration must be measured by the full value of *W*'s property that she allowed to pass under *H*'s will.

The court also noted that the justification for the "adequate and full consideration" exemption found in section 2036 (and the other retained interest provisions) is that the amount included in a transferor's gross estate is not diminished by a transfer for which the transferor receives full compensation and hence no need exists to add the transferred property back into his gross estate.²⁷ In light of this rationale, the court held that the exception requires "at a minimum, [that] the sale accomplish an equilibrium for estate tax purposes,"²⁸ that is, that the consideration received fully replenish the amount removed from the estate by the transfer. The court asserted this purpose would be frustrated if the consideration received were deemed adequate so long as it merely equaled the actuarial value of the remainder. If that were so, the court insisted, "the exception [for a bona fide sale] would swallow the rule. A young person could sell a

24. *Id.* at 809-10. The court granted Government's motion for partial summary judgment where parties stipulated that *W*'s life estate in *H*'s property was worth less than her share of the community, even though taxpayer asserted that the value of such life estate exceeded the value of the remainder she gave up in her share. See *id.*

25. The court first found that the formula stated in the prior cases—that adequacy of the consideration *W* received (i.e., *W*'s life estate in *H Trust*) should be measured against the total value of the property she allowed to pass into *W Trust*—would have been followed by the courts in those cases even if such consideration had exceeded the value of the remainder *W* gave up in *W Trust*. See *id.* at 811 & n.3. It then concluded that this approach was correct. See *id.* at 813.

26. *Id.* at 813.

27. See *id.* at 813-14.

28. *Id.* at 814.

remainder for a fraction of the property's worth, enjoy the property for life, and then pass it along without estate or gift tax consequences."²⁹

The taxpayer countered that where a remainder is sold for its current actuarial value, the amount received, when invested and compounded at the rate used in the Government's tables in valuing that remainder, would grow over the transferor's life expectancy to the property's value as of the date of the transfer.³⁰ Hence, the transfer of the remainder would cause no reduction in the transferor's gross estate, and the purpose of the "adequate and full consideration" exception would be fully satisfied. But the court rejected this contention, stating that:

The fond hope that a surviving spouse would take pains to invest, compound, and preserve inviolate all life income from half of a trust, knowing that it would thereupon be taxed without his or her having received any lifetime benefit, is a slim basis for putting a different construction on § 2036(a) than the one heretofore consistently adopted.³¹

At the same time the courts were applying this rule in the estate tax context, they were applying the opposite rule in gift tax cases. Section 2512(b) provides that a taxable gift occurs only to the extent that "the value of the property [transferred] exceed[s] the value of the consideration" received.³² Thus no taxable gift takes place if a transferor receives "adequate and full consideration." In contradistinction to their rulings in estate tax cases, the courts held that consideration in a spousal election is "adequate and full" for gift tax purposes if the consideration merely equals the value of the remainder.³³ Thus, *W* makes no taxable gift by allowing her property to pass under *H*'s will, so long as the value of the life estate she receives in *H Trust* equals or exceeds the value of the remainder she gives to *C* in *W Trust*.³⁴ The IRS acquiesced in these holdings in 1964.³⁵ When confronted with this discrepancy, the courts could do

29. *Id.* at 815.

30. *See id.*

31. *Id.* at 816.

32. IRC § 2512(b).

33. *Turman v. Commissioner*, 35 T.C. 1123 (1961), acq., 1964-2 C.B. 7. *See also Siegel v. Commissioner*, 26 T.C. 743 (1956), acq., 1964-2 C.B. 7, aff'd, 250 F.2d 339 (9th Cir. 1957).

34. Even where there is a taxable gift, the amount of the gift is limited to the amount by which *C*'s remainder in *W Trust* exceeds *W*'s life estate in *H Trust*. Put differently, *W*'s gift of a remainder in her property to *C* is offset by the value of the life estate she receives in *H Trust*. *Siegel v. Commissioner*, 26 T.C. 743 (1956), acq., 1964-2 C.B. 7, aff'd, 250 F.2d 339 (9th Cir. 1957).

35. *See* 1964-2 C.B. 7 (acquiescing to the holdings in *Turman v. Commissioner*, 35 T.C. 1123 (1961) and *Siegel v. Commissioner*, 26 T.C. 743 (1956), aff'd, 250 F.2d 339 (9th Cir. 1957)).

little more than respond that one case involved the gift tax while the other involved the estate tax.³⁶

All the foregoing cases involved spousal elections. Prior to *Gradow*, no court had held that the amount received in a simple sale of a remainder—as contrasted with a spousal election—must equal the value of the underlying fee to constitute “adequate and full consideration.” Indeed, the Service had ruled privately that the consideration received by a fee owner who simply sells a remainder interest in his property is adequate if it merely equals the actuarial value of the remainder as determined under the Government’s tables.³⁷ But after *Gradow*, the Service started issuing rulings holding that consideration in a sale of a remainder is inadequate unless it equals the full value of the underlying fee.³⁸ The Tax Court³⁹ and a number of Federal District courts⁴⁰ followed suit and endorsed the Government’s new position. It was these rulings that the Courts of Appeal in the Third and Fifth Circuits firmly rejected in *D’Ambrosio*⁴¹ and *Wheeler*.⁴²

The court in *D’Ambrosio* disputed the contention of the *Gradow* court that, “fundamental principles of grammar dictate” that the phrase “adequate and full consideration” as used in section 2036 must be read as applying to the entire “property” transferred by the decedent.⁴³ The *D’Ambrosio* court asserted that the *Gradow* court had ignored the words following “property” in section 2036; specifically, it had failed to note that the actual language used in the statute was “all property to the extent of any interest therein” transferred by the decedent.⁴⁴ The *D’Ambrosio* court concluded that the phrase “adequate and full consideration” refers back to the “interest” the decedent transferred, not to the

36. See *Gradow v. United States*, 11 Cl. Ct. 808, 816 n.12 (1987), aff’d, 897 F.2d 516 (Fed. Cir. 1990)—an estate tax case involving a spousal election—where the court stated, “as legal support, [taxpayer] points to *Commissioner v. Siegel*, 250 F.2d 339 (9th Cir. 1957). *Siegel* was a gift tax case, however, and was distinguished later on that basis by the same court in [*United States v.*] *Past*, 347 F.2d [7] at 13 n.4 [9th Cir. 1965].”

37. See Tech. Adv. Mem. 78-06-001 (Oct. 31, 1977); Tech. Adv. Mem. 81-45-012 (July 20, 1981).

38. See Tech. Adv. Mem. 91-33-001 (Jan. 31, 1990).

39. See *D’Ambrosio v. Commissioner*, 105 T.C. 252 (1995), rev’d, 101 F.3d 309 (3d Cir. 1996), cert. denied, 520 U.S. 1230 (1997).

40. See *Pittman v. United States*, 878 F. Supp. 833 (E.D.N.C. 1994); *Parker v. United States*, 894 F.Supp. 445, 447 (N.D. Ga. 1995) (expressing “reservations about correctness of *Gradow*”); *Wheeler v. United States*, 77 A.F.T.R. 2d (RIA) 1045 (W. D. Tex. 1995), rev’d, 116 F.3d 749 (5th Cir. 1997).

41. *D’Ambrosio v. Commissioner*, 101 F.3d 309 (3d Cir. 1996), cert. denied, 520 U.S. 1230 (1997).

42. *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997).

43. *D’Ambrosio*, 101 F.3d at 314-15.

44. *Id.* at 314. See IRC § 2036(a).

“property” of which such “interest” is a part. Hence, consideration is adequate if it merely equals the value of the “interest” transferred, that is, the remainder.⁴⁵

The opinions in both *D'Ambrosio* and *Wheeler* agreed with *Gradow* that the “adequate and full consideration” exception should apply only where the consideration received was sufficient to fully replenish the depletion in the transferor’s estate caused by the transfer.⁴⁶ However, they rejected the *Gradow* court’s concern that a transferor’s gross estate would not be fully replenished where the consideration was limited to the actuarial value of the remainder. They pointed out that if such consideration is invested at the yield used in the Government’s tables to compute the present value of the remainder, it will grow over the life of the transferor (if he lives his full life expectancy) to the date-of-transfer value of the underlying fee. Hence there will be no diminishment in the transferor’s gross estate.⁴⁷ Indeed, there will be an excessive inclusion of value in the transferor’s gross estate under the *Gradow* approach for then his gross estate will include *both* the date-of-death value of the underlying fee *and* the consideration received for the transferred remainder *plus* all the income that accumulated on such consideration.⁴⁸

Moreover, the court in *D'Ambrosio* dismissed the concern expressed in *Gradow* that the transferor might consume all or part of the consideration received, or the income earned thereon, so that there would not be a full restoration of value in the transferor’s gross estate. The court first noted that the “[t]ax law . . . imposes no burdens on how a person spends her money.”⁴⁹ It acknowledged that if the income from *W*’s retained life estate were inadequate to support her, she would have to “invade the consideration she received in exchange for her remainder.”⁵⁰ But it argued that the amount of this invasion, and hence the depletion in her gross estate, would be “to no different an extent than [if] . . . she retained the fee simple interest.”⁵¹

The impact of *D'Ambrosio* and *Wheeler* on spousal election cases is unclear. The court in *D'Ambrosio* made no distinction between a simple sale of a remainder and a spousal election, and appears to have simply found *Gradow*—a spousal election case—wrongly decided.⁵² The *Wheeler* opinion is more circumspect, stating it found the Third Circuit’s rejection of *Gradow*

45. *D'Ambrosio*, 101 F.3d at 315.

46. *Id.* at 312-13; *Wheeler v. United States*, 116 F.3d 749, 761-62 (5th Cir. 1997).

47. See *D'Ambrosio*, 101 F.3d at 316-17; *Wheeler*, 116 F.3d at 762.

48. See *D'Ambrosio*, 101 F.3d at 316.

49. *Id.*

50. *Id.*

51. *Id.*

52. See *id.*

“persuasive” but adding it saw “little utility in revisiting the federal estate tax ramifications of the widow's election device”⁵³

The Ninth Circuit's recent decision in *Magnin*, however, bears directly on spousal elections, since the exchange in that case is analytically indistinguishable from what occurs in a spousal election. In a spousal election, *W* exchanges a remainder in her property for a life estate in *H*'s property. In *Magnin*, a son exchanged a remainder in his property for voting control and a life income interest in his father's property.⁵⁴ The transaction in *Magnin* was therefore quite different from the simple sales of remainders in *D'Ambrosio* and *Wheeler*. Unfortunately, the *Magnin* court followed *D'Ambrosio* and *Wheeler* without considering whether these differences compelled a different analysis. I believe they do, and in Part IV, I develop that analysis and apply it to the facts of *Magnin*.

III. WHAT IS “ADEQUATE AND FULL CONSIDERATION” IN A SIMPLE SALE OF A REMAINDER?

A. Critique of the *Gradow* and the *D'Ambrosio-Wheeler* Views of “Adequate and Full Consideration”

In *Gradow*, the court found the phrase “adequate and full consideration” referred back and thus applied to the “property” transferred by the decedent,⁵⁵ while the court in *D'Ambrosio* found the phrase referred back and applied to the “interest therein” (i.e., the remainder) transferred by the decedent.⁵⁶ In fact, it is unlikely that the draftsman intended “adequate and full consideration” to modify either the words “property” or the “interest therein” transferred by the decedent. In the original 1931 formulation of section 2036, the draftsman tagged the exception for “a bona fide sale for an adequate and full consideration” on at the end of a long subsection dealing with both gifts in contemplation of death and transfers with retained life estates.⁵⁷ The language regarding the

53. *Wheeler v. United States*, 116 F.3d 749, 757 n.7 (5th Cir. 1997). The court also noted that “the widow election cases present factually distinct circumstances that preclude the wholesale importation of *Gradow*'s rationale into the present case.” *Id.* at 756.

54. See *Estate of Magnin v. Commissioner*, 184 F.3d 1074, 1075 (9th Cir. 1999).

55. *Gradow v. United States*, 11 Cl. Ct. 808, 813 (1987), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990).

56. *D'Ambrosio*, 101 F.3d at 314-15 (3d Cir. 1996).

57. The 1931 predecessor to § 2036(a) read as follows:

The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all *property*, real or personal, tangible or intangible, wherever situated—

. . . .

(c) To the extent of any *interest therein* of which the decedent has at any time made a transfer, by trust or otherwise, in contemplation of or intended to take effect in possession or enjoyment at or after his death, including a transfer under which the transferor has retained for his life or any period not

“adequate and full consideration” exception was placed so far away from the terms “property” and “interest therein” that it is highly unlikely that the drafter expected or intended the reader to read the latter phrase as modifying the earlier ones. Indeed, the language relating to “adequate and full consideration” was separated from the rest of the subsection by a semi-colon. The meaning of the exception must therefore be found in the words of the exception itself; not by tying the words of the exception to words found in remote portions of the section.

What the language of the exclusion requires is that there be a “bona sale for an adequate and full consideration.” When is there a “bona fide sale for an adequate and full consideration”? Surely this contemplates a transfer in which the buyer pays fair value (or what she believes is fair value) for what she gets, and the seller receives fair value (or what she believes is fair value) for what she gives up. What the buyer “gets” and the seller “gives up” in a sale of a remainder is the remainder itself—not the underlying fee—and thus adequacy of consideration should be determined solely with reference to the remainder. It is implausible that Congress intended the words “a bona fide sale for an adequate and full consideration” to impose a requirement that the buyer pay substantially in excess of fair value for what she is buying. Indeed, as several commentators have pointed out, if the buyer were to pay the full value of the underlying property when she acquires only a remainder, the buyer—under established gift tax principles—will normally be making a gift to the seller of the amount by which the value of the fee exceeds the value of the remainder.⁵⁸ The *Gradow* construction has the strange result of almost always limiting the “bona fide sale” exception to cases of gifts.⁵⁹

ending before his death (1) the possession or enjoyment of, or the income from, the property or (2) the right to designate the persons who shall possess or enjoy the property or the income therefrom; *except in the case of a bona fide sale for an adequate and full consideration in money or money's worth.*

Revenue Act of 1926, § 302(c), ch. 27, 44 Stat. 9, 70 as amended by H.R.J. Res., 71st Cong., 3d Sess., 46 Stat. 1516 (1931) (emphases added).

58. See Martha W. Jordan, *Sales of Remainder Interests: Reconciling Gradow v. United States and Section 2702*, 14 Va. Tax Rev. 671, 682-83 (1995); Steven A. Horowitz, *Economic Reality in Estate Planning: The Case for Remainder Interest Sales*, 73 Taxes 386, 388 (1995).

59. Theoretically, the buyer could avoid gift tax treatment if he could show that his purchase was “made in the ordinary course of business (a transaction which is bona fide, at arm’s length, and free from any donative intent)” since the Regulations deem such purchases to be made for “adequate and full consideration.” Regs. § 25.2512-8 (as amended in 1992). However, since the purchase price for the remainder would be grossly excessive and since such purchases are almost always between family members, a buyer in this situation would find it difficult to establish that his purchase was at arm’s length and free from donative intent.

Moreover, Congress when it created the exception for "bona fide sale[s] for an adequate and full consideration" clearly intended it to apply to at least some sales where the seller retains a life interest, or put differently, where the seller sells a remainder. Otherwise, the exception would never apply. But no rational, good faith buyer ever buys a remainder for the full value of the underlying fee. The *Gradow* construction of the exception renders it meaningless surplusage.

The approach of the *D'Ambrosio* and *Wheeler* courts also better carries out the purpose of the "adequate and full consideration" exception, which is to exempt from transfer tax those transfers which do not reduce the transferor's gross estate. When the seller of a remainder receives consideration equal to the remainder's actuarial value, that amount, when invested and compounded at the rate of return used in the Government's actuarial tables, will grow over the transferor's life (provided he lives his life expectancy) to an amount equal to the value of the underlying fee as of the date of the transfer.⁶⁰ Thus, the transferor's gross estate will be no less than it would have been if the remainder had not been sold (assuming no change in the underlying property's value).⁶¹

60. For example, assume that A who has a five year life expectancy sells a remainder in her property *Blackacre* (fair market value: \$500,000) at a time when the interest rate used for valuing remainders is 6%. The actuarial value of the remainder based on the Government tables on the date of sale is \$373,629. See Internal Revenue Service, Actuarial Values, Alpha Volume (Publication 1457) 3-10 (1989) [hereinafter Actuarial Values] (remainder factor for a 5 year term at 6% compounded annually is 0.747258; $0.747258 \times \$500,000 = \$373,629$). If A sells the remainder for this amount, reinvests the proceeds at 6% interest compounded annually and lives exactly her life expectancy of five years, the accumulated value of the invested proceeds will be \$500,000 on the date of her death. Thus, there will be no depletion in her estate.

Year	Amount at Year-Beginning	+ Income during Year @ 6%	= Amount at Year-End
1	\$373,629	\$22,418	\$396,047
2	396,047	23,763	419,810
3	419,810	25,189	444,999
4	444,999	26,700	471,699
5	471,699	28,302	500,001*

Note, however, that if A uses any part of the sale proceeds or even *some* of the income therefrom to finance consumption in excess of what she was previously consuming, the size of her gross estate will be reduced.

*The one dollar discrepancy is due to rounding; all numbers are rounded to the nearest dollar. All computations in this article were made on a Hewlett-Packard HP-12C Programmable Financial Calculator.

61. The approach advocated in the text is fully consistent with *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961), cert. denied, 368 U.S. 944 (1961). In that case, Mrs. Allen sold her retained life estate in a trust she had created to her son for an amount slightly in excess of its actuarial value. The trial court found that her transfer of her life estate was made in

Of course, in some cases, the transferor will die prematurely, in which case his gross estate will be not be fully replenished by reinvestment of the sale proceeds, while in others the transferor will outlive his life expectancy, in which event the amount of the reinvested proceeds should exceed that value of the underlying fee on the date of the sale. Likewise, in some cases, the return realized by the seller of the remainder will be greater than that assumed in the Government's tables while in other cases it will be less. But as the Supreme Court recognized in another context, "the United States is in business with enough different taxpayers so that the law of averages has ample opportunity to work."⁶²

Moreover, the *Gradow* construction of "adequate and full consideration" results in an excessive inclusion of value when a fee owner sells a remainder for its actuarial value, since then the seller's gross estate will include not only the underlying fee at its date-of-death value, but *also* the consideration received for the sale of the remainder together with all income that has accumulated on that consideration.

Assume that A, who has a five-year life expectancy, sells a remainder interest in *Blackacre* (which has a current fee value of \$500,000) to B at a time when the interest rate used for valuing remainders is 6%, reserving a life estate to herself. If A sells the remainder for its actuarial value of \$373,629⁶³ rather than its fee value of \$500,000, *Blackacre* will, according to *Gradow*, be included in A's gross estate at its date-of-death value, i.e., \$500,000 if *Blackacre* does not change value. However, A's gross estate will *also* include the consideration A received for the remainder and the income that accumulates on it. If A reinvests her sale proceeds of \$373,629 at 6% interest compounded annually and lives exactly her life expectancy of five years, the proceeds will grow to \$500,000 by

"contemplation of death." Consequently, the trust principal was includible in her gross estate under § 2035 as then in effect *unless* the sale was for an "adequate and full consideration." *Id.* at 917. On appeal, the majority opinion held that the consideration was inadequate, since the purpose of the statute was to include in the gross estate the same amount that would have been if no transfer had occurred. *Id.* at 917-18. If Mrs. Allen had retained her life estate until death, the full date-of-death value of the trust principal would have been included in her gross estate pursuant to § 2036. Obviously, the consideration Mrs. Allen received for her life estate did not replenish her estate for the amount that had been removed from it (i.e., the value of the trust *principal*); indeed, it only reimbursed her for the *income* she otherwise would have received from her life estate. Full replenishment could be accomplished only by including the trust principal at its date-of-death value. In contrast, where a *remainder* is sold for its actuarial value, the amount included in the seller's gross estate will equal the value of the entire property at the time of transfer if she lives her full life expectancy and invests the sale proceeds. See *supra* note 60. Hence the equilibrium sought by the court in *Allen* will be achieved. Paul R. McDaniel et al., *Federal Wealth Transfer Taxation* 304 (4th ed. 1999). See also discussion of this issue in *Wheeler v. United States*, 116 F.3d 749, 759-61 (5th Cir. 1997).

62. *Northeastern Pa. Nat'l Bank & Trust Co. v. United States*, 387 U.S. 213, 224 (1967) (quoting *Gelb v. Commissioner*, 298 F.2d 544, 551-52 (2d Cir. 1962)).

63. See *supra* note 60.

the time of her death.⁶⁴ The estate will be entitled to an offset under section 2043(a) for the consideration *A* received for the sale of the remainder, that is, \$373,629.⁶⁵ Thus, the *Gradow* approach causes \$626,371 to be included in *A*'s gross estate when *A* sells the remainder [$\$500,000 + \$500,000 - \$373,629$], as contrasted with only \$500,000 when *A* retains the fee.⁶⁶ *A*'s gross estate has been substantially increased—not simply replenished—as a result of the sale. Use of the *Gradow* approach frustrates the very “equilibrium for estate tax purposes” which that court sought to achieve.⁶⁷

The *Gradow* court rejected these arguments because of its skepticism that the seller of the remainder would “take pains to invest [the sale proceeds], compound [them], and preserve inviolate all life income” from the reinvested proceeds.⁶⁸ If, as the court feared, the seller consumes *just some of the income earned on the sale proceeds*, those proceeds will not grow back over the seller's life expectancy to the property's date-of-sale value.⁶⁹

A frequent response to this argument is that there will be no reduction in the seller's gross estate even if he consumes some of the proceeds (or the income thereon), since use of the proceeds for consumption “frees up” other property that the seller would have otherwise used to pay for his consumption. Thus, the sale proceeds (and accumulations thereon) either directly or indirectly will find their way into the seller's gross estate.⁷⁰

This argument does not give the *Gradow* court its just due, since it “fondly” assumes the seller's level of consumption is unaffected by his sale of the remainder.⁷¹ This is by no means certain. A sale of a remainder increases the

64. See *supra* note 60.

65. See *supra* notes 17-21 and accompanying text.

66. In either case (that is, whether *A* sells the remainder in *Blackacre* or not), *A*'s gross estate will *also* include any income *A* receives from *Blackacre* that remains unconsumed at *A*'s death.

67. *Gradow v. Commissioner*, 11 Cl. Ct. 808, 813-14, *aff'd*, 897 F.2d 516 (Fed Cir. 1990).

68. *Id.* at 816.

69. See *supra* note 60 (providing example). *A*'s estate in that example will be fully restored to its pre-sale size (i.e., \$500,000), only if both the proceeds from the sale of the remainder, \$373,629, and the income thereon are kept intact and reinvested at 6% compounded annually.

70. See, e.g., *Jordan*, *supra* note 58, at 695-96.

71. The size of the seller's gross estate will be unaffected where he maintains his pre-sale level of consumption, even if he consumes part of the sale proceeds or the income thereon. Consider the case of *C*, a person who owns a single asset that yields insufficient income to pay for his current level of consumption. If *C* sells a remainder interest in the property and maintains his pre-existing level of consumption, he will no doubt consume part or all of the sale proceeds and/or the income thereon. This will reduce the size of his gross estate, but the size of the reduction will be no greater than if he had retained the fee interest in the property. In the latter case, *C* would have needed to “invade the principal” of his property (for example, by selling a

seller's income, and people tend to increase their consumption as their income increases.⁷² After selling a remainder, the seller will receive not only income from the underlying property, as he did before the sale, but also income on the reinvested proceeds. (Note that this increased income will not increase the size of the seller's gross estate, since the increased income is needed just to restore his gross estate to its presale size.) Although people may be inhibited from "dipping into principal," this inhibition probably does not extend to the *income* earned on the proceeds from a sale of principal. Indeed, many people sell principal, like nonincome producing property, just so they can consume the income that the reinvested proceeds produce. If the sale of a remainder causes the seller to consume more, his gross estate will be reduced.⁷³

The correct response to this concern is that it is irrelevant whether the seller consumes part or even all of the consideration he receives (or any of the income thereon). No gift occurs where a person sells his property for "adequate and full consideration." The theory is that the sale has not diminished the seller's gross estate, and hence there is no need to impose a gift tax to protect the integrity of the estate tax. This result is not changed by the possibility that the

partial interest in it or by mortgaging it) to maintain his existing level of consumption, and this would have reduced his gross estate by the same amount as occurred when he sold the remainder interest. See *D'Ambrosio v. Commissioner*, 101 F.3d 309, 316 (3d Cir. 1996), cert. denied, 520 U.S. 1230 (1997).

The weakness in this analysis is the dubious assumption that *C*'s consumption would remain the same regardless of whether he sold the remainder. If he did not sell the remainder, *C*, given the "traditional reluctance to 'dip into principal,'" would probably at some point have curtailed his expenditures to prevent further erosion of his dwindling principal. See Stanley M. Johanson, *Revocable Trusts, Widow's Election Wills, and Community Property: The Tax Problems*, 47 *Tex. L. Rev.* 1247, 1287 (1969).

72. See Johanson, *supra* note 71, at 1287-88. Professor Johanson writes that where there is an increase in overall income, "it is likely that Parkinson's Second Law would come into play: 'Expenditure rises to meet income.' Items that might have been regarded as luxuries at a lower income level would now become 'necessities.'" *Id.* at 1288 (footnote omitted).

73. Note that a surviving spouse may also adjust her level of consumption as a result of her spousal election. *If W retains her share of the community and forgoes life income interest in H Trust*: Marriage effects savings by reducing the duplication of fixed expenses that two people incur when living apart (e.g., lodging and utilities), but these savings disappear when the marriage ends. If *W* continues to live in the same lodging as she did before *H*'s death, she must pay from her income alone the rent, mortgage interest expense, real estate taxes, etc., that were paid from *W*'s and *H*'s joint income when *H* was alive. Theoretically, *W* could make up for this shortfall by invading her principal, but "[g]iven widows' traditional reluctance to 'dip into principal'—particularly when . . . principal would be consumed at a fairly rapid rate, . . . she would likely adjust her living scale accordingly." Johanson, *supra* note 71, at 1287. *If W allows her property to pass under H's will thereby receiving a life income interest in both H Trust and W Trust*: The amount of income available for *W*'s consumption may increase following *H*'s death (*H*'s expenses having ceased), and in this case "it is likely that Parkinson's Second Law would come into play: 'Expenditure rises to meet income.'" *Id.* at 1288.

seller may (or in fact does) consume the proceeds, even though this means that his gross estate will be less than it would be if he had retained the property until his death. A taxpayer is always free to "beat" the estate tax through consumption or dissipation of his assets. Likewise, the possibility that the seller of a remainder may consume the proceeds, unproductively invest them, or let them lie fallow should not disqualify the proceeds as "full and adequate consideration."⁷⁴

Some might argue that section 2036 should still apply because every transfer of a remainder is potentially testamentary, even when effected by a sale. Section 2036 treats a gratuitous transfer of a remainder, coupled with a retained life estate, as a testamentary substitute. This is because the decedent continues to enjoy the property throughout his life, just as if he had retained ownership of the fee, and the remainderman comes into possession of the property only upon the decedent's death, just as if the decedent had kept the fee and devised it to him at death. Furthermore, the remainderman realizes a net economic benefit upon the transferor's death, just as if the decedent had left him a bequest or devise.

The first two of these factors will also be present where the fee owner sells a remainder interest for its actuarial value. Unlike the case of a person who sells his property in fee simple absolute and thereby terminates his interest in the property, a fee owner who sells a remainder continues to enjoy the underlying property for the rest of his life, while the buyer takes possession of the property only upon the seller's death. If, in addition, the buyer realizes a net economic benefit from his receipt of the property at the seller's death (after taking into account his payment of consideration), all the reasons for treating the transfer of the remainder as testamentary may arguably be said to exist. The case for applying section 2036 would be particularly strong where the seller had donative feelings for the buyer (e.g., where the buyer was a natural object of his bounty).⁷⁵

Note, however, that where the seller lives out her life expectancy and the remainderman buys the remainder for its actuarial value, the remainderman

74. *Wheeler v. United States*, 116 F.3d 749, 762-63 (5th Cir. 1997).

75. This analysis may underlie Professor Jordan's assertion that § 2036 should apply in a "non-arm's length" sale of a remainder even if the seller receives "adequate and full consideration":

While it may be the case that the consideration received in a non-arm's length transfer is sufficient to prevent depletion of the taxpayer's gross estate, the donative character of the transaction combined with the taxpayer's retention of an interest in the property is nevertheless sufficient to make the transfer testamentary in nature. Therefore, the most appropriate result is to include the property in the taxpayer's gross estate.

Jordan, *supra* note 58, at 717-18. Professor Jordan does not explain how she would resolve in the case of a "non-arm's length transaction" the problem of over-inclusion of value that results when the "seller's" gross estate includes both the consideration received for the remainder and the underlying property itself, although she recognizes the problem where the seller and the remainderman are unrelated. *Id.* at 689-92.

derives no economic benefit upon the seller's death unless the property has appreciated. The net economic benefit a remainderman realizes upon the seller's death is the date-of-death value of the property less (1) the consideration he paid for the remainder, *and less* (2) the income thereon which he has forgone by paying that consideration to the seller. Under the Government's actuarial tables, the total amount of these subtractions will exactly equal the fee value of the property where the property does not appreciate. Consider *A* in the above example who sold a remainder in *Blackacre* to *B* for its actuarial value of \$373,629 while she retained a life estate for herself. Since *B* has foregone the additional \$126,371 he could have earned on the \$373,629 he paid *A* during the five years that she survived,⁷⁶ the total economic cost to *B* of the purchase is \$500,000. His receipt of *Blackacre* at *A*'s death, assuming it is still worth \$500,000, is economically a "wash." Obviously, section 2036 should not apply where the decedent confers no benefit on her supposed beneficiary.

On the other hand, if *Blackacre* appreciates, *B* will realize a net economic gain upon *A*'s death.⁷⁷ Here *A*'s sale of the remainder to *B* may be said to be functionally indistinguishable from the normal case covered by section 2036: (1) *A* continued to enjoy the property during her life; (2) possession of the property passed to *B* only at *A*'s death; and (3) at her death, *A* conferred a net economic benefit on *B*. Indeed, this transaction may have been intentionally donative. *A* may have expected the property to appreciate and wanted to pass this anticipated increment on to *B* as a gift, but structured the transfer so that she could continue her lifetime enjoyment of the property while also avoiding any current economic loss.⁷⁸

76. See *supra* note 60, where it is shown that \$373,629 will grow to \$500,001 over five years (the actuarially-determined remainder of *A*'s life) when it is invested at 6% interest compounded annually.

77. This of course assumes that had *B* retained the consideration he paid *A* for the remainder, it would have grown in his hands at the same rate as that used in determining the remainder's present value (i.e., 6% compounded annually) rather than the greater growth rate realized on *Blackacre*.

78. *B* could also realize an economic gain if *A* fails to live out her actuarially determined life expectancy. In that case, *B* will forgo a return on the consideration he paid *A* for a shorter period than envisioned by the actuarial tables, and thus his loss of return will be less than the amount by which *Blackacre*'s value was discounted in determining the remainder's present value. Sellers in poor health may actually anticipate this type of "gain" and intend it as a gift when they sell a remainder interest to a close family member at its actuarially determined value. Arguably such gain should be taxed. Of course, a buyer of a remainder will incur an economic loss if the seller outlives her life expectancy, but tax planners can be counted on to avoid this technique where the seller's health is robust. See *infra* text accompanying notes 79-81 for an alternative approach that could be used to measure and tax this type of gain or loss.

The current regulations attempt to limit tax avoidance by prohibiting the use of the actuarial tables to value an individual's interest where "there is at least a 50 percent probability that the individual will die within 1 year." Regs. § 20.7520-3(b)(3). However, taxpayers may

Consequently, a plausible case exists for applying section 2036 to tax any appreciation that occurs between the time the remainder is sold and the seller's death. One way of accomplishing this is to include the underlying property in the seller's gross estate at its date-of-death value but then allow the estate an offset for the consideration paid *and the imputed income thereon from the date of sale through the date of death*.⁷⁹

If the underlying property does not appreciate and the seller lives out her life expectancy, this approach will produce the same result as excluding the property from the seller's gross estate, since the offset will exactly equal the property's value. This is because offset is the amount that the consideration, when invested at the imputed interest rate, will grow to over the seller's life expectancy. This amount will equal the property's date-of-death value when there is no appreciation.⁸⁰ On the other hand, this way of applying section 2036 will capture any appreciation that occurs in the underlying property while such appreciation would escape taxation if section 2036 did not apply.⁸¹

apparently use them in all other cases (e.g., where there is an 80% chance that an individual will fail to live out his 5-year life expectancy but only a 40% chance that he will die within one year). See Regs. § 20.7520-1(a)(1) and *infra* text accompanying notes 119-20.

79. Use of the actual growth in the consideration (i.e., income plus appreciation) would arguably be more accurate but presents difficult tracing problems. Imputed income, based on the applicable federal rates, is more practicable. Cf. Lowndes, *supra* note 21, at 56-60 (discussing tracing problems in an analogous case of determining the § 2043 offset). Professor Dodge argues that use of an "actual consideration" approach is not conceptually mandated in that situation. Dodge, *supra* note 21, at A-87.

80. Consider again the case presented in note 60 where A, having a life expectancy of five years, sells a remainder in *Blackacre* (fair market value: \$500,000) for its actuarial value of \$376,629. Assume also that A lives exactly her actuarially-determined life expectancy of five years and that *Blackacre* does not appreciate. As can be seen below, the method suggested in the text for applying § 2036 produces the same result as if § 2036 did not apply.

Where *Blackacre* Does Not Appreciate

	§ 2036 <u>Not Applicable</u>	§ 2036 Applies But Offset For Consideration <u>and Imputed Income Thereon</u>
Consideration & income thereon actually in estate (based on an assumed yield of 6% per annum)	\$500,000	\$500,000
Date-of-death value of <i>Blackacre</i>	Not Included	\$500,000
Offset (as described in text)	<u>Not Applicable</u>	<u>(\$500,000)</u>
Net amount included in gross estate	\$500,000	\$500,000

81. Assume the same facts as in the example in *supra* note 80, except that *Blackacre* appreciates to \$700,000. As can be seen below, the method of applying § 2036 described in the text (date of-death value of property minus consideration minus imputed income on consideration) will tax the appreciation of \$200,000 whereas such appreciation goes untaxed if § 2036 does not apply.

The trouble is that no matter how appealing this approach may be as a matter of policy, it is incompatible with the current statutory framework.

First, section 2043(a) takes no account of the income or other growth realized on the consideration following the date of sale, but fixes the offset at the consideration's value on the date of its receipt.⁸²

Secondly, this approach employs hindsight while the present "adequate and full consideration" exception focuses on the facts existing on the date of sale. Under the suggested approach, section 2036 would have operative effect only if underlying property had appreciated by the time of the seller's death, a fact that is unknown and unknowable at the time of the sale. In contrast, the current "adequate and full consideration" exception asks: Was the sale a "bona fide sale for adequate and full consideration"? This answer depends on the facts existing and known on the date of sale. If a person sells property in an arm's length transaction for its fair market value on the date of sale, this condition is satisfied. The possibility that the property may (or in fact does) subsequently appreciate in no way negates the existence of a "bona fide sale for adequate and full consideration."⁸³

The decisions in *D'Ambrosio* and *Wheeler* are clearly correct under the existing statutory framework.

B. The IRS's "Legitimate" Concern: Value Manipulation—And Congress's Response

Was the Government's position in *D'Ambrosio* and *Wheeler* simply a case of perverse obduracy? I do not think so. I believe instead that the

Where *Blackacre* Appreciates

	§ 2036 <u>Not Applicable</u>	§ 2036 Applies But Offset For Consideration and Imputed Income Thereon
Consideration & income thereon actually in estate (based on an assumed yield of 6% per annum)	\$500,000	\$500,000
Date-of-death value of <i>Blackacre</i>	Not Included	\$700,000
Offset (as described in text)	<u>Not Applicable</u>	<u>(\$500,000)</u>
Net amount included in gross estate	\$500,000	\$700,000

82. See *supra* notes 20-21 and accompanying text.

83. See *United States v. Righter*, 400 F.2d 344, 348 (8th Cir. 1968) (whether a transfer is a "bona fide sale for an adequate and full consideration" can only be decided "at the time of the transfer and cannot be deferred and made to hang on future fortuitous circumstances of longevity and of income"). Cf. Joseph M. Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines*, 43 *Tax L. Rev.* 241, 244 (1988) (transfer tax system should be revised to avoid "reliance on estimates of, or speculation about, future events. . . . Hindsight . . . should be used whenever possible.") *Id.*

Government was using its conceptually flawed position on “adequate and full consideration” to foreclose a tax avoidance opportunity made possible by the then existing valuation rules.

Prior to the enactment of section 2702, taxpayers could structure the transfer of a remainder combined with a retained income interest so that Government’s actuarial tables would substantially overvalue the retained income interest and correspondingly undervalue the remainder.

For example, in the case of a person transferring a remainder interest in trust while retaining a life income interest, the trustee could invest the trust funds in companies that plow their earnings back into their businesses rather than paying them out as dividends. “Growth stocks” in publicly held companies and stock in almost all closely held corporations fall in this category. Retention of a corporation’s earnings, of course, increases the value of its stock thereby ultimately benefiting the trust remaindermen, but by the same token reduces and possibly eliminates altogether the value of a transferor’s retained income interest. Since the Government’s tables assume that all income is being paid to the income beneficiary, using the tables in this case will overvalue the income interest and undervalue the remainder. By investing in these types of stocks, the income that the tables assume is being paid to the income beneficiary is shifted to the remainderman in the form of stock appreciation.

This ability to create disparities between economic value and table value offered an opportunity for tax avoidance. The facts of *D’Ambrosio* provide an excellent illustration.⁸⁴ The decedent and her son were sole shareholders of a corporation.⁸⁵ The decedent, who held noncumulative convertible preferred stock worth \$2,350,000, sold a remainder interest in her stock to the corporation for a private annuity valued at approximately \$1,320,000.⁸⁶ Not a single penny of dividends was paid on this stock during the approximately three years decedent lived following the sale.⁸⁷ Decedent’s retained income interest in the stock provided her with no economic benefit. Nevertheless, the Government surprisingly—maybe shockingly—conceded that the value of her income interest was \$1,030,000.⁸⁸ Correspondingly, the remainder was valued at only

84. The transaction in *D’Ambrosio* occurred before the effective date of § 2702. Decedent’s sale of the remainder occurred in 1987. See *D’Ambrosio v. Commissioner*, 105 T.C. 252, 253, rev’d, 101 F.3d 309 (3d Cir. 1996), cert. denied, 117 S. Ct. 1822 (1997). Section 2702 applies to transfers after October 8, 1990. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602(e)(1)(A)(i), 104 Stat. 1388-1 (1990).

85. See *D’Ambrosio*, 105 T.C. at 253.

86. See *id.* at 253-54. The numbers in the text have been rounded to the nearest \$10,000.

87. See *id.* at 254 n.4.

88. Since the total value of the stock was \$2,350,000, and the stipulated value of the remainder interest was \$1,320,000, the resulting value of the income interest was \$1,030,000.

\$1,320,000 [$\$2,350,000 - \$1,030,000 = \$1,320,000$]. This enabled the estate to argue that the decedent had received “adequate and full consideration” for the remainder, namely the \$1,320,000 annuity, and thus that section 2036 did not apply. Adding “icing on the cake,” the decedent died prematurely after receiving only \$590,000 of annuity payments.⁸⁹

As a result of the taxpayer’s ultimate victory in *D’Ambrosio*, the decedent succeeded in transferring \$2,350,000 of value (the stock’s date-of-death value)⁹⁰ via the corporation to her son (its only other shareholder), while her estate was replenished for this transfer by only \$590,000 of annuity payments. Thus, approximately \$1,760,000 of value was passed to her son *free of all gift and estate tax*.⁹¹ This result was the combined effect of valuing the decedent’s income interest at \$1,030,000, when its economic value to her was effectively zero, and her premature death which caused her to receive only \$590,000 from an annuity valued at \$1,320,000.

Congress enacted section 2702 to prevent results like this. Section 2702 provides that where a person transfers property in trust to or for the benefit of a family member, any interest he retains will be valued at zero for gift tax purposes unless it is a “qualified interest.”⁹² When a person gratuitously transfers property, he makes a taxable gift to the extent the property’s fair market value exceeds the value of any interest he retains.⁹³ Consequently, if he transfers a remainder to a family member while retaining a *nonqualified interest*, his taxable gift will be the full value of the transferred property since his retained interest will be valued at zero. On the other hand, if he retains a qualified interest, his

See *id.* The Tax Court noted that because of the stipulation, it was relieved from deciding “whether Decedent’s reserved life estate in a noncumulative preferred stock from which she received no dividends following the transaction at issue actually had value.” *Id.*

89. *Id.* at 254.

90. See *id.*

91. The approximate amount listed in the text as passing free of estate and gift taxes, \$1,760,000, was computed by subtracting the annuity payments decedent received, \$590,000, from the value of the stock at her death, \$2,350,000. This computation assumes that decedent did not consume any portion of her annuity payments so that they were fully included in her gross estate. Any portion of the payments she consumed would of course reduce the amount included in her gross estate, thereby increasing the net tax savings. Conversely, the amount passing tax free would be reduced to the extent she earned income on her annuity payments that remained unconsumed at the time of her death.

92. IRC § 2702(a)(1), (a)(2)(A).

93. See Regs. § 25.2512-5(d)(2) (“When the donor transfers property in trust or otherwise and retains an interest therein, generally, the value of the gift is the value of the property transferred less the value of the donor’s retained interest.”); Regs. § 25.2702-1(b) (“The amount of the gift, if any, is then determined by subtracting the value of the interests retained by the transferor or any applicable family member from the value of the transferred property.”).

retained interest will be valued in the normal manner under the Government's actuarial table.⁹⁴

The two principal types of qualified retained interests are a qualified annuity interest (a "GRAT interest") and a qualified unitrust interest.⁹⁵ In a GRAT, the holder of the retained interest is entitled to receive annually a fixed dollar amount regardless of the property's actual income or value,⁹⁶ while in a unitrust he is entitled to receive each year a fixed percentage of the property's fair market value (including any accumulated income) determined annually.⁹⁷ In a GRAT, the dollar amount remains fixed while in a unitrust the payout percentage remains fixed.

Qualified interests are designed to frustrate any attempt to shift value from the holder of the retained interest to the remainderman. This is achieved by requiring the trust to pay each year to the holder of the qualified interest either a fixed dollar amount (the annuity amount) or a fixed percentage of the trust's value (the unitrust amount) regardless of the trust's actual income. Thus, even if a trustee invests exclusively in nondividend paying stocks (such as the preferred stock in *D'Ambrosio*), the trust will nonetheless be required to pay each year either the annuity amount or the unitrust amount to the holder of the retained interest. This permits more accurate valuation of the retained interest and precludes the manipulative shifts of value that occurred in *D'Ambrosio*.

Under the regulations, a person who sells a remainder to a family member and retains a *nonqualified* interest (e.g., a common law life estate) is treated as making a gift to the remainderman.⁹⁸ The amount of the gift is the *property's* value less the consideration received for the *remainder*.⁹⁹ In effect, the regulations treat the seller as transferring the entire property (not just the remainder) in exchange for the consideration received. If *D'Ambrosio* occurred today (and the Government again accepted the table values as the true values of the various interests), the decedent, who had retained a nonqualified common law

94. See IRC § 2702(a)(2)(B).

95. See IRC § 2702(b)(1), (2). A noncontingent remainder interest is also a qualified interest if all the other interests in the trusts are either qualified annuity or unitrust interests. See IRC § 2702(b)(3). Moreover, § 2702 does not apply to "regular" personal residence trusts and qualified personal residence trusts. Such a trust consists of the grantor's residence in which he retains either a lifetime or term interest. See IRC § 2702(a)(3)(A)(ii); see Regs. §§ 25.2702-5(b), 25.2702-5(c).

96. See IRC § 2702(b)(1). However, the regulations permit the fixed dollar amount of the distribution to decrease from year to year, see Regs. § 25.2702-3(c), ex. 3, and also permit the amount to increase but by no more than 120% of the annuity amount paid during the preceding year. See Regs. § 25.2702-3(b)(1)(ii)(B).

97. See IRC § 2702(b)(2). The regulations permit the unitrust amount to be increased up to 120% of the unitrust percentage paid for the preceding year. Regs. § 25.2702-3(c)(1)(ii).

98. See Regs. §§ 25.2702-4(a), 25.2702-4(d), ex. 2.

99. See Regs. § 25.2702-4(d), ex. 2.

life estate in the preferred stock, would be deemed to have made a taxable gift of \$1,030,000, that is, the value of her preferred stock, \$3,250,000, less the value of her annuity, \$1,320,000. In one way, this result is harsher than if the decedent had retained the stock outright and bequeathed it to her son, since payment of the tax is accelerated from the date of death to the date of sale.

Enactment of section 2702 should eliminate most, if not all, of the IRS's concerns about possible tax abuses arising under the old valuation rules. Whatever merit the Service's position on adequacy of consideration may once have possessed no longer exists. The Service should now hold that in a simple sale of a remainder, payment of the remainder's actuarial value constitutes "adequate and full consideration."

C. Tax Considerations in Selling a Remainder Today: The Effects of Section 2702 and the Holdings of the D'Ambrosio Trilogy

Because of section 2702, selling a remainder to a family member will be less tax efficient today even if the holdings of the *D'Ambrosio* trilogy are followed. Section 2702 effectively compels a grantor establishing a GRAT¹⁰⁰ to base his annual annuity payment on an interest rate that is at least as high as the rate used under section 7520 in valuing term and remainder interests (the "section 7520 rate"). Otherwise the grantor will be deemed to be making a gift for tax purposes. However, the section 7520 rate will almost invariably be higher than the actual income yield from the trust. Consequently, to avoid a gift tax upon the establishment of a GRAT, the annual payment to the grantor must be set at an abnormally high amount, and these enlarged payments, unless consumed by the grantor, will inflate his gross estate. This phenomenon is best illustrated by a concrete example.

Suppose *P*, aged 55, establishes a trust of \$100,000 in which she reserves a life estate, and sells the remainder interest to her child *C*. If the section 7520 rate at the time is 6%, the present value of the *C*'s remainder will be \$30,473.¹⁰¹ For *P* to avoid gift tax liability on her sale of the remainder, the annual annuity payment she receives from the GRAT must be fixed using an interest rate at least as high as the section 7520 rate. Here that rate is 6% so the GRAT must pay *P* \$6,000 annually [6% of \$100,000]. If the payment were less, only a part of the trust's assumed income of \$6,000 would be considered paid

100. A taxpayer trying to avoid the draconian rule of § 2702(a)(2)(A) valuing retained interests at zero will normally use a GRAT rather than a unitrust if the trust property is expected to appreciate. The annual payments in a unitrust will increase as the trust property appreciates—and thus inflate the transferor's gross estate—while such payments will remain constant in a GRAT.

101. See Actuarial Values, *supra* note 60, Table S (6.0) at 1-20.

out, and the balance would be viewed as retained for future distribution to the remainderman C. The present value of these assumed income accumulations over P's anticipated lifetime would constitute a taxable gift to C.

Section 7520 requires that life estates, remainders and similar interests be valued by assuming an income yield of 120% of the federal midterm rate (i.e., the average market yield on U.S. debt obligations having a remaining maturity of more than three years but no more than nine years).¹⁰² The rub is that this rate will almost invariably exceed the actual income yield from the trust. Almost all trusts invest a significant portion of their funds in stock.¹⁰³ The section 7520 rate however is based on the yields on Government debt securities (augmented by a 20% premium). Since the early 1960s, these yields have consistently exceeded the dividend rates on equities, and hence the section 7520 rate, being keyed to yields on Government securities, will almost invariably exceed the actual income yields of a trust that has a significant investment in stocks.¹⁰⁴

Suppose the actual rate of income realized by the trust in the above example is 4%. Before the enactment of section 2702, there would almost certainly be no gift tax liability if C paid \$30,473 for the remainder (its table value based on an assumed yield of 6%) even though the actual annual income yield was only 4%, i.e., \$4,000.¹⁰⁵ Under current law, the annual GRAT payment

102. See IRC §§ 7520(a), 1274(d)(1).

103. See Robert B. Wolf, *Defeating the Duty to Disappoint Equally—The Total Return Trust*, 32 *Real Prop., Prob. & Tr. J.* 45, 51 (1997) ("most corporate fiduciaries are reluctant to invest less than one-half of their long-term portfolios in equity securities, simply because of the duty of impartiality [as between the income beneficiary and the remainderman] and the historical truth that fixed income investments yield dramatically less in total return over long periods of time").

104. One study found that income returns, as opposed to total returns, on long-term government bonds and intermediate-term government bonds exceeded the income returns on large company stocks every year during the period 1959 through 1995. See Ibbotson Associates, *Stocks, Bonds, Bills, and Inflation 1996 Yearbook* 40-41, Table 2-6. Moreover, the spread has been increasing. In 1959, the spread between the income return on long-term government bonds and large company stock was only 0.70 percentage points (4.01% vs. 3.31%) but by 1995 the spread had increased to 4.69 percentage points (7.60% vs. 2.91%). *Id.* Consequently, it will be virtually impossible for a trust which has a significant stock investment to generate an income yield equivalent to that of government bonds. As of January 1, 1997, intermediate government bonds were yielding about 6.5% while the Standard & Poor's 500 stock index was yielding about 2%. If the portfolio were an even mix of stocks and bonds, the net yield (after charging trustee's fees of 0.35% to income) would be only 3.9%, substantially less than the 6.5% yield on intermediate-term government bonds. See Wolf, *supra* note 103, at 50-51.

105. The rule applied by the courts was that the actuarial tables must be used unless it was shown that their use produces a "substantially unrealistic and unreasonable result, and a more reasonable and realistic means of determining value is available." *O'Reilly v. Commissioner*, 973 F.2d 1403, 1408 (8th Cir. 1992). In *Rev. Rul. 77-195*, 1977-1 C.B. 295, the Service held that the 6% actuarial tables then in effect had to be used in valuing a life estate, even though the trust was funded with stock of a company that had paid an average dividend in

would have to be \$6,000 to avoid gift tax liability, and these enlarged payments in turn will augment *P*'s gross estate.

This enlargement of *P*'s gross estate can be avoided by fixing the annuity payment below the amount determined under the section 7520 rate, but in that case *P* will be deemed to make a taxable gift to *C*. If the annual annuity payment to *P* were fixed at \$4,000 to reflect the trust's actual income, *P* would be deemed to make a taxable gift to *C* of \$23,176.¹⁰⁶ To avoid a taxable gift, *P* would have to charge *C* an additional \$23,176 for the remainder, and this amount (and earnings thereon) would be included in *P*'s gross estate. Alternatively, the trust might invest exclusively in fixed income securities and thereby attempt to match its actual return with the section 7520 rate. This approach however will probably produce inferior investment results, since the economic return on equity investments (income plus appreciation) has historically outperformed the return on debt instruments.¹⁰⁷

In short, selling a remainder today to a family member presents a series of unappealing choices. Nevertheless, selling a remainder can still, in certain cases, produce beneficial tax results if the *D'Ambrosio* trilogy's view of adequate consideration prevails.

each of the preceding 10 years of 3% and the trustee was forbidden to dispose of the stock. See also *Vernon v. Commissioner*, 66 T.C. 484 (1976) (holding that 6% actuarial tables had to be used in valuing life income interest when trust funded with stock paying an average annual yield of 3.75% over preceding seven years despite settlor's nonbinding admonition to trustee not to sell stock). A variation of two percentage points (4% vs. 6%) when the trustee's ability to change investments is unrestricted seems well within the variance permitted by these authorities.

The courts have occasionally rejected use of the tables. See *O'Reilly*, 973 F.2d 1403 (rejecting use of 10% tables in valuing remainder when trust funded with stock historically yielding about 0.2% and trustees relieved of duty to diversify or increase income); *Hanley v. United States*, 105 Ct. Cl. 638 (Ct. Cl. 1945) (rejecting use of 4% tables in case of portfolio yielding 3.09% on valuation date when trustees' reinvestment of funds were restricted to lower-yielding government and municipal bonds).

106. The value of the remainder interest in a GRAT is determined by subtracting the value of the annuity from the principal of the trust. Regs. § 25.2702-1(b); see also Regs. § 1.664-2(c) (valuation of remainder in a charitable remainder trust). Thus:

Value of trust principal	\$100,000
Less value of annuity	<u>46,351</u>
Value of remainder	53,649
Less consideration received	<u>30,473</u>
Amount of gift	\$ 23,176

The value of the annuity was determined by multiplying the annual annuity payment, \$4000, by the factor for a lifetime annuity of a person aged 55 when the interest rate is 6%, 11.5878. See Actuarial Values, *supra* note 60, Table S (6.0) at 1-20. All figures rounded to the nearest dollar.

107. See *Wolf*, *supra* note 103, at 57-60.

1. *Sales of Remainders in High-Growth Properties to Family Members.*—If the holdings of the *D'Ambrosio* trilogy are followed, sales of a remainder in a GRAT to a family member can be tax advantageous where the economic growth in the trust property (this is, its income plus appreciation) exceeds the section 7520 rate.¹⁰⁸

In that case, only a portion of the GRAT's growth will be used to fund the annual annuity payments to the grantor. The balance will be kept in the trust and will pass to the remainderman upon the trust's termination. If the remainderman paid full actuarial value for his remainder interest, there will be no gift tax on the establishment of the trust, and under the holdings of the *D'Ambrosio* trilogy, no estate tax at the grantor's death.¹⁰⁹ Since the GRAT will be excluded from the grantor's gross estate, the portion of the growth not used to fund the annual annuity payments passes to the remainderman free of any transfer tax.¹¹⁰

The actual reduction in the grantor's gross estate—and thus the tax benefit of this strategy, if any—depends not only on the rate of growth in the GRAT property, but also on the offsetting *increases* in the grantor's gross estate resulting from her receipt of consideration from the sale of the remainder, her annuity payments, and any growth on those amounts.¹¹¹

108. See Lawrence P. Katzenstein, *Economic and Valuation Planning Opportunities: GRITS, GRATS, GRUTS and QRPTS*, SB90 ALI-ABA 1221 (1997). Mr. Katzenstein points out that if the GRAT's rate of economic growth exceeds the § 7520 rate, the grantor will be able to transfer the excess amount to family members without transfer tax cost. See *id.* at 1223-27. See also Jonathan G. Blattmachr & Georgiana J. Slade, *Partial Interests—GRATs, GRUTs, QRPTs* (Section 2702), 836 *Tax Mgmt.* (BNA) § IV.F.2. at A-42 (1996) (noting that GRAT is effective transfer tax technique only where GRAT earns more than the applicable § 7520 rate).

109. See *supra* notes 33-35 (gift tax), and 7-9 (estate tax).

110. Assume *M*, having a life expectancy of five years, establishes a GRAT with property having a value of \$100,000 when the § 7520 rate is 6%; fixes the annual annuity payment at \$6,000 (based on the § 7520 rate of 6%); and sells the remainder interest therein to *N*, a family member, for its actuarial value of \$74,726. Actuarial Values, *supra* note 60, Table B (6.0) at 3-10. Assume that *M* exactly lives out her life expectancy of five years and that the GRAT property realizes economic growth of 15% during that period. Because the annuity payments remained fixed at \$6,000 while the actual economic growth in the GRAT was 15%, the GRAT will have grown from \$100,000 when *M* created it, to \$160,682 when she died—an increase in value of \$60,681:

Year	Value of GRAT at year-beginning	Growth in value of GRAT during year	Annuity payment during year	Value of GRAT at year-end
1	\$100,000	\$15,000	(\$6,000)	\$109,000
2	109,000	16,350	(6,000)	119,350
3	119,350	17,903	(6,000)	131,253
4	131,253	19,688	(6,000)	144,940
5	144,941	21,741	(6,000)	160,681

111. For example, assume in the case described in the preceding footnote that *M* realized a 10% growth rate on the consideration she received for the remainder (i.e., \$74,726)

An obvious risk in this strategy is that the economic growth in the GRAT property may fail to exceed the section 7520 rate; indeed, it is always possible that the GRAT property may experience a loss. If so, the strategy may boomerang, since the amount removed from the grantor's gross estate (i.e., the value of the GRAT upon the grantor's death) is likely to be *less* than the amount added back to her gross estate by the consideration received for the remainder, the annuity payments, and any growth in these amounts.

Nevertheless, taxpayers who are convinced that the total economic return on the underlying property will significantly outpace the section 7520 rate may want to consider selling a remainder to a family member. If they live outside the Third, Fifth or Ninth Circuits, they must also assess the likelihood of their circuit following the holdings of the *D'Ambrosio* trilogy. Moreover, their planners will need to determine how to fund the annual annuity payments since income alone will probably be insufficient to cover them.

2. *Sales of Remainders to Nonfamily Members.*—Section 2702 applies only to transfers made to or on behalf of a member of the transferor's family.¹¹² "Member of the family" is broadly defined as meaning the transferor's ancestors and lineal descendants and those of his spouse, the transferor's siblings, spouses of the foregoing persons, and the transferor's own spouse.¹¹³ Although

and on her annual \$6000 payments from the GRAT. In that case, the reduction in *M's* gross estate would be \$44,158 rather than the \$60,681 appreciation in the value of the GRAT:

Amount in *M's* gross estate if she retains property instead of selling remainder:

Value at <i>M's</i> death of property (i.e., \$100,000 compounded annually at 15% for 5 years)	\$201,136
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Amount in *M's* gross estate if she creates GRAT and sells remainder therein:

Value at <i>M's</i> death of consideration received for remainder + growth thereon (i.e., \$74,726 compounded annually at 10% for 5 years)	\$120,347
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<i>Plus</i> value of annuity payments + growth thereon (i.e., \$6,000 annual payments compounded annually at 10%)	<u>36,631</u>
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Value at <i>M's</i> death of property replacing remainder	<u>156,978</u>
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Net reduction in <i>M's</i> gross estate by selling remainder	44,158
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Note that the *actual* period that the decedent lives after the sale of the remainder will also affect the amount of the reduction, if any, in her gross estate.

112. See IRC § 2702(a)(1).

113. IRC §§ 2702(e), 2704(c)(2).

comprehensive, this definition omits the transferor's nephews, nieces, cousins, their respective descendants, as well as any unmarried "significant other" of the transferor.

A taxpayer may therefore sell a remainder to any of these persons (or any other non-family member) and retain a nonqualified interest (e.g., a common law life estate) in the property without triggering section 2702. The great advantage of avoiding section 2702 is that both the seller's retained interest and the remainder will be valued in the normal fashion using the applicable section 7520 rate. Indeed, according to the Regulations, the section 7520 rate is to be used *regardless* of the trust's actual income yield so long as the income beneficiary may compel the trustee to "make the trust corpus productive consistent with income yield standards for trusts under applicable state law."¹¹⁴ This is so even if the state-mandated minimum yield is "substantially below the section 7520 interest rate" on the valuation date.¹¹⁵

These rules provide an opportunity for transferring value to nonfamily members free of transfer tax. If the owner of a property sells a remainder interest therein to a nonfamily member for the remainder's present value (as computed by using the section 7520 rate), there will be no gift tax at the time of the sale, and under the *D'Ambrosio* trilogy holdings, no estate tax when the owner dies.¹¹⁶ However, if—as is usually the case—the section 7520 rate exceeds the trust's actual income yield,¹¹⁷ the income interest will be overvalued and the remainder undervalued.¹¹⁸ This "bargain element" in the sale of the remainder passes free of all gift and estate tax to the remainderman.

3. Sales of Remainders by Persons Who Are Ill, But Not Too Ill, for Private Annuities.—At first glance, it would seem that one *in extremis* could

114. Regs. § 20.7520-3(b)(2)(v), ex. 2. The gift tax regulations contain a comparable provision. Regs. § 25.7520-3(b)(2)(v), ex. 2.

115. See Regs. § 20.7520-3(b)(2)(v), ex. 2. These regulations appear to assume a degree of specificity concerning "income yield standards for trusts under applicable state law," *id.*, which does not exist. The Restatement of Trusts recognizes a "fiduciary duty to make the trust estate productive of trust accounting income." Restatement (Third) of Trusts § 227 cmt. i. (1990). However, the amount of income which the trustee must try to generate is dependent on the "trust's circumstances and terms." *Id.*

To assure the applicability of the actuarial tables, it may be advisable to explicitly grant the income beneficiary the right to compel the trustee to make the trust corpus "productive consistent with income standards for trusts under applicable state law." However, to the extent the income beneficiary fails to exercise this right, he may be deemed to have made a taxable transfer of the amount he was entitled to, thereby possibly triggering gift and estate tax liability. Cf. *Dickman v. Commissioner*, 465 U.S. 330 (1984). Given the vague nature of state law on this subject, this possibility appears highly unlikely except in the most egregious cases.

116. See *supra* notes 33-35 (gift tax), and 7-9 (estate tax).

117. See *supra* notes 103-04 and accompanying text.

118. See discussion *supra* Part III B.

dramatically reduce his gross estate by selling a remainder in his property for an annuity having the same actuarial value as the remainder. Because of the seller's foreshortened life, the actuarial tables will overvalue his retained income interest and correspondingly undervalue the remainder. This, in turn, will permit the remainder to be sold for less than its true worth and yet be considered sold for "adequate and full consideration." Furthermore, because the seller lives for a shorter period than indicated by the actuarial tables, the amount he receives under his annuity (and thus the amount included in his gross estate) will be less than the annuity's actuarial value.

To prevent this windfall, the regulations under section 7520 proscribe use of the Government's actuarial tables where the person whose interest is being valued "is known to have an incurable illness or other deteriorating physical condition" on the valuation date and "there is at least a 50 percent probability that the individual will die within 1 year."¹¹⁹ The corollary is that the tables will, indeed *must*, be used where the individual has more than a 50% chance of surviving a year.¹²⁰ Apparently this is so even if his poor health makes it unlikely that he will live out his full actuarial life expectancy.

A person in this condition (i.e., in poor health but having a more than a 50% chance of surviving one year) can reduce his gross estate by selling a remainder interest in his property for a private annuity having the same actuarial value as that of the remainder, provided he fails to live out his full life expectancy. Since the actuarial values of the annuity and the remainder are equal, the sale will be for "adequate and full consideration." Thus there will be no gift tax liability, and under the *D'Ambrosio* trilogy holdings, no estate tax.¹²¹ Any amounts the seller receives under the annuity (and any income thereon) which remain unconsumed at death will be included in his gross estate, but because of his shortened life, these amounts should be significantly less than the value eliminated from his estate.

4. *Sale of a Remainder in a Residence to a Family Member.*—A transfer of a remainder interest in a trust whose sole asset consists of the income beneficiary's residence (a "personal residence trust") is exempt from the

119. Regs. § 25.7520-3(b)(3) (gift tax regulations). If the individual survives by 18 months or longer after the gift is completed, he is presumed not to have been terminally ill on that date "unless the contrary is established by clear and convincing evidence." *Id.* The estate tax regulations have a comparable provision that contains certain exceptions not found in the gift tax regulation. See Regs. § 20.7520-3(b)(3) (estate tax regulations).

120. See Regs. §§ 20.7520-1(a)(1), 25.7520-1(a)(1).

121. See *supra* notes 33-35 (gift tax), and 7-9 (estate tax). If the sale is to a family member, the seller must retain a qualified interest to avoid having it treated as a gift. See IRC § 2702(a).

provisions of section 2702.¹²² The regulations provide that the transfer of a remainder interest in a “qualified personal residence trust” (a “QPRT”), which is similar to a personal residence trust but more flexible, is also exempt.¹²³ Therefore, the regular valuation rules will prevail, and if the remainder is sold for its actuarial value, there will be no gift tax liability, and under the holdings of the *D'Ambrosio* trilogy, no estate tax.

The sale of a remainder interest in a personal residence trust or a QPRT will be an attractive option where the value of the residence is expected to appreciate at a greater rate than the return on the reinvested sales proceeds.

IV. THE EFFECT OF THE *D'AMBROSIO* TRILOGY ON SPOUSAL ELECTIONS

A. Tales of Tax Avoidance

The spousal election technique offers opportunities for substantial transfer tax savings, particularly if the holdings of the *D'Ambrosio* trilogy extend to this technique. Consider the following cases.

1. *The Untutored Estate Plan*.—*H* and *W*, who live in a community property state, have each decided to leave their respective shares of the community in trust, with income payable to the survivor for life and principal passing to their child *C* upon the survivor's death. A scrivener, lacking in tax sophistication, prepares wills implementing this plan. *H* predeceases *W*, and at the time of his death, each spouse's share of the community is worth \$1,000,000. At *W*'s death, the value of her property has increased to \$1,500,000.

Assuming that *H*'s executor forgoes a QTIP election¹²⁴ so as to equalize the two estates, the tax consequences will be as follows:

122. IRC § 2702(a)(3)(A)(ii). The specific requirements for qualifying as a “personal residence trust” are set out in Regs. § 25.2702-5(b).

123. The requirements for qualifying as a QPRT are set out in Regs. § 25.2702-5(c). A QPRT has been summarized as follows:

A qualified personal residence trust must satisfy the general requirements applicable to a regular personal residence trust, but is permitted (1) to hold cash and other assets that are related to the residence; (2) to sell the residence and reinvest the proceeds in another residence; (3) to receive or make improvements to the residence; and (4) to be converted into a qualified annuity trust. As a result of its flexibility, a qualified personal residence trust, rather than a regular personal residence trust, generally will be used by taxpayers wishing to avoid Section 2702.

Richard B. Stephens et al., *Federal Estate and Gift Taxation* ¶ 19.03[3][d][iii] (7th ed. 1996) (footnotes omitted).

124. *H*'s executor could elect under § 2056(b)(7) to treat his bequest as “qualified terminable interest property” (i.e., “QTIP”) and thus qualify for the marital deduction, since *W* has a “qualifying income interest for life.”

CASE 1

<i>H</i> 's Estate:	\$1,000,000 less the \$650,000 exclusion amount (§ 2010) ¹²⁵	\$350,000
<i>W</i> 's Estate:	\$1,500,000 less the \$650,000 exclusion amount (§ 2010)	<u>850,000</u>
Total value of property subject to transfer tax		\$1,200,000

2. *The Spousal Election Will as an Estate Tax Saving Plan.*—In this scenario, *H* and *W* go to a sophisticated tax planner who proposes a plan having the same testamentary effect as the plan in Case 1 but with significant transfer tax savings. Under his plan, *each* spouse leaves *all* of the community property (including the other spouse's share) in trust with income payable to the survivor for life and principal payable to *C* on the survivor's death. This, of course, gives the survivor a spousal election. *H* and *W* enthusiastically adopt this plan because of its purported tax benefits and because it carries out their dispositive wishes.

H dies first, and *W* elects to let her share of the community pass under *H*'s will into *W Trust*. As in Case 1, each spouse's share of the community at the time of *H*'s death is worth \$1,000,000, and *W*'s share (which is now in *W Trust*) grows to \$1,500,000 by the time of her death. The transfer tax consequences will depend on the absolute and relative values of *W*'s life estate in *H Trust* and *C*'s remainder in *W Trust*.

a. *Where W's Life Estate in H Trust is Worth Less Than C's Remainder in W Trust.*—Assume that at *H*'s death the present value of *W*'s life estate in *H Trust* is \$400,000 and that the present value of *C*'s remainder in *W Trust* is \$600,000.

For gift tax purposes, *W* is treated as exchanging the remainder interest in *W Trust* for the income interest in *H Trust*.¹²⁶ Consequently, she will be deemed to make a gift of \$200,000, that is, the value of the remainder she gives to *C* in *W Trust*, \$600,000, less the income interest she receives in *H Trust*, \$400,000.

The method for determining the estate tax effect of the election is less certain. Under *Gradow*, *W*'s transfer of a remainder to *C* in *W Trust* would not be supported by adequate consideration, since the value of her life estate in *H Trust* (i.e., the consideration she received for setting up *W Trust*) is less than the value of her property she allowed to pass into *W Trust*.¹²⁷ The *D'Ambrosio*

125. The "exclusion amount" is the amount of wealth that may be transferred without transfer tax by reason of the unified credit. See IRC §§ 2010 & 2505. The exclusion amount for 1999, \$650,000, is used in the examples throughout this article. The exclusion amount is scheduled to increase over a nine-year period and ultimately to reach \$1,000,000 in the case of estates of decedents dying in 2006 and thereafter. See IRC § 2010(c).

126. See *supra* notes 33-35 and accompanying text.

127. See *supra* notes 23-31 and accompanying text.

trilogy courts *arguably* would find the consideration adequate so long as *W's* life estate in *H Trust* equals or exceeds the value of the remainder she transferred to *C* in *W Trust*.¹²⁸ However, the result here is the same regardless of which test is used. The consideration received, *W's* \$400,000 life estate in *H Trust*, is inadequate whether measured against the value of the remainder *W* surrendered, \$600,000, or the full value of the property she let pass into *W Trust*, \$1,000,000. However, *W's* estate is entitled to reduce *W's* gross estate by the value of her life estate in *H Trust* (i.e., the \$400,000 consideration *W* received), pursuant to section 2043.

Ignoring for the time being the effect of section 2702, and assuming again that *H's* executor forgoes a QTIP election, the transfer tax results will be as follows:

CASE 2		
<i>H's</i> Estate:	\$1,000,000 less the \$650,000 exclusion amount (§ 2010)	\$350,000
<i>W's</i> Gift	\$600,000 (<i>C's</i> remainder in <i>W Trust</i>) less \$400,000 (<i>W's</i> life estate in <i>H Trust</i>) and less \$200,000 of the exclusion amount (§ 2505)	-0-
<i>W's</i> Estate:	\$1,500,000 less \$400,000 consideration (§ 2043) and less the \$650,000 exclusion amount (§ 2010) ¹²⁹	450,000
Total value of property subject to transfer tax:		\$800,000

Behold the magic wrought by the tax planner! By using a spousal election, the planner has reduced the total amount subject to transfer tax by \$400,000 while producing nearly the same testamentary result as in Case 1.

b. *Where W's Life Estate in H Trust is Worth More Than C's Remainder in W Trust.*—Assume that the value of *C's* remainder in *W Trust* is \$400,000 and *W's* income interest in *H's* estate is \$600,000. Even if *Gradow* is still good law, the result will probably be better than in Case 2, simply because the increased value of *W's* life estate (\$600,000 vs. \$400,000) should produce

128. See *supra* notes 41-54 and accompanying text.

129. *W's* estate is entitled to the full benefit of the "estate tax" exclusion amount even though a part of the "gift tax" exclusion amount was used to determine the portion of *W's* gift (i.e., *C's* remainder in *W Trust*) that was subject to gift tax. That gift is not an "adjusted taxable gift" within the meaning of § 2001(b), since the full value of the underlying property will be included in *W's* gross estate pursuant to § 2036. See IRC § 2001(b) (last sentence). Accordingly, the gift is not included under § 2001(b)(1)(B) in the computation of *W's* estate tax and therefore does not "absorb" any part of the \$650,000 "estate tax" exclusion amount.

a corresponding larger offset under section 2043. If so, the tax results, again assuming *H's* executor does not make a QTIP election and again ignoring the effect of section 2702, will be as follows:

CASE 3

<i>H's</i> Estate:	\$1,000,000 less the \$650,000 exclusion amount (§ 2010)	\$350,000
<i>W's</i> Gift	\$400,000 (<i>C's</i> remainder in <i>W</i> <i>Trust</i>) less \$600,000 (<i>W's</i> life estate in <i>H Trust</i>)	-0-
<i>W's</i> Estate:	\$1,500,000 less \$600,000 consideration (§ 2043) and less the \$650,000 exclusion amount (§ 2010)	<u>250,000</u>
Total value of property subject to transfer tax:		\$600,000

The above computation assumes that the \$200,000 increase in the value of *W's* life estate (from \$400,000 to \$600,000) results in a corresponding increase in the section 2043 offset. This can be disputed. If one views *H's* estate as having “sold” *W* a life estate in *H Trust* in exchange for her gift of a remainder to *C* in her property, *H's* estate has transferred something worth \$600,000 (i.e., *W's* life estate in *H Trust*) but received something worth only \$400,000 (i.e., *C's* remainder in *W Trust*). One may argue that only \$400,000 of the \$600,000 value of *W's* life estate should be viewed as “consideration” paid by *H's* estate, since that is the only value *H's* estate received for its money.¹³⁰ Under this view, the remaining \$200,000 would be treated as a bequest from *H* to *W*.¹³¹ If this analysis is adopted, the total amount subject to transfer tax will be \$400,000—the same as when *W's* life estate in *H Trust* was worth only \$400,000 (Case 2)—since the section 2043 offset is limited to the actual consideration paid.

However, the underlying rationale of the *Gradow* line of cases strongly supports the contrary result. Those cases measure the *adequacy* of the consideration *W* receives (i.e., her life estate in *H Trust*) by comparing it to the value of the property she transfers into *W Trust*.¹³² This implicitly views *W's* life estate in *H Trust* as “consideration,” not only for the remainder *W* gives to *C*, but also for all of the property she transfers into *W Trust*. If so, the entire value of

130. See Johanson, *supra* note 71, at 1307-09.

131. See Herbert E. Schwartz & Alan D. Liker, *The Widow's Election*, 1 Univ. Miami Inst. Est. Plan., ch. 67-10, ¶ 67.1032 (1967) (“The typical approach to an exchange by related parties of property of unequal values . . . is to presume—for income as for gift tax purposes—that the party receiving the smaller consideration has made a gratuitous transfer.”).

132. See sources cited *supra* note 6.

W's life estate will count as "consideration" for purposes of the section 2043 offset, since *H's* estate has received something (i.e., the entire amount *W* permitted to pass into *W Trust*) having more value than what it gave up (i.e., *W's* life estate in *H Trust*). There are some suggestions in the case law supporting this result.¹³³

Consequently, if *Gradow* is still good law, the result where *W's* life estate in *H Trust* is worth more than *C's* remainder in *W Trust*, will be at least as good—and likely better—than where the values of the life estates and remainders are reversed.

But if the *D'Ambrosio* trilogy has effectively overruled *Gradow*, the tax saving becomes astounding. In that case, section 2036 will no longer apply and hence no part of *W Trust* will be included in her gross estate, since *W's* transfer of the remainder in *W Trust* (value: \$400,000) to *C* in return for her life estate in *H Trust* (value: \$600,000) will be for "adequate and full consideration."

CASE 4

<i>H's</i> Estate:	\$1,000,000 less the \$650,000 exclusion amount (§ 2010)	\$350,000
<i>W's</i> Gift	\$400,000 (<i>C's</i> remainder in <i>W Trust</i>) less \$600,000 (<i>W's</i> life estate in <i>H Trust</i>)	-0-
<i>W's</i> Estate:	Nothing included under §2036	<u>-0-</u>
Total value of property subject to transfer tax:		\$350,000

Note that without significantly changing the final dispositive result, use of a spousal election has reduced the amount subject to transfer tax by \$850,000 from what it would have been under the untutored plan. The results of Cases 1–4, based on existing law, are summarized below:

133. See *United States v. Past*, 347 F.2d 7, 13-16 (9th Cir. 1965) (allowing a § 2043 offset for the full value of *W's* life estate in *H Trust*, even though under its figures the life estate's \$143,000 value exceeded the \$101,000 value of *C's* remainder in *W Trust*); see also *supra* note 22 for a further discussion of *Past*; cf. *Gradow v. United States*, 11 Cl. Ct. 808, 810 (1987), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990) ("Case law generally supports the conclusion that . . . [the § 2043] offset includes the actuarial value . . . of a life estate in [*H's*] share.").

	Total amount <u>Subject to transfer tax</u>
The Untutored Plan (Case 1)	\$1,200,000
The Spousal Election:	
W's life estate in <i>H Trust</i> [\$400,000] < C's remainder in <i>W Trust</i> [\$600,000] (Case 2)	\$800,000
W's life estate in <i>H Trust</i> [\$600,000] >C's remainder in <i>W Trust</i> [\$400,000]; <i>Gradow</i> still good law (Case 3)	Probably \$600,000 (but no more than \$800,000)
W's life estate in <i>H Trust</i> [\$600,000] >C's remainder in <i>W Trust</i> [\$400,000]; <i>D'Ambrosio</i> trilogy overrules <i>Gradow</i> (Case 4)	\$350,000

3. Modifications to Avoid Section 2702; the Marital Deduction; and Emergency Needs of the Surviving Spouse

a. *Section 2702*.—Section 2702 applies to the typical spousal election, because *W*, by allowing her share of the community to pass to *W Trust*, is transferring property in trust for the benefit of a family member, *C*, while retaining an interest for herself. If the draconian valuation rule of section 2702(a)(2)(A) applies, *W* will be deemed to have made a gift of the entire value of *W Trust*—not just the remainder—to the extent it exceeds the value of her life estate in *H Trust*. Hence the estate tax savings resulting from the spousal election will be eroded by *W*'s increased gift tax liability.

H can avoid this result by giving *W* a qualified annuity interest in *W Trust*, thereby making it a GRAT.¹³⁴ *W*'s interest will then be valued in accordance with the normal actuarial tables (rather than arbitrarily at zero), and the value of *C*'s remainder will be limited to the remaining value of the property *W* transfers into *W Trust*.¹³⁵ The downside is that a GRAT invariably results in larger annual payments to *W* than a common law life estate, and these increased payments, if not consumed, will increase the size of *W*'s gross estate.¹³⁶

134. Although § 2702(a)(2)(A) can be avoided if *W Trust* is structured either as a unitrust or a GRAT, *W* should normally retain a qualified annuity interest where the trust property is expected to appreciate in value. This is because *W*'s annual payments in a unitrust will increase as the value of the trust property appreciates—and thus inflate her gross estate—while such payments will remain constant in a GRAT despite any appreciation.

135. See IRC § 2702(a)(2)(B), (b)(1).

136. See *supra* notes 102-07 and accompanying text.

However, this effect can be limited to *W Trust*, since there is no need to make *H Trust* a GRAT.¹³⁷

If the value of *W's* life estate in *H Trust* exceeds the value of the remainder she gives to *C*, the resulting tax savings will almost always exceed the disadvantage caused by the increased payments to *W* (assuming that the *D'Ambrosio* trilogy holdings govern spousal elections). In that case, section 2036 will not apply since *W* will have received "adequate and full consideration" for her transfer. This not only reduces the total amount subject to transfer tax, but in many cases "frees up" *W's* unified credit. This was the situation in Case 4 above, where use of the spousal election reduced the amount subject to transfer tax by \$850,000, but also freed up *W's* entire unified credit. *W* can use this "newly-liberated" unified credit to shelter gifts or testamentary dispositions of the increased distributions she receives from *W Trust* and any noncommunity property she possesses. Even if the value of *W's* separate (i.e., noncommunity) property exceeds the exclusion amount, so that her unified credit is not "freed up," the estate tax savings of excluding *W Trust* from *W's* gross estate will be substantial. Moreover, *W* can always use her annual exclusion (if she is not otherwise doing so) to rid her estate of any unconsumed distributions from the GRAT.

The benefits of this approach will not be as great if *W's* life estate in *H Trust* is worth less than the remainder she gives to *C*. Then section 2036 will apply, and *W's* estate's only consolation will be a section 2043 offset equal to the value of *W's* life estate in *H Trust* computed as of *H's* death. This approach will nevertheless be attractive if *H* intends to give *W* all of his income from his estate in any event. Then the allowance of the section 2043 offset is a pure "freebie."¹³⁸ This was the situation in Case 2 above where adoption of the spousal election approach reduced the total amount subject to transfer tax by \$400,000. This saving will help offset any enlargement of *W's* estate caused by the increased annual payments from the GRAT (i.e., *W Trust*).

137. Ironically, § 2702 is not used to value the consideration *W* receives in a spousal election (i.e., her interest in *H Trust*) but is used to value the property she transfers in the same transaction (i.e., the remainder in *W Trust*). This result seems compelled by the statute's language. Section 2702 applies to "any interest in . . . trust retained by the transferor or any applicable family member." IRC § 2702(a)(1) (emphasis added). Neither the decedent *H* nor his estate is retaining any interest in the property transferred to *H Trust*. Likewise, *W*, an "applicable family member" of *H* while he was alive, is not "retaining" any interest in the property transferred to *H Trust*, since she had no interest in that property prior to the transfer. See Regs. § 25.2702-2(d), ex. 3.

138. It will not be a "freebie" if *H* would otherwise have directed that some or all of the income from his property be paid to another beneficiary during *W's* life. For example, *H* may feel that *W* has sufficient income from her own property and that any additional income will only inflate her taxable estate. He may also wish to minimize the overall income tax burden by having income from his property spread among multiple beneficiaries who may be in a lower tax bracket than *W*. *H's* use of the spousal election technique precludes these tax savings.

Moreover, the trustee of *H Trust* can, within reason, offset the effect of excessively high distributions from *W Trust* by adopting a “high growth-low income” investment strategy for *H Trust*. This is possible because *H Trust* need not be a GRAT or a unitrust and therefore is not subject to the payout requirements of those interests. If, for example, the section 7520 rate (and hence the rate for computing the fixed annuity amount payable from *W Trust*) is 6% at the time of *W*’s election and the prevailing income yield in trusts is then 4%, the trustee may be able to reduce (and even eliminate) the effect of the high payouts from *W Trust* by investing the funds of *H Trust* in growth stocks yielding 2-3%. This strategy would be particularly attractive if *H*’s executor did not make a QTIP election for *H Trust*. Then any increase in the value of the principal of *H Trust* resulting from the “high growth-low income” investment strategy will pass tax free at *W*’s death. Conversely, any invasion of principal in *W Trust* occasioned by the need to fund *W*’s high fixed payments from that trust will reduce any amount taxable at her death.

This strategy will not reduce the value of *W*’s interest in *H Trust* (and thus the section 2043(a) offset), provided the beneficiary can compel the trustee “to make the trust corpus productive consistent with income yield standards for trusts under applicable state law.”¹³⁹ This is so even if the state minimum yield is “substantially below the section 7520 interest rate on the valuation date.”¹⁴⁰

b. *The Marital Deduction.*—In the above cases, we assumed that *H*’s executor did not make a QTIP election. That is often advisable where *W*’s life estate in *H Trust* is worth less value than the remainder she gave *C* in her property. In that case, *W* has not received full consideration for her transfer, section 2036 will apply, and *W Trust* (less the section 2043 offset) will be included in *W*’s gross estate. If *H*’s executor makes a QTIP election, both the portion of *H Trust* for which the election was made and *W Trust* (less the offset) will be included in *W*’s gross estate,¹⁴¹ and the resultant “bunching” will push up the effective estate tax rate under the progressive rate schedule. On the other hand, if *H*’s executor does not make a QTIP election, these amounts will be split between the two estates and may result in a lower aggregate tax.¹⁴² A frequent

139. Regs. § 25.7520-3(b)(2)(v), ex. 2. See also *supra* notes 114-15 and accompanying text.

140. Regs. § 25.7520-3(b)(2)(v), ex. 2.

141. See IRC § 2044(a), (b)(1)(A) (property for which QTIP election was made is included in surviving spouse’s gross estate).

142. On the facts of Case 2, see *supra* pages 571-72, the decision of *H*’s executor not to make a QTIP election reduced the aggregate amount of taxes paid by the two estates. The marginal tax rates for *H*’s taxable estate (\$1,000,000) and *W*’s taxable estate (\$1,100,000) were 39% and 41% respectively. Had *H*’s executor made a QTIP election, no tax would be due at *H*’s death, but the marginal tax rate on *W*’s taxable estate (now increased to \$1,450,000) would have been 43%. These figures assume that *H*’s executor made the QTIP election for only the portion

reason for avoiding estate equalization is *H's* desire to maximize *W's* income.¹⁴³ Where no QTIP election is made, estate tax will be due at *H's* death, thereby diminishing the amount of principal available for generating income for *W*. However, this should be less of a concern if *W Trust* is in the form of a GRAT and *W* is therefore receiving an extraordinarily high return from that trust. Moreover, equalizing the estates will often result in more wealth passing to the next generation.¹⁴⁴

On the other hand, *H's* executor should make a QTIP election where *W's* life estate is worth more the remainder she gives to *C*, assuming the *D'Ambrosio* trilogy holdings apply to spousal elections. Then section 2036 will not apply and *W Trust* will not be included in *W's* gross estate. In this situation, a QTIP election provides the benefits of tax deferral without any offsetting disadvantages. *H's* executor will be able to make a QTIP election so long as *W* is entitled to all of the income from *H Trust*.¹⁴⁵ This can be accomplished by structuring *H Trust* either as a common law life estate or even as a GRAT, provided in the latter case that *W* is assured of the *greater* of the fixed annual payout amount or the trust's income.¹⁴⁶ The size of the marital deduction, however, will be reduced by the value of the remainder *W* is required to give *C* to obtain her life income interest in *H Trust*.¹⁴⁷

c. *Emergency Needs of W.*—*H* may wish to guard against the possibility of *W's* receiving too little, for example, where an unexpected emergency occurs. *H* can achieve this objective without tax detriment by giving

of the *H Trust* not sheltered by the unified credit, and that *H Trust*, unlike *W Trust*, did not appreciate in value. If *H Trust* appreciates, the case for estate equalization is strengthened. The effect of the credit for state death taxes was disregarded.

To achieve equalization of the estates, one must take into account various other factors including the amount of noncommunity property owned by the respective spouses, the rate of growth in the value of *W's* property, and the maximum marital deduction that *H's* estate can take under *United States v. Stapf*, 375 U.S. 118 (1963).

143. See, e.g., *McDaniel et al.*, supra note 61, at 689 (listing as an advantage of maximum tax deferral "provision of a larger pool of assets specifically dedicated to the support of the surviving spouse").

144. See *id.* at 688-89 ("[I]f the aim is to maximize the amount passing to the next generation and a constant rate of growth is projected, equalization as a strategy may be the better choice.").

145. IRC § 2056(b)(7) permits QTIP elections for property in which the surviving spouse possesses a "qualifying income interest for life," which requires among other things that the surviving spouse be "entitled to all the income from the property," payable at least annually for life. IRC § 2056(b)(7)(B)(i), (ii).

146. See Regs. § 25.2702-3(b)(1)(iii) (paying the annuitant income in excess of the fixed annuity payment does not disqualify the retained interest as a "qualified annuity interest," but the right to receive such excess is not considered in valuing such interest).

147. See *United States v. Stapf*, 375 U.S. 118, 127 (1963).

the trustee a *discretionary* power to invade the principal of *H Trust* on *W's* behalf.¹⁴⁸ He can also give *W* a power to invade the principal of *H Trust* limited to an ascertainable standard relating to her health, education, support or maintenance. Although this is a “power of appointment,” it is not a *general* power of appointment.¹⁴⁹ Hence, *W's* release of the power will not be a taxable gift nor will her retention of it until death cause *H Trust* to be included in *W's* gross estate.¹⁵⁰ Although this type of power undoubtedly enhances the value of *W's* interest in *H Trust*, it would normally not count in determining the value of the consideration *W* received for purposes of the section 2043 offset or the section 2036 exclusion, since a power that is contingent upon this type of future unknown event (e.g., sickness) cannot be actuarially valued.¹⁵¹

H can also give *W* a noncumulative power to withdraw each year from *H Trust* the greater of \$5,000 or 5% of its principal (a “5 and 5 power”). *W* will not be treated as making a taxable gift if she allows it to lapse.¹⁵² However, any amount *W* could have withdrawn at her death under an *unlapsed* power will be included in her gross estate.¹⁵³ A 5 and 5 power can be actuarially valued.¹⁵⁴ Consequently, giving *W* this power in *H Trust* should increase the value of her life estate, and hence the section 2043(a) offset, and also make it more likely that *W's* estate will satisfy the “adequate and full consideration” exception to section 2036.¹⁵⁵

On the other hand, *H* should not give *W* or the trustee any power over the principal of *H Trust*. *H* should be particularly wary of giving *W* a power to

148. Sections 2036 through 2038 will not apply because *W* is not the “transferor” of *H Trust*; Section 2041 will not apply because *W* had no power over *H Trust* at her death.

149. See IRC §§ 2041(b)(1)(A), 2514(c)(1).

150. Section 2514(b) treats only the exercise or release of a *general* power as a “transfer” of property by the power holder, and § 2041(a)(2) only includes in the gross estate property over which the power holder held a *general* power at the time of his death.

151. Cf. *Robinette v. Helvering*, 318 U.S. 184 (1943). In *Estate of Pardee v. Commissioner*, 49 T.C. 140 (1967), the court refused to value the effect of a divorce court’s continuing power to increase decedent’s support obligation if the need arose, because any such increase was “dependent upon a contingency beyond decedent’s control.” *Id.* at 149.

152. See IRC § 2514(e).

153. See IRC § 2041(a)(2).

154. See, e.g., Rev. Rul. 79-211, 1979-2 C.B. 319 (value of decedent’s 5 and 5 power, as determined “[o]n the basis of recognized actuarial principles,” qualified for credit for tax on prior transfers under § 2013(a)).

155. Professor Johanson asserts that a 5 and 5 power should not be counted in computing the value of *W Trust* since there is no certainty that *W* will exercise it. See Johanson, *supra* note 71, at 1301. This seems almost certainly wrong since the value of an interest is measured by the powers it confers rather than the donee’s subsequent decision whether to exercise such powers. Thus, the holder of a “Crummey” power is treated as receiving a present interest gift equal to the value of the property he could withdraw, even if he fails to exercise it. See *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).

invade the principal of *W Trust* which *cannot be quantified* (e.g., a power to invade for *W's* happiness). Where such open-ended powers exist, *W* may be unable to establish that she has "transferred" *anything to anybody*.¹⁵⁶ If there is no transfer, then there is no "consideration," since there can be no consideration for a transfer that never occurred.¹⁵⁷ *W's* estate would not qualify for either the section 2043 offset or the "bona fide sale" exclusion under section 2036, since both these benefits depend upon there being a transfer for "consideration."¹⁵⁸

H should also avoid giving *W* even a quantifiable power to invade the principal of *W Trust* for herself, such as a 5 and 5 power. Such a power will reduce the value of *W's* transfer to *C* and therefore increase the likelihood that *W* received full consideration for that transfer. On the other hand, release or even a lapse of such a power will be a taxable gift to the extent of the amount released (less any applicable annual exclusion).¹⁵⁹ *W's* power is not a "power of appointment" within the meaning of the gift and estate tax law, since *W*, rather than a third party, created the power.¹⁶⁰ Consequently, the exemption from gift tax accorded by section 2514(e) to lapses of 5 and 5 powers created by *others* does not apply.¹⁶¹

156. See Johanson, *supra* note 71, at 1302-11.

157. See Johanson, *supra* note 71, at 1302 ("In order to qualify for a section 2043(a) consideration offset, the wife must give something up in exchange for the interest she receives from her husband"); see also Stephens et al., *supra* note 123, at ¶ 4.08[7][d] n.129 (If *W* has not made a completed gift, "the bargain or exchange aspect of the widow's election seems to disappear.").

158. If something in fact passes to the remainderman at *W's* death, it will be because of *W's* post-election decision not to exercise her power of invasion. *W's* receipt of a life estate *at the time of her election* therefore cannot have been the "consideration" or inducement for *W's* subsequent decision not to invade. See Johanson, *supra* note 71, at 1303; cf. *Robinson v. Commissioner*, 675 F.2d 774 (5th Cir.), cert. denied 459 U.S. 970 (1982) (holding for gift tax purposes that *W's* receipt of a life estate in *H Trust* at the time of her election was not "consideration" for her subsequent release of a special power of appointment over *W Trust*).

159. *W's* retention of a 5 and 5 power over her property which passed into *W Trust* makes her transfer incomplete to the extent she can revest the property in herself. Regs. § 25.2511-2(c); her relinquishment of that power "completes" the transfer making it subject to the gift tax. Regs. § 25.2511-2(f); cf. *Robinson*, 675 F.2d at 777-78 (holding *W's* release of a "special power of appointment" she had reserved over *W Trust* was a taxable gift).

160. Regs. § 25.2514-1(b)(2) (For gift tax purposes, "the term 'power of appointment' does not include powers reserved by a donor to himself."); Regs. § 20.2041-1(b)(2) (same for estate tax); *Robinson*, 675 F.2d at 778.

161. Cf. *Robinson*, 675 F.2d at 778-79, where the court observed that if *W's* power to appoint trust principal among *H's* and her children had *not* been created by *W* (for example, if it had been granted by *H* to *W* over *H Trust*), it would have been a special power of appointment and its release would not be a taxable gift.). However, since it was a power *W* created over property *she* transferred to *W Trust*, its release constituted her completion of a taxable gift. *Id.*

Moreover, any property subject to a power of withdrawal over *W Trust* that *W* has not exercised or released by the time of her death will be included in her estate under section 2038 as a power to “alter, amend, revoke or terminate” exercisable at *W*’s death.¹⁶² Neither the section 2043(a) offset nor the section 2036 exclusion for “adequate and full consideration” will apply since *W*’s receipt of a life estate in *H Trust at the time of her election* cannot have been the “consideration” or inducement for her *subsequently-made* decision not to exercise the power.¹⁶³

Giving the trustee of *W Trust* a power to make discretionary payments to *W* is also problematic. In many states, the settlor’s creditors can satisfy their claims out of trust property where the trustee can make discretionary payments to the settlor.¹⁶⁴ Since this effectively enables the settlor to enjoy the trust corpus by incurring debts and then relegating her creditors to the trust, she is treated for tax purposes as possessing a power to revest the trust property in herself.¹⁶⁵ Where this is the law, giving the trustee of *W Trust* a power to make discretionary payments to *W* is the same as giving the power to *W* and presents the same problems as those discussed above.

Even where this is not the law, giving a discretionary power of invasion to the trustee of *W Trust* may entail risks. One commentator has argued that no section 2043 offset should be permitted, since there is no guarantee that the remainderman will receive anything.¹⁶⁶ I disagree with this position, since *W* has surrendered all power to deprive the remainderman of his interest and indeed has made a completed gift for gift tax purposes.¹⁶⁷ Nevertheless, caution may advise against giving the trustee discretionary power over the principal of *W Trust* even here.

162. Section 2038(a)(1) provides that property which the decedent transferred after June 22, 1936, will be included in his gross estate “where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power . . . to alter, amend, revoke, or terminate.” See *Robinson*, 675 F.2d at 779 (dictum).

163. See authorities cited supra note 158.

164. See *Ware v. Gulda*, 117 N.E.2d 137 (Mass. 1954) (Massachusetts law).

165. See *Outwin v. Commissioner*, 76 T.C. 153 (1981).

166. *Johanson*, supra note 71, at 1309 (“If the trustee’s discretionary power is so broad that there is no assurance that anything of value will ever be received by the remainderman, the wife has not made a transfer to which section 2043(a) should apply.”).

167. See Rev. Rul. 77-378, 1977-2 C.B. 347. When Professor’s *Johanson*’s article, supra note 71, was published, the Service had intimated in Rev. Rul. 62-13, 1962-1 C.B. 181, that a trustee’s broad discretionary power to invade trust property for the settlor’s benefit, in and of itself, rendered the settlor’s transfer incomplete for gift tax purposes. In Rev. Rul. 77-378, issued after Professor *Johanson*’s article, the IRS clarified Rev. Rul. 62-13 by specifically stating that a trustee’s wholly discretionary power to benefit the settlor does not render the settlor’s transfer incomplete.

4. *The "Fly in the Ointment"—Uncertain Income Tax Effects.*—The present estate and gift tax treatment of a spousal election presupposes that *W* and *H*'s estate are "exchanging" a remainder for a life estate (and vice versa) and therefore raises the specter of there being a taxable "exchange" for *income tax* purposes. Apparently, the Government has never asserted this position in a litigated case, and no court has directly ruled on it.¹⁶⁸ Nevertheless, the arguments for finding a taxable exchange are strong, and if successful, the consequences would be severe.

a. *Exchange Made by H's Estate.*—One may question whether *H*'s estate has engaged in an exchange at all. Although *H*'s estate has indubitably transferred a life estate in *H Trust* to *W*, it has not received any property or goods in return.¹⁶⁹ Moreover, *H*'s offer of a life estate to *W* is almost always motivated, at least in part, by a desire to benefit *W* as well as the remainderman *C*. Arguably, therefore, the benefits conferred on *W* and on *C* should both be viewed as bequests.¹⁷⁰

Indeed, the Internal Revenue Service itself at one time viewed *W* as receiving her interest in *H Trust* as a beneficiary under *H*'s will rather than as a purchaser.¹⁷¹ It even rejected a request that the Regulations be amended to

168. Prior to the enactment of § 167(e), the courts held that *W* obtained an amortizable "cost basis" in her life estate in *H Trust* equal to value of the remainder she surrendered in her share of the community (or the value of the life estate she received, if less). See *Gist v. United States*, 296 F. Supp. 526 (S.D. Cal. 1969), *aff'd*, 423 F.2d 1118 (9th Cir. 1970); see *Estate of Christ v. Commissioner*, 54 T.C. 493 (1970), *aff'd*, 480 F.2d 171 (9th Cir. 1973); see *Kuhn v. United States*, 392 F. Supp. 1229 (S.D. Tex. 1975). This conclusion was based on the premise that *W* "bought" her life estate by transferring a remainder in her share of the property to *C*, see *Kuhn* at 1235-40—a premise that necessarily implies that the estate had "sold" *W* her life estate in *H Trust* in a taxable transaction. See Joseph M Dodge, *Retentions, Receipts, Transfers, and Accumulations of Income and Income Rights: Ruminations on the Post-Byrum Role of Estate Tax Sections 2036, 2037, 2039 and 2043(a)*, 58 *Tex. L. Rev.* 1, 72 n.342 (1979) ("If there is a purchase, . . . there must be a sale.") The IRS has never asserted this position and no court has ever so held. Under current law, *W* is prohibited from amortizing her basis in her life estate, if, as almost always is the case, the remainderman is a related party. See IRC § 167(e).

169. See Dodge, *supra* note 83, at 293 n.220 ("But here, neither the decedent nor his estate receives property or services.").

170. See *id.*

171. The IRS argued in *Gist*, 423 F.2d at 1120, and *Kuhn*, 392 F. Supp. at 1235-36, that in a spousal election *W* acquires her life estate in *H Trust* as "beneficiary" of *H*'s will rather than as a "purchaser" (citing *Helvering v. Butterworth*, 290 U.S. 365 (1933)), and thus has no "cost basis" to amortize.

Professor Morrison supports this view arguing that treating *W* as a "beneficiary" achieves the objectives of the income tax law (i.e., "assurance that all income from estates and trusts is taxed once, and only once; that the income is attributed to the proper taxpayer; and that ordinary income is not converted into capital gains") while avoiding the complications which

include a statement to this effect on the ground the result was “too obvious . . . to warrant a specific statement.”¹⁷² Nevertheless, the failure of the Service to explicitly rule on this issue and the case law on related issues have led to a continuing concern that a spousal election is a taxable event.¹⁷³

If it is, the election can probably best be understood by viewing *H's* estate as “selling” a life estate in *H Trust* to *W* for a remainder interest in *W Trust*, and then transferring the remainder to *C* as a bequest from *H*. If *H* had directed his executors to sell *Blackacre* and give the proceeds to *C*, *H's* estate would be taxed on any gain (at least if *Blackacre* were subject to estate administration),¹⁷⁴ while the payment of the proceeds to *C* would be treated as a bequest. Similarly in this case, *H's* estate may be viewed as “selling” a life estate in *H Trust* for the remainder in *W Trust*, and then transferring the “sale proceeds” (i.e., the remainder) to *C* as *H's* agent in carrying out his bequest.¹⁷⁵

The weakness in this analysis is its failure to recognize the donative elements involved in a spousal election. Ultimately, proper income tax treatment of a spousal election depends on its true nature—an issue discussed later in this article.

If *H's* estate is regarded as making a taxable exchange, the consequences will be severe. The “amount realized” will be the value of *C's* remainder in *W Trust* (or *W's* life estate in *H Trust* if less).¹⁷⁶ Since the life estate that *H's* estate

ensue when *W* is treated as a “purchaser.” Keith E. Morrison, *The Widow's Election and its Alternatives*, 1971 Tex. Tech. Tax Inst. 141, 150 (1971).

172. Tech. Mem. 1971-7142 (July 30, 1971). The IRS rejected a request by a practitioner that the Regulations be amended to specifically provide that *H's* estate does not make a “sale” of the life estate in *H Trust* for purposes of § 1001(e) in a spousal election on the ground that the rule sought “was too obvious, particularly in view of § 1.661(a)-2(f)(1), to warrant a specific statement.” *Id.* The Service's citation of this regulation, which deals with the income tax treatment of estate and trust distributions to beneficiaries, was consistent with its then position that *W* takes as a beneficiary and not a purchaser in a spousal election. The Service may not be as firm in that view today. In the action-on-decision on *Kuhn*—which was decided after *Gist* and *Christ*—the Service stated it was reexamining the position it had “taken in widow's election cases” and was considering publication of a revenue ruling on the subject. See Action on Decision 1976-54 (Jan. 16, 1976). However, no ruling was ever issued.

173. See Gary C. Randall, *Estate Planning and Community Property*, 28 Idaho L. Rev. 807, 831 (1992).

174. See IRC § 641(a)(3) (income received by estate during period of administration taxable to estate). See Rev. Rul. 57-133, 1957-1 C.B. 200 (income from real property subject to estate administration includible in estate's taxable income even though title vests immediately in devisee).

175. Cf. Dodge, *supra* note 168, at 72 n.342 (*H's* estate, in making the exchange, is acting as “an ‘agent’ executing the wishes of the decedent in carrying out a ‘bequest’”).

176. The amount *H's* estate realizes is limited to the *lesser* of *C's* remainder in *W Trust* or *W's* life estate in *H Trust*. If the value of the remainder *W* transfers in her property exceeds the value of the life estate she receives, the excess is viewed as a “gift” from *W* to *C* rather than additional consideration to *H's* estate. Conversely, if the value of *W's* life estate

is "selling" is a term interest, the estate's basis in it will be zero by reason of section 1001(e).¹⁷⁷ Thus, the estate will recognize gain on the "sale" equal to the remainder's full value on the date of the "sale," i.e., the day of the election,¹⁷⁸ (or the value of *W*'s life estate on such day if less).¹⁷⁹ If *H*'s estate is treated as selling a property interest, the gain will qualify for capital gain treatment.¹⁸⁰ More likely the estate will be treated as making an anticipatory sale of income and will therefore recognize ordinary income under the teaching of *Commissioner v. P.G. Lake, Inc.*¹⁸¹ Rubbing salt into the wound, section 167(e)

exceeds the value of *C*'s remainder in *W Trust*, the excess is treated as a bequest from *H* to *W*. See Schwartz & Liker, *supra* note 131, at 10-22, 10-23; see Norman H. Lane, *The Widow's Election as a Private Annuity: Boon or Bane for Estate Planners*, 44 S. Cal. L. Rev. 74, 93 (1971).

The courts in *Estate of Christ* and *Kuhn* adopted this approach: they limited the amount of *W*'s amortizable cost basis to the value of the life estate she received in *H Trust* and treated the excess value of the remainder as a gift from *W* to *C*. *Estate of Christ v. Commissioner*, 54 T.C. 493, 530 (1970), *aff'd*, 480 F.2d 171 (9th Cir. 1973); *Kuhn v. United States*, 392 F. Supp. 1229, 1239-40 (S.D. Tex. 1975). See also Dodge, *supra* note 168, at 72 n.342.

177. Section 1001(e) states that in determining gain or loss from the disposition of a "term interest in property"—defined as either a term of years or a life estate in property or an income interest in a trust—the portion of the adjusted basis of such interest determined pursuant to § 1014 shall be "disregarded," i.e., treated as zero. IRC § 1001(e)(1), (e)(2). Thus, if a spousal election is viewed as a taxable "sale," the estate's adjusted basis in the life estate it conveys to *W* will be zero since the basis of the property the estate received from *H* is determined pursuant to § 1014. See IRC § 1014(a), (b)(1).

178. In *Estate of Christ v. Commissioner*, 480 F.2d 171, 173 (9th Cir. 1973), the court held that the proper date for valuing *W*'s life estate in *H Trust* was "the date of the distribution to the trust and the date . . . [*W*'s] election became irrevocable" rather than the date of *H*'s death.

179. See Lane, *supra* note 176, at 93.

180. See *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947); see *Allen v. First Nat'l Bank*, 157 F.2d 592 (5th Cir. 1946) *cert. denied*, 330 U.S. 828 (1947); see *Bell's Estate v. Commissioner*, 137 F.2d 454 (8th Cir. 1943); see Rev. Rul. 72-243, 1972-1 C.B. 233 (IRS will follow *McAllister*).

181. 356 U.S. 260 (1958). Most commentators have concluded that if a spousal election is a taxable "exchange," *P.G. Lake* probably requires any resulting gain to be taxed as ordinary income. See James J. Freeland et al., *What are the income tax effects of an estate's sale of a life interest?*, 34 J. Tax'n 376, 377 (1971); Schwartz & Liker, *supra* note 131, at 10-22 ("It appears likely that . . . the estate will be deemed to have realized ordinary income"); Dodge, *supra* note 21, at A-91 (ordinary income treatment is the "more likely result"). Others are less certain: see, e.g., Carol L. Wilson, *The Widow's Election Viewed in the Light of the 1976 Tax Reform Act and the 1975 California Probate Code Revision*, 28 Hastings L.J. 1435, 1445 (1977) ("[N]o one is certain how the gain will be characterized"); Ralph Gano Miller Jr. and Philip P. Martin Jr., *Voluntary Widow's Election: Nation-Wide Planning for the Million Dollar Estate*, 1 Calif. West. L. Rev. 63, 78 (1965) (ordinary income treatment "possible, but not probable").

Those arguing for ordinary income treatment note that where the courts allowed capital gain treatment (see *McAllister*, *First Nat'l Bank* and *Bell's Estate*, *supra* note 180), the transferor had transferred all the interest he had. In contrast, in a spousal election, *H*'s estate,

will prevent *W* from amortizing her “cost basis” in her life estate in *H Trust*, if *W*, as is almost always the case, is related to the remainderman.¹⁸²

b. *Exchange Made by W*.—If there is a taxable exchange, the results should be nowhere near as calamitous to *W* as to *H*'s estate. *W* should realize little or no taxable gain, since her basis in her share of the community will be “stepped-up” (or “stepped-down”) to its fair market value on the date of *H*'s death (or alternate valuation date if applicable).¹⁸³ In determining *W*'s gain or loss on the exchange, this basis will be allocated between the remainder and *W*'s retained life estate in *W Trust* based on their respective actuarial values on the day of the exchange.¹⁸⁴ The “amount realized” will be the value of the life estate *W* receives in *H Trust* (or the value of *C*'s remainder in *W Trust* if less).¹⁸⁵ *W*'s gain, if any, will therefore be the excess of the amount so realized over her adjusted basis in the carved-out remainder and will be taxed as capital gain.¹⁸⁶

Neither *W* nor *H*'s estate nor *H Trust* will be able to recognize any loss realized on the exchange since they are “related parties.”¹⁸⁷

The uncertain income tax consequences make a spousal election a risky proposition. Tax planners may nonetheless wish to consider using it given the lack of any direct authority holding that a taxable “exchange” has occurred and in light of the technique's significant transfer tax advantages—particularly if the *D'Ambrosio* trilogy has effectively overruled *Gradow*.

which starts out holding the entire fee interest, “carves out” and transfers only a part of its interest to *W*, arguably making the situation more analogous to that found in *P.G. Lake*. An old case allowed capital gain treatment where the owner of a fee interest carved out a legal life estate, sold it to her husband and retained the remainder for herself. See *Estate of Camden*, 47 B.T. A. 926 (1942), nonacq., 1943 C.B. 28, aff'd, 139 F.2d 697 (6th Cir. 1943). Its viability is questionable in light of the Supreme Court's later decision in *P. G. Lake*. See Charles S. Lyon & James S. Eustice, *Assignment of Income: Fruit and Trees as Irrigated by the P.G. Lake Case*, 17 Tax L. Rev. 295, 326 (1962).

182. A “related person” is any person who bears the same relationship to the taxpayer as that described in § 267(b) or (e). IRC § 167(e)(5)(B). The disallowed amortization deductions are added to the basis of the remainder interest. See IRC § 167(e)(3)(B).

183. Section 1014 provides that a surviving spouse's share of the community property shall receive a new basis equal to property's fair market value as of the decedent's death (or the alternate valuation date if applicable) if at least one-half of the whole of the community interest in such property is included in the decedent's gross estate. See IRC § 1014(a)(1)-(2), (b)(6).

184. See Rev. Rul. 77-413, 1977-2 C.B. 298. Section 1001(e) will not apply because *W* is not selling a “term interest.” IRC § 1001(e)(1), (2).

185. See *supra* note 176 for reason the amount realized is limited to the lesser of the value of *W*'s life estate in *H Trust* or *C*'s remainder in *W Trust* and authorities so holding.

186. The Service recognizes that gain realized on the sale of a “carved-out” remainder interest qualifies for capital gain treatment. See *Hunter v. Commissioner*, 44 T.C. 109 (1965).

187. IRC § 267(a)(1), (b)(1), (b)(6), (b)(13).

B. Searching for the True Nature of a Spousal Election

The estate and gift tax consequences of a spousal election set out above are disquieting. By using this technique, the surviving spouse may be able to transfer her entire property (or a significant portion of it) to lower generation beneficiaries without payment of any estate or gift taxes. This defeats Congress's intent that a married couple's property should be subject to transfer tax when it passes to the next generation.¹⁸⁸ Presently the only judicially recognized barrier to this result is the conceptually flawed position that only the full fee value of the underlying property constitutes "adequate and full consideration" for the transfer of a remainder interest.

Is there any theory, consistent with transfer tax doctrine and proper valuation that can avoid this apparently unjustified tax benefit? The balance of this article will consider three theories proposed by the commentators:

No Bona Fide Sale.—A spousal election is not a "bona fide sale," and thus the exception to section 2036 does not apply.¹⁸⁹

Mutual Gifts.—*W's* transfer of a remainder in her property to *C*, a natural object of her bounty, is motivated by her love for *C* rather than in "consideration" of a life estate in *H Trust*. Likewise, *H's* transfer of a life estate in *H Trust* to *W* is induced by his love for *W*—not in "consideration" of *W's* transfer of a remainder to *C*. Since this theory views *H* and *W* as each making gifts of their own property in concert, it is sometimes called the "mutual gifts" theory.¹⁹⁰

Reciprocal Trusts.—A spousal election creates reciprocal trusts and is governed by the doctrine of the same name.¹⁹¹

1. *No "Bona Fide Sale."*—As noted above, current case law interprets the phrase "adequate and full consideration" differently for the gift tax than it does for the estate tax. In the case of the gift tax, *W's* transfer of a remainder to *C* in her property is considered supported by full consideration if *W's* life estate in *H Trust* merely equals the actuarial value of that remainder.¹⁹² In contrast, the *Gradow* line of cases holds that, for estate tax purposes, *W's* transfer of the remainder to *C* is supported by full consideration only where *W's* life estate in *H Trust* equals or exceeds the full value of the property passing into *W Trust*.¹⁹³

188. See *United States v. Stapf*, 375 U.S. 118, 128 (1963) (Congress's purpose in enacting the marital deduction was "to permit a married couple's property to be taxed in two stages and not to allow a tax-exempt transfer of wealth into succeeding generations.").

189. *Jordan*, supra note 58, at 716-23.

190. See *Lowndes*, supra note 21, at 69-71; *Johanson*, supra note 71, at 1288-95.

191. *Lowndes*, supra note 21, at 76-81; *Johanson*, supra note 71, at 1288-95.

192. See supra notes 33-36 and accompanying text.

193. See supra notes 14-16, 22-25 and accompanying text.

Professor Jordan has proposed an ingenious solution that reconciles the results in these cases and at the same time prevents *W*'s estate from escaping tax on the disposition of her property. Professor Jordan notes that under section 2512(b), *W* can avoid gift tax if she merely receives "full consideration" on her transfer of the remainder in *W Trust*. However, to avoid inclusion of *W Trust* in *W*'s gross estate, section 2036 requires not only that *W* receive "full consideration," *but also* that she receive it in a "bona fide sale." This "additional requirement" of a "bona fide sale" explains, according to Professor Jordan, why, in the case of a spousal election, there can be estate tax liability (which requires a "bona fide sale"), and at the same time, no gift tax liability (which does not).¹⁹⁴

Professor Jordan believes that a spousal election invariably produces a result that is testamentary in nature. As a result of *W*'s election, she retains enjoyment of her property until death, while the transfer of her property upon her death to the remaindermen—who almost always are her own issue—is "donative in character."¹⁹⁵ In contrast, a "bona fide sale" involves "an arm's length exchange" where "both parties seek to receive value equal to that which they surrender."¹⁹⁶ Professor Jordan summarizes her position as follows: "If property is transferred in a transaction that is donative in character and the taxpayer retains the benefits of the property until death, the property is included in the taxpayer's gross estate *even though adequate consideration was received for the remainder interest.*"¹⁹⁷

It is difficult to envision an exchange being "donative in character" where the transferor obtains full value for her transfer.¹⁹⁸ Even were that possible, it would not justify including the transferor's property in her gross estate.

The universally recognized purpose of the "adequate and full consideration" exception to sections 2036 through 2038 is to exclude transfers that do not deplete the transferor's estate.¹⁹⁹ As Professor Jordan recognizes, if the transferor receives "full consideration" for the transferred property, no depletion occurs in the transferor's estate.²⁰⁰ This is equally true whether the transfer be deemed "donative in character" or not. Professor Jordan also

194. Jordan, *supra* note 58, at 716-18.

195. *Id.* at 717.

196. *Id.* at 718.

197. *Id.* at 717 (emphasis added).

198. Professor Jordan may envision a case where the transferor did not *consciously* seek to realize full value for her property but in fact received an *objectively* fair value. This is interpretation consistent with her definition of an "arm's length exchange" as one in which "both parties *seek* to receive value equal to that which they surrender." *Id.* at 718 (emphasis added).

199. See *supra* note 5 and accompanying text.

200. See Jordan, *supra* note 58, at 692-96.

recognizes that requiring inclusion of the transferor's property in her gross estate where she obtains "full consideration" in the exchange "creates double taxation" (i.e., taxation of both the transferred remainder and the consideration received therefor).²⁰¹ Again this is equally true and equally unjust whether the transfer be deemed "donative" or otherwise. In short, the policy reasons for excluding transferred property where the transferor has received full value are equally valid whether the transfer is "donative" or not, and both cases should be treated alike.

Professor Jordan apparently finds support for her position in a gift tax regulation²⁰² and *Estate of Friedman v. Commissioner*.²⁰³ But these authorities merely hold that a transfer, which is bona fide, at arm's length and free from donative intent, will be *considered* as made for "adequate and full consideration," even should the IRS or a court later find the consideration inadequate. They provide no support for the *converse* proposition that a "donative" transfer is taxable even though made for "full and adequate consideration." The rule in the gift tax regulations is designed to prevent bad business bargains from being converted into taxable gifts.²⁰⁴ This policy is simply irrelevant where adequate consideration is received.

The most likely purpose of the "bona fide sale" language in the exception to section 2036 is to exclude "sham" sales from its scope.²⁰⁵ For example, a transaction where the purported seller retains the benefits and burdens of ownership of the property he purportedly sells will not qualify as a "bona fide sale." The exchange occurring in a spousal election, however, is not a "sham," since it effects a real change in the rights of the parties (e.g., *W* surrenders all interest in and power over the remainder in her property; the life estate in *H Trust* passes to *W* instead of another beneficiary).

The cases hold that a transfer *not induced or motivated* by the transferee's reciprocal transfer but instead by a donative impulse does not qualify for the exclusion in section 2036.²⁰⁶ But this does not explain the purpose of the words "bona fide sale" since those words are not needed to reach this result. The requirement that there be "consideration" is sufficient. A transfer not induced by the transferee's reciprocal action is not made for "consideration." When used in the law, the word "consideration" means that which induces or motivates the

201. *Id.* at 689-92.

202. Regs. § 25.2512-8.

203. 40 T.C. 714 (1963).

204. See 5 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 121.4.5 (2d ed. 1993).

205. See Charles B. Lowndes et al., *Federal Estate and Gift Taxes* ¶ 14.8 (3d ed. 1974).

206. See *Mollenberg's Estate v. Commissioner*, 173 F.2d 698 (2d Cir. 1949); See *Giannini v. Commissioner*, 148 F.2d 285 (9th Cir. 1945), cert. denied, 326 U.S. 730 (1945); see *Safe Deposit & Trust Co. v. Tait*, 295 F. 429 (D.C. Md. 1923).

other party's performance.²⁰⁷ If the "bona fide sale" language were needed to impose this requirement, persons making simultaneous transfers of equal value to each other would never owe a gift tax, even if such transfers were motivated solely by donative impulses and without regard to the other's transfer, since section 2512(b) contains no "bona fide sale" requirement. The value of one transfer would always offset the value of the other. But this is not the law; there is no offset unless one transfer is the "inducement" for the other. The word "consideration" standing by itself achieves this result.

Judicial construction of the phrase "bona fide sale" and congressional action support neither the meaning nor the significance Professor Jordan would attribute to it. Courts have found transfers to be "bona fide sale[s]" even where the transferor appeared motivated, at least in part, by donative impulses.²⁰⁸ In one case, the decedent in "consideration" of his intended wife's release of her dower rights established a trust providing income to the decedent for his life, then income to his wife for her life, and then principal to certain beneficiaries.²⁰⁹ This transfer was donative in part, since one of the decedent's objectives was to benefit his wife. As the court stated, the "evident intent of [the decedent] was to make provision for [his intended wife], for his four children, and for the management and disposition of his property free from the restraint of dower rights."²¹⁰ Despite the presence of a donative intent, the court found the transfer to be a "bona fide sale."²¹¹

207. The Second Restatement of Contracts states that something constitutes "consideration" only if it is "bargained for," that is, that "it is sought by the promisor in exchange for his promise and is given by the promisee in exchange for that promise." Restatement (Second) of Contracts § 71 (1979). The comments add that "in the typical bargain, the consideration and the promise bear a reciprocal relation of motive or inducement: the consideration induces the making of the promise and the promise induces the furnishing of the consideration." *Id.*, cmt. b. See also Oliver Wendell Holmes, *The Common Law* 230 (Mark DeWolfe Howe ed., 1963) ("[I]t is the essence of a consideration, that . . . it is given and accepted as the motive or inducement of the promise"). For this reason, a promise made after an action has already been performed is not consideration for that action, since the action was not *induced* by the subsequently-made promise. See E. Allan Farnsworth, *Contracts* § 2.7 (3d ed. 1999).

In *Giannini v. Commissioner*, 148 F.2d 285 (9th Cir. 1945), cert. denied, 326 U.S. 730 (1945), the court adopted this concept of "consideration" as something "bargained for" in holding that the "adequate and full consideration" exception did not apply. The court held that decedent's transfer to a trust in which the decedent was an income beneficiary was not in "consideration" of his parents' simultaneous transfer to the trust, since the parents' transfer "resulted . . . not from bargaining, but from . . . [their] largess." *Id.* at 287.

208. See *Ferguson v. Dickson*, 300 F. 961, 962 (3d Cir. 1924); see *McCaughn v. Carver*, 19 F.2d 126 (3d Cir. 1927).

209. See *Ferguson*, 300 F. at 962.

210. See *id.* at 962.

211. See *id.* at 963.

Congress has legislatively overruled these “dower” cases. What is significant is the way it did so. Congress accomplished its objective—not by changing the “bona fide sale” requirement—but by modifying the “consideration” requirement: first by substituting the phrase “adequate and full consideration” for the phrase “fair consideration”²¹² and then by expressly providing that a release of dower or curtesy rights did not constitute “a consideration in ‘money or money’s worth.’”²¹³ In short, Congress was not concerned that donative-tinged transactions were considered “bona fide sale[s]” but rather that they were found to be supported by sufficient “consideration.”

Professor Jordan makes many telling points when she argues as a matter of policy that the surviving spouse’s property in a spousal will election should be included in her gross estate.²¹⁴ However, this result cannot be achieved by relying on the requirement of a “bona fide sale.”

2. *A Spousal Election as Mutual, But Separate, Gifts by H and W.*—In some cases, a spousal election may simply carry out the dispositive plans that each spouse had already individually decided upon. Where this is true, it is wrong to say that *H* and *W* are exchanging property in “consideration” of each other’s transfer, since their respective transfers are not induced by the reciprocal transfer of the other. They are merely doing what they would have done in any event. Where this is the case, neither *W* nor her estate should be allowed any of the offsets or exclusions provided for under sections 2512(b), 2043, and 2036. These provisions apply when a transferor receives “consideration” for his transfer. In tax law, substance prevails over form and the amounts the transferor receives must be real “consideration,” that is, they must be the actual “inducement” or “motivation” for her transfer.²¹⁵ If her transfers are in fact “gifts” she would have

212. *Merrill v. Fahs*, 324 U.S. 308, 312 (1945). Since courts had held that “‘fair consideration’ included the relinquishment of dower rights,” Congress was “led . . . to substitute in the 1926 Revenue Act, the words ‘adequate and full consideration.’ . . . Congress undoubtedly intended the requirement of ‘adequate and full consideration’ to exclude relinquishment of dower and other marital rights.” *Id.* at 312. See also *Commissioner v. Bristol*, 121 F.2d 129 (1st Cir. 1941) and *Empire Trust Co. v. Commissioner*, 94 F.2d 307 (4th Cir. 1938) (holding that the “adequate and full consideration” language required that property the decedent had transferred in exchange for release of his spouse’s marital rights be included in his gross estate).

213. Revenue Act of 1932, Pub. L. No. 72-54, ch. 209, § 804, 47 Stat. 169, 280 (1932) (amending the Revenue Act of 1926, ch. 27, § 303(d), 44 Stat. 9, 73 (1926)). However, the courts held that this change was merely declaratory of what the law had been under the “adequate and full consideration” language and that Congress had acted out of an excess of caution. See *Commissioner v. Bristol*, 121 F.2d at 135; see *Empire Trust Co. v. Commissioner*, 94 F.2d at 309-10.

214. See *Jordan*, *supra* note 58, at 720-23.

215. See *supra* notes 206-07 and accompanying text.

made in any event, then she did not make the transfers in “consideration” of the other party’s transfer, and no offset or exclusion is allowed.

Where this analysis applies, the tax consequences of a spousal election are as follows: *W*’s establishment of *W Trust* constitutes a completed gift of a remainder to *C*. Since *C* is *W*’s child, section 2702 will apply and *W* will be taxed on the entire value of the property placed in *W Trust* unless her interest is a qualified interest. Since *W*’s transfer of the remainder to *C* was not induced by, or put differently, was not made in “consideration” of her receiving a life estate, neither the exception under section 2036 nor the offset under section 2043 will apply. This analysis may also solve the income tax problem: since *W*’s transfer of a remainder to *C* was not made in an “exchange” but rather as a “gift,” there is no taxable event.²¹⁶

The weakness of the foregoing analysis is its failure to recognize the amount of real bargaining and even coercion often involved in spousal elections. The above analysis implicitly assumes that each party would have made their transfers irrespective of what the other did. In fact, the election posed to *W* exerts real pressure on *W*—amounting in some cases to coercion—to allow her property to pass in a manner different from what she would normally prefer. Left to her own druthers, *W* would usually prefer to retain ownership of her property outright rather than place it in *W Trust*. There are two reasons for this: *W* would want to maintain her ability to invade the principal of her property at will should the need or desire arise, and secondly, *W* would like to retain until death her ability to determine how her property will pass.²¹⁷ The hard fact is that the choice given to *W* in *H*’s will—either let her property pass under *H*’s will or else forgo all benefits in his estate—frequently “coerces” or “locks in” *W* to a disposition she would prefer to defer and one that she might ultimately decide not to make.

Indeed, *H* may have used the election will format precisely because of its coercive effect. For example, *H* might use the device to assure himself that *W* leaves her property to his child *C*.²¹⁸ This would be especially true if *W* and *C* are estranged, or if *C* is *H*’s child by a prior marriage. *H* may also be concerned that *W* will remarry and make provision for her new spouse to the prejudice of their children’s interest. *H* might employ the spousal election will model because he

216. See IRC §§ 102 (a), 1001(a); see Boris I. Bittker & Martin J. McMahon, Jr., *Federal Income Taxation of Individuals* ¶ 28.3 (2d ed. 1995) (gift of appreciated property is nontaxable event).

217. See Dodge, *supra* note 168, at 66-68; see also Morrison, *supra* note 21, at 226 n.21 (describing as “untenable” the argument that *W* would have made the same transfer even if no spousal election since *W*, by making the election, “makes a definite decision which she might otherwise postpone until her death with all the intervening uncertainties.”).

218. See Johanson, *supra* note 71, at 1264. By restricting *W*’s interest to an income interest in the entire community estate, *H* can assure that it will pass to couple’s children “without undue dissipation.”

is concerned about *W*'s spendthrift proclivities and therefore wants to limit her ability to spend principal.²¹⁹ Or *H* might be concerned about *W*'s lack of business and financial experience and therefore want her property to be held in a trust where a professional trustee will manage it.²²⁰ Likewise, *H* may believe that the nature of the community property (e.g., a closely held business) requires unified management.²²¹

Given the strong desire of most surviving spouses to retain the control over both the use and disposition of their principal until death, the "mutual gift" approach should be used in only extreme cases. Before invoking this approach, the IRS should be required to show by a preponderance of the evidence that *W* would have set up a trust having the same dispositive provisions as *W Trust* even if there had been no spousal election, and *further* that she would have done so *shortly* after *H*'s death. Professor Dodge has suggested that this showing is likely only where *W* was infirm, bordering on incompetency, or quite wealthy at the time of *H*'s death.²²² Otherwise, it is quite likely that the offer of a life estate in *H Trust* did in fact induce *W* to let her property pass under *H*'s will.²²³

3. A Spousal Election as the Creation of Reciprocal Trusts

a. *The Rationale of the Reciprocal Trust Doctrine.*—Several commentators have argued that spousal will elections come within the purview of the reciprocal trust doctrine.²²⁴ In my opinion, these commentators have failed to convincingly explain why the doctrine *should* apply. Their use of the doctrine seems little more than invoking a doctrine to reach a desired result. To determine the propriety of applying the doctrine, we must first understand its rationale.

219. See Johanson, *supra* note 71, at 1264.

220. See *id.* (stating that *H* may want to "protect his wife . . . against improvident investments or bad advice from relatives"). See also Wilson, *supra* note 181, at 1436 (providing a comprehensive list of nontax reasons for using the spousal election will format).

221. See Johanson, *supra* note 71, at 1264; Wilson, *supra* note 181, at 1436.

222. See Dodge, *supra* note 168, at 69.

223. Professor Dodge suggests this approach may be used where *H* and *W* join in setting up an inter vivos trust which provides that one-half of the income be paid to each during their joint lives, then income to the survivor, then remainder to *C*. Since *W* has no assurance of receiving any additional benefits under this arrangement (because she may predecease *H*), her inter vivos commitment to "an arrangement that provides her no certain benefits, current or future, smacks of a simple gratuitous transfer by" *W*, effective upon *H*'s death, of a remainder to *C*. See Dodge, *supra* note 168, at 69-70. However, even here, *W* may simply be responding to the coercion by *H*: *H* may have told *W* that unless she joined in the setting up of the trust, he would exclude her from his will. In at least some marriages, husbands can exert more coercion over their wives while alive than dead.

224. See Lowndes, *supra* note 21, at 76-77; Lowndes et al., *supra* note 205, § 9.8, at 195-96; Johanson, *supra* note 71, at 1288-95.

The doctrine is generally recognized as having originated in *Lehman v. Commissioner*.²²⁵ The decedent and his brother set up trusts.²²⁶ The trusts established by decedent provided that income was to be paid to his brother for life, authorized his brother to withdraw \$150,000 from the trusts, and directed that principal be paid to his brother's issue upon his brother's death.²²⁷ His brother's trusts contained reciprocally identical provisions, that is, they provided that income be paid to decedent for life, authorized decedent to withdraw \$150,000 from the trusts, and directed that principal be paid to decedent's issue upon the decedent's death.²²⁸ Ruling in favor of the Commissioner, the court held the trusts purportedly created by decedent's brother were in substance created by decedent.²²⁹ The court cited Scott on Trusts that "[a] person who furnishes the consideration for the creation of the trust is the settlor, even though in form the trust is created by another."²³⁰ It ruled that "the transfer by decedent's brother, having been paid and bought for by the decedent, was in substance a 'transfer' by the decedent."²³¹ Consequently, the \$150,000 that the decedent could withdraw from the trust nominally created by his brother was included in his gross estate as that part of decedent's "transfer" over which he retained a power "to alter, amend, or revoke."²³²

The effect of the doctrine, when it applies, is to "uncross" or "switch" grantors.²³³ Thus, in *Lehman* the decedent was treated as creating the trust nominally created by his brother, and his brother was treated as creating the trust nominally created by the decedent. The underlying rationale of the theory is that the decedent has created a trust nominally created by another, since he "paid and bought for" it by setting up a reciprocal trust for that other person's benefit.

225. 109 F.2d 99 (2d Cir. 1940), cert. denied, 310 U.S. 637 (1940).

226. See *id.* at 100.

227. See *id.*

228. See *id.*

229. See *id.*

230. See *id.*

231. *Lehman v. Commissioner*, 109 F.2d 99, 100-01 (2d Cir. 1940), cert. denied, 310 U.S. 637 (1940).

232. *Id.* at 101. Although the decedent retained a life income interest in the trusts he was deemed to have created, the full principal of the trusts was not included in his gross estate as transfers "intended to take effect in possession or enjoyment at or after [decedent's] death," *id.*, since those trusts were created before the enactment of the Joint Resolution of March 3, 1931, H.R.J. Res. 529, 71st Cong., 3d Sess., 46 Stat. 1516 (1931), which amended § 302(c) of the Revenue Act of 1926, 44 Stat. 9, 70 (1926), and overruled *May v. Heiner*, 281 U.S. 238 (1930). See *id.* and *supra* note 1.

233. See, e.g., Rev. Rul. 74-533, 1974-2 C.B. 293; *Bischoff's Estate v. Commissioner*, 69 T.C. 32 (1977); *Exchange Bank & Trust Co. v. United States*, 694 F.2d 1261 (Fed Cir. 1982). But see *Estate of Green v. United States*, 68 F.3d 151, 153 (6th Cir. 1995) (court, assuming arguendo that trusts were "interrelated," refused to "uncross" grantors because grantors did not retain an economic benefit in the transferred property).

In *United States v. Estate of Grace*, the Supreme Court rejected the contention that the Government needed to show, before invoking the doctrine, that each trust was the “bargained-for quid pro quo” for the other.²³⁴ The Government merely had to show that the trusts were “interrelated” (for example, that they were created at about the same time, were set up pursuant to a common plan, and had similar terms), and that their creation “to the extent of mutual value, leaves the settlors in approximately the same objective economic position as they would have been in if each had created his own trust with himself, rather than the other, as life beneficiary.”²³⁵

The *Grace* decision leaves the underlying rationale or justification for the reciprocal trust doctrine in doubt.²³⁶ Arguably, *Grace* rejected the *Lehman* rationale and replaced it with a “net effect” rationale. Under this interpretation, each party is treated as the creator of the trust nominally established by the other, simply because each party is in the same position he would have been had he in fact set up the other trust. In other words, since the transaction had the same “net effect” as one covered by section 2036, it should be treated in that manner.

A less sweeping interpretation of *Grace* is that it relaxes or eases the evidentiary burden needed to invoke the doctrine for practical and administrative reasons but leaves unaltered the underlying justification for the doctrine. The Court noted that requiring a finding that each trust was created as the quid pro quo for the other would necessitate “perilous” inquiries into the subjective intent of the parties where at least one of them, and possibly both, are deceased, and where the transaction may have occurred many years before.²³⁷ The Court noted the difficulty of showing subjective intent in intrafamily transactions where the parties rarely bargain in the same conscious, explicit manner that business people do.²³⁸ The Court also observed the high probability that such transactions were tax-motivated.²³⁹ I prefer this view of *Grace*, but some of the language in the decision points in the other direction.

Grace did not adopt a “pure” net effect rationale, since the Court also required that the two trusts be “interrelated.”²⁴⁰ Apparently, the doctrine does not apply if two people—without knowledge of the other’s intent or actions—separately create trusts naming the other as income beneficiary, since such trusts would not be viewed as “interrelated.”²⁴¹ It is difficult to justify this

234. 395 U.S. 316, 324 n.9 (1969).

235. See *id.*

236. See discussion of this issue in Lowndes et al., *supra* note 205, at § 9.8.

237. *Estate of Grace*, 395 U.S. at 323.

238. See *id.* at 324.

239. See *id.* at 323.

240. *Id.* at 324.

241. The dissenting opinion in the Court of Claims in *Grace*, alluding to O. Henry’s “Gift of the Magi,” stated that the reciprocal trust doctrine would *not* apply “even if the chance

result under the net effect rationale, since the settlors are *just as much* in the same economic position as if each had created a trust naming himself as income beneficiary. Moreover, the “net effect” rationale seems to conflict with case law holding that taxpayers are not required to structure transactions in a manner producing the highest possible tax.²⁴² The fashion in which taxpayers structure their transactions is normally respected for tax purposes so long as it has substantive economic effect.²⁴³ The creation of reciprocal trusts would certainly have economic substance in some cases. For example, the establishment of reciprocal trusts with significantly different investments would appear to have economic substance since it markedly changes the nature of the investments from which each grantor derives his income.²⁴⁴

Still the Supreme Court’s rationale in *Grace* remains unclear. I contend, however, that regardless of how one interprets *Grace*, the *Lehman* rationale provides the only proper basis for applying the reciprocal trust doctrine in the context of spousal elections. While *Grace* may have broadened the rationale for applying the reciprocal trust doctrine, the Court recognized that the *Lehman* rationale of bargained-for consideration is still a valid justification for applying

effect of . . . independent transfers is to leave [the transferor] in the exact situation he would have been in had he transferred his property retaining an interest or power similar to that granted by his benefactor.” 393 F.2d 939, 952 (Ct. Cl. 1968) (Judges Davis and Nichols dissenting), rev’d, 395 U.S. 316 (1969). The Supreme Court cited this dissenting opinion with approval but not specifically on this point. See *Lehman*, 395 U.S. at 322. It has been stated that “[p]resumably, the requirement that the trusts be ‘interrelated’ would preclude, as it should, an application of the doctrine where two settlors quite unknowingly and coincidentally happened to create similar trusts for each other.” Stephens et al., supra note 123, at ¶ 4.08[7][d] n.137.

242. See *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), aff’d, 293 U.S. 465 (1935). It was stated by Judge Learned Hand that “Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose the pattern which will best pay the Treasury. . . .” *Id.* at 810.

243. See David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 *Tax Law* 235 (1999). The author states that tax-motivated transactions will be respected under this principle so long as they “meaningfully alter the taxpayer’s economic position (apart from their tax consequences) as compared to not undertaking them.” *Id.* at 241. Even where they lack economic substance, they will be respected unless the “tax benefits themselves are unreasonable and unwarranted in light of the objective rules which give rise to them.” *Id.*

In *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958), the Supreme Court respected the form of a transaction for estate tax purposes which had minimal, if any, economic substance apart from reducing estate tax. The decedent purchased combined life insurance-annuity contracts where any loss of the issuer on the life insurance contracts would be counterbalanced by its gain on the annuity contracts. The decedent irrevocably assigned the insurance policies. Although the net effect of the transaction was the same as if decedent had retained a life income interest in the total amount paid for the combined contracts, the Court refused to apply the predecessor of § 2036, since the policies and the annuities were separate items of property. *Fidelity-Philadelphia Trust Co.*, 356 U.S. at 280.

244. Cf. *Cottage Savings Ass’n v. Commissioner*, 499 U.S. 554 (1991).

the doctrine in cases having the appropriate facts.²⁴⁵ More importantly, unlike the facts in *Grace*, a court in a spousal election case *cannot* ignore *W*'s subjective intent and decide the case solely on the basis of the transaction's net effect. In such cases, *W*'s estate is claiming either an offset or an exclusion on the ground that *W* received "consideration" for her transfer of the remainder in her property to *C*.²⁴⁶ The courts have properly held that for the taxpayer to prevail the purported consideration must be the actual "inducement" or "motivation" for *W*'s transfer.²⁴⁷ Consequently, the court must necessarily pass upon *W*'s intent in establishing *W Trust*. If *W*'s estate establishes that *W* transferred a remainder in her property to *C* solely to obtain a life estate in *H Trust*, the court *must* allow the offset or the exemption, since this result is statutorily mandated. This is so even if the transfers are interrelated; indeed, it is so because they are interrelated, that is, because *W*'s transfer was induced by her receipt of a life estate in *H Trust*.

If the court finds that *W*'s establishment of *W Trust* was unaffected by the election, that is, that she would have established a trust similar to *W Trust* at or about the time of the election in any event, the court will deny the offset and the exclusion.²⁴⁸ However, as we have seen, this will rarely be the case.²⁴⁹

If—as is more likely to be the case—the court finds that *W* would not have established *W Trust* at that time but for the election, *must* it then allow the offset or exclusion? In this situation, the *Lehman* rationale provides the proper conceptual tool for analysis. Application of this approach will usually, though not always, result in disallowance of both the offset and the exclusion.

b. *The Lehman Rationale Applied to Spousal Elections.*—*Lehman* applies a "unitary" approach to the creation of reciprocal trusts, that is, it views each party as creating the entirety of the other party's trust and not just the portion that personally benefits him.²⁵⁰

245. *United States v. Estate of Grace*, 395 U.S. 316, 324 n.10 (1969) ("We do not mean to say that the existence of "consideration" . . . can never be relevant. In certain cases, inquiries into the settlor's reasons for creating the trusts may be helpful in establishing the requisite link between the two trusts.").

246. See IRC §§ 2512(b), 2036(a) (parenthetical expression), and 2043(a).

247. See *supra* notes 206-07 and accompanying text.

248. See *supra* Part IV.B.2.

249. See *id.*

250. One consequence of the unitary approach is that where the reciprocal trust doctrine applies, the amount included in the decedent's gross estate is determined by reference to the value of the property in the trust nominally created by the other transferor. See Rev. Rul. 74-533, 1974-2 C.B. 293. Professor Dodge argues that one might logically apply the doctrine by treating the decedent as transferring his own trust but "retaining" his interest or power in the other trust. Under such an approach, the amount includible in decedent's gross estate would be determined by reference to the date-of-death value of the trust he purported to create. See Dodge, *supra* note 21, at A-60 to A-61. He concludes, however, that the approach used (i.e., the

In *Lehman* itself, for example, the court viewed the decedent as creating not only those portions of his brother's trust that personally benefited him (i.e., his life estate and his power to withdraw \$150,000) but also the portion of his brother's trust that benefited decedent's issue (i.e., the remainder). Assuredly this is correct. The brother did not give the remainder in his property to decedent's issue because of his love for them; he gave it because the decedent had reciprocally given a remainder in his property to the brother's issue.²⁵¹

In contrast to the reciprocal trust doctrine, the courts in analyzing spousal elections apply a "fragmented" approach. *H* is not viewed as causing *W* to create the entirety of *W Trust* but rather as inducing her to relinquish only the remainder.²⁵² I contend that the "unitary" approach of the reciprocal trust doctrine better captures reality in most spousal elections than the "fragmented" approach currently used.

What *H* is attempting to do by giving *W* an election is to induce *W* to dispose of her property in a comprehensive manner that will benefit not only *C* but also *W* herself. After all, *H*'s donative feelings run to *W* as well as to *C*. It is contrary to our knowledge of human relationships to assume, as the current approach does, that *H* is offering the election solely to benefit *C*. Indeed, *H* may desire *W* to place her property in trust and to limit her interest to that of an income beneficiary out of genuine concern for *W*. Although most people today may regard such concerns as paternalistic, if not sexist, they may nevertheless represent *H*'s honest feelings of concern and affection for *W*. *H* may be concerned about *W*'s lack of business and financial experience, and may therefore want to induce her to place her property in trust where an experienced, professional trustee will manage it.²⁵³ *H* may be concerned that given *W*'s lack of experience in managing property, she might imprudently consume principal to her own disadvantage, and therefore limit her interest to that of an income beneficiary.²⁵⁴ In any event, *H* is seeking to have *W* commit herself to dispose of her property in a manner benefiting herself as well as *C*. If *H* were solely

"unitary" approach) "derives from the broader indirect-transfer principle that causes the trust to be includible in the first place," i.e., the principle that the decedent has indirectly funded the other trust. *Id.* at A-61.

251. Similarly, the court in *Commissioner v. Warner*, 127 F.2d 913 (9th Cir. 1942), applied the reciprocal trust doctrine where each of three brothers purported to create a trust for family members of a different brother. Thus, Jack Warner was treated as the grantor of a trust nominally created by his brother Albert for the benefit of Jack's family, since simultaneously Jack had created a trust for the benefit of his brother Harry's family and Harry had created a trust for the benefit of Albert's family. See *id.* at 915.

252. See *supra* notes 33-36 and accompanying text.

253. See *supra* note 220 and accompanying text.

254. See *supra* note 219 and accompanying text.

concerned with *C*, he could have accomplished his objective more effectively simply by leaving his property outright to *C*.

H is seeking a “package deal” from *W*. *H* is attempting to secure this package from *W* by offering her in turn a package she finds attractive. In making her decision, *W* will be influenced not only by the enticement of a life estate in *H Trust*, but also by the way *H* ultimately disposes of his property. Certainly this is the case where the life estate *W* receives is worth less than the remainder she surrenders. Then *W* will be sustaining an economic loss by allowing her property to pass under *H*'s will and will not rationally do so unless she derives a psychic benefit from *H*'s leaving a remainder interest to *C*. Even where the life estate offered *W* is worth more than the remainder she must surrender, *W* will rarely be indifferent to how the property in *H Trust* ultimately passes. *W* may very well be unwilling to give up access to her principal and her ability to determine how her property will pass at death, unless she is happy with *H*'s designation of the remainderman.²⁵⁵ If *H* left the remainder in his property to his mistress who was 25 years younger than *W*, *W* will be loathe to allow her property to pass under *H*'s will no matter what the value of her income interest in *H Trust*.

The “unitary” approach—which recognizes that *H* is offering *W* a “package deal” in *H Trust* in return for a “package deal” in *W Trust*—better reflects reality than the “fragmented” approach—which views *H* and *W* as just undertaking an exchange of a life estate for a remainder. The reciprocal trust doctrine therefore properly applies to most spousal elections. *H* is inducing *W* to dispose of her property in a certain way (i.e., creating *W Trust*) by disposing of his property in a certain way (i.e., creating *H Trust*). Put more crudely, *H* is “buying and paying for” *W Trust* by his establishment of *H Trust*, and conversely, *W* is “buying and paying for” *H Trust* by allowing her property to pass under *H*'s will. *H* should therefore be treated as the grantor of *W Trust* and *W* as the grantor of *H Trust*.

Unlike the “mutual gift” theory, this approach recognizes both the bargaining and donative aspects that usually co-exist in an election: It recognizes that *W*'s decision to allow her property to pass under *H*'s will was partially induced by the prospect of receiving a life estate in *H*'s property (the bargaining aspect), but it also recognizes that *W*'s decision was partially induced by *H*'s designation of *C*—her child—as remainderman (the donative aspect).

This approach resolves the appropriate gift tax treatment of the transaction. Since *W* is viewed as the grantor of *H Trust*, she should be treated as making a gift of the remainder in that trust to *C*.²⁵⁶ Since the remainderman, *C*,

255. See supra note 217 and accompanying text.

256. The IRS uses the “fragmented” rather than the “unitary” approach in determining gift tax liability. See Rev. Rul. 69-505, 1969-2 C.B. 179. Assume *A* creates *A Trust*, with income payable to *B* for life, remainder to *C*, and *B*, in an interrelated transaction, creates *B*

is her child, section 2702 will apply, and unless *W* retains a “qualified interest” in *H Trust*, she should be treated as making a gift of the entire value of that trust.

This approach differs fundamentally from existing law, where both the courts and the IRS permit *W* to offset her gift of a remainder in *W Trust* by the value of the life estate she receives in *H Trust*.²⁵⁷ There is a section 2512(b) consideration offset in the transaction, but it is different from the one recognized by the courts and the IRS. To understand this, we must once again delve into the conceptual foundations of the reciprocal trust doctrine.

Consider this case: *A* transfers *Blackacre* in trust with income payable to *B* for life, remainder to *B*'s issue, and *B*, in an “interrelated” transaction, transfers *Whiteacre* in trust with income payable to *A* for life, remainder to *A*'s issue. Under the reciprocal trust doctrine, *B* is treated as the real grantor of *A*'s trust; *B* is therefore viewed as transferring *Blackacre*. How can this be when *Blackacre* belonged to *A*? The answer is that the reciprocal trust doctrine necessarily requires that *A* and *B* be viewed as first exchanging beneficial interests in *Blackacre* and *Whiteacre*. The reciprocal trust doctrine, properly analyzed, involves two constructive steps: The two parties first exchange beneficial interests in their respective properties, and each party subsequently transfers the property he physically holds (but which now beneficially belongs to the other) as the other party's agent. In terms of the above example, *A* and *B* first exchange their beneficial interests in *Blackacre* and *Whiteacre*. *A* then transfers *Blackacre* (which he now holds on *B*'s behalf) as *B*'s agent; and *B* transfers *Whiteacre* (which he now holds on *A*'s behalf) as *A*'s agent.

The following example may clarify this point. Assume *D* owns *Greenacre* having a fair market value of \$500,000. If *D* accepts \$500,000 from *E* in consideration for transferring *Greenacre*, at *E*'s behest, to a trust for the benefit of *E* and *E*'s issue, *D* in effect has sold *Greenacre* to *E* for \$500,000, and

Trust, with income payable to *A* for life, remainder to *C*. Rather than treating *A* as the grantor of *B Trust* and *B* as the grantor of *A Trust* for gift tax purposes, the Service bifurcates the transaction. First, *A* and *B* are treated as exchanging their respective life estates in the two trusts. Thus *A* makes a taxable gift to *B* to the extent, if any, that the value of *B*'s life estate in *A Trust* exceeds the value of *A*'s life estate in *B Trust*; *B*'s gift, if any, is determined in the same manner. Then each party is treated as making a gift of the remainder in the trust he or she purportedly created (i.e., *A* is treated as making a gift of the remainder in *A Trust*). See *id.*

This approach is inconsistent with the approach the IRS uses for estate tax purposes. See Rev. Rul. 74-533, 1974-2 C.B. 293. If the gift tax approach were followed, the IRS would include the value of *A Trust* in *A*'s gross estate under § 2036, since the gift tax approach viewed *A* as having transferred the remainder in *A Trust*. However, the Service bases the amount included in *A*'s gross estate solely on the value of *B Trust*. See *id.* The Service's gift tax approach is also inconsistent with the underlying rationale for applying the reciprocal trust doctrine, that is, that each transferor is the grantor of the other party's trust. See *supra* note 250 and accompanying discussion.

257. See *supra* notes 33-35 and accompanying text.

then, acting as *E*'s agent, transferred *Greenacre* to the trust. This is what happens when the reciprocal trust doctrine applies.

In the context of a spousal election, *W* should thus be viewed as first exchanging ownership of her share of the community for ownership of *H*'s share of the community.²⁵⁸ *W* should then be viewed as transferring her share of the community, which she now holds on behalf of *H*'s estate, to *W Trust* as the agent for *H*'s estate. Likewise, *H*'s estate should be viewed as transferring *H*'s share of the community to *H Trust* as *W*'s agent, thereby making *W* the grantor of that trust. The section 2512(b) gift tax consideration offset applies to the first constructive step—*W*'s exchange of her beneficial interest in her share of the community for *H*'s share of the community. *W* realizes no gift tax liability on this constructive "exchange" because the values of the properties being exchanged are equal.²⁵⁹ Since *W* fully utilizes the consideration she receives as an offset in the first constructive step, she may not use it again in the second constructive step. Thus, *W* is not entitled to any offset in her deemed creation of *H Trust*.

Since *W* is viewed as the grantor of *H Trust* in which she has retained a life estate, the entire value of *H Trust* will be included in her gross estate under section 2036. The consideration *W* received in the election was not for her deemed creation of *H Trust* but rather in the constructive exchange of her share of the community for *H*'s share of the community. Consequently, neither the section 2036 exclusion nor the section 2043 offset will apply.²⁶⁰

258. Some have asserted that the Supreme Court's decision in *United States v. Stapf*, 375 U.S. 118 (1963), validates current law, which views a spousal election as an "exchange" by *W* of a remainder in her property for a life estate in *H*'s property. See *Morrison*, supra note 21, at 226-27. Indeed, the decision seems to implicitly assume that a spousal election involves an "exchange" between *W* and *H*'s estate. See *Lowndes*, supra note 21, at 73-74 (the Court of Appeals "apparently considered the widow's election a transfer for consideration" and the Supreme Court "without close analysis of the issue, seems to have made the same assumption"); *Morrison*, supra note 21, at 226 (*Stapf* recognized the "validity of intraspousal transfers and exchanges."). But the existence of an "exchange" is fully consistent with the reciprocal trust doctrine, since the doctrine likewise assumes an "exchange," namely, an exchange of *W*'s share of the community for *H*'s share of the community (i.e., the first constructive step).

259. In many cases, *W*'s share of the community will be larger than *H*'s share, since death taxes and administration expenses will have depleted his share. In that case, the amount of *W*'s property that she is treated as exchanging for the creation of *H Trust* is limited to the value of *H Trust*, and the excess amount in *W Trust* will be treated as a transfer by *W* resulting in a gift. *Grace* limits application of the reciprocal trust doctrine to the "extent of mutual value" transferred by the parties, i.e., the smaller amount. *United States v. Estate of Grace*, 395 U.S. 316, 324 (1969). See also supra note 176.

260. Although a definitive answer of this question is beyond the scope of this article, use of the reciprocal trust doctrine may also resolve the income tax treatment of a spousal will election. Since the values of *W*'s share and *H*'s share that are exchanged for each other are equal, and since each of these shares acquires the same basis, that is, their values on the day of

However, there will be cases where the “fragmented” approach of the current law better fits the facts of a spousal will election than the “unitary” approach of the reciprocal trust doctrine. Consider the case where *W* is indifferent, or even antagonistic, toward *C*, *H*’s child by a prior marriage, but allows her property to pass under *H*’s will because the life estate she receives in *H Trust* is worth substantially more than the remainder she gives to *C* in her trust. Clearly, the fragmented approach better explains what is happening here than the unitary approach. In this case, *W* should be allowed, as under current law, to offset the amount of her “gift” to *C* by the value of the life estate she receives in *H*’s property. Here, *W*’s receipt of that life estate constitutes the real “consideration” for her relinquishment of the remainder to *C*. Likewise, the value of *W*’s life estate in *H Trust* constitutes “consideration” for purposes of the section 2043 offset. Again this result conforms to the existing law. However, the adequacy of the consideration *W* received (i.e., her life estate in *H Trust*) should be measured against the value of the remainder she gives to *C* and not the value of the property *W* places in *W Trust* in determining whether the exclusion from section 2036 applies. To this limited extent, the holdings of the *D’Ambrosio* trilogy should change the existing law in spousal elections.

The cases where the fragmented approach applies should be few in number. Since the normal desire of every parent is to benefit her children, there should be a strong presumption that the parent’s decision to accede to the election was partially motivated by the benefits it conferred on her children. Other reasons for a strong presumption in favor of the unitary approach are the high likelihood that the spousal election device will be used for tax avoidance; the difficulty of determining the intent of deceased persons to transactions that may have occurred many years before; and the fact that parties in an intrafamily transactions rarely deal with each other on a conscious arm’s length basis. The same factors that led the Supreme Court to relieve the Government of the need to prove a bargained-for, quid pro quo consideration before invoking the reciprocal trust doctrine support a strong presumption here.²⁶¹

To invoke the fragmented approach, *W*’s estate should be required to show by clear and convincing evidence that *W*’s decision to allow her property to pass under *H*’s will was not influenced by *H*’s designation of *C* as the remainderman.²⁶² Whenever courts are called on to determine subjective intent,

H’s death (or the alternate valuation date), see IRC § 1014(b)(6), the deemed exchange of the two shares should not produce any significant amount of taxable gain.

261. See *supra* text accompanying notes 237-39.

262. The suggested presumption is analogous to the rule applicable to divorce settlements that provide benefits to the payor’s adult children. The IRS and the courts treat such benefits as gifts by the payor spouse, unless he can prove otherwise. See *Spruance v. Commissioner*, 60 T.C. 141 (1973); Rev. Rul. 77-314, 1977-2 C.B. 349.

they necessarily place great weight on objective factors in judging the genuineness of the party's alleged intent.²⁶³ Here, *two* objective showings should normally be required. First, *W's* estate should be required to show that *W* was antagonistic, or at least indifferent, to the remaindermen designated in *H's* will. This might be true, for example, where the remaindermen were *H's* children by a prior marriage. Secondly, *W's* estate should be required to show that *W* possessed a *reasonable* basis for believing that her economic position would be improved by allowing her property to pass under *H's* will. This showing could be established by use of the Government actuarial tables or other convincing valuation techniques.

An absolute rule eliminating the need to determine subjective intent cannot be applied in spousal elections. Unlike the situation in *Grace*, *W's* estate is statutorily entitled to an estate tax offset or exclusion if it shows that *W's* receipt of a life estate was the inducement for the relinquishment of the remainder in her property. However, the above requirements should make use of this approach administratively feasible as well as satisfying the requirements of the law.

c. Estate of Magnin, *Spousal Elections and the Reciprocal Trust Doctrine*.—Although *Magnin*²⁶⁴ is not technically a spousal election case, analytically it involved the same type of exchange. Only the identity of the parties differed: the exchange occurred between father and son rather than husband and wife. Consequently, the Ninth's Circuit's decision to apply the *D'Ambrosio-Wheeler* test for "full consideration" to *Magnin* is strong precedent for extending this test to spousal elections, and as such, the case deserves close scrutiny.

In *Magnin*, the combined stock holdings of decedent and his father constituted voting control of a company operating women's clothing stores.²⁶⁵ The father desired control of the business to remain "in the family" and consequently did not want his son to leave his stock to any of the women he had

It is unclear whether the suggested presumption can be judicially developed or would require legislative approval. Section 7491 provides generally that in any income, estate, or gift tax controversy, the Commissioner has the burden of proof with respect to any factual issue on which the taxpayer has introduced credible evidence. The Senate Finance Committee Report, in explaining this provision, speaks of the prior "general rule of presumptive correctness of the Commissioner's determination." S. Rep. No 174, 105th Cong., 2d Sess. 43 (1998). Arguably, § 7491 applies only to this general presumption, and not to judicially created presumptions limited to special situations; however, the statute's language does contain such a limitation.

263. For example, under § 183 a taxpayer is entitled to deduct his ordinary and necessary expenses if he engages in an activity with the intent of making a profit, even if his expectation of a profit is unreasonable. However, the taxpayer's intent is determined by reference to objective standards. See Regs. § 1.183-2(a).

264. Estate of Magnin v. Commissioner, 184 F.3d 1074 (9th Cir. 1999).

265. Estate of Magnin v. Commissioner, 71 T.C. Memo (CCH) 1856, 1858, T.C. Memo (RIA) ¶ 96,025, at 239, 241 (1996).

started dating following his wife's death.²⁶⁶ The decedent, on the other hand, was concerned he might lose control of the company following his father's death, which he valued for social, political and business reasons.²⁶⁷

To accommodate these objectives, decedent and his father entered the following agreement. The father agreed to leave his stock in four trusts, one for the benefit of decedent and one for each of the decedent's three children.²⁶⁸ One-half of the father's stock was to go to the decedent's trust in which the decedent was to have a life income interest.²⁶⁹ The father designated decedent as the sole trustee of all four trusts with sole power to vote the stock thereby assuring the son of continued control of the company.²⁷⁰ In return, the son agreed to leave all his stock in the company to his children upon his death.²⁷¹ The decedent was enjoined from transferring or encumbering his shares but was permitted to give them to his children.²⁷² Decedent agreed that if the company was dissolved, or all its stock acquired, he would place the proceeds in a trust in which he would enjoy a life income interest with the remainder passing to his children at death.²⁷³

Following his father's death all the company's stock was bought by an outside corporation, and decedent, in accordance with the agreement, placed the proceeds from the sale of his stock in a trust having the terms described above.²⁷⁴ When the decedent died, the IRS asserted that this trust was includible in his gross estate under section 2036 since he had retained a life estate in it.²⁷⁵ The estate countered that the decedent had received full consideration for his transfer of the remainder interest to his children, namely, voting control and a one-half life income interest in his father's stock.²⁷⁶

The court found there was "some" or "an element" of bargained-for consideration in the transaction,²⁷⁷ but, following *Gradow*, found the consideration decedent received inadequate since it did not equal the full value of his stock he agreed to transfer to his children.²⁷⁸ On appeal, the Ninth Circuit

266. See *id.*

267. See *id.*

268. See *Magnin*, 71 T.C. Memo (CCH) at 1859, T.C. Memo (RIA) at 241-42. The father also agreed to leave to these trusts shares he owned in a separate corporation that operated a women's clothing store in Reno, Nevada. See *id.*

269. See *Magnin*, 71 T.C. Memo (CCH) at 1858-59, T.C. Memo (RIA) at 243 (describing provisions of decedent's trust).

270. See *Magnin*, 71 T.C. Memo (CCH) at 1858-59, T.C. Memo (RIA) at 241-42.

271. See *id.*

272. See *id.*

273. See *Magnin*, 71 T.C. Memo (CCH) at 1859, T.C. Memo (RIA) at 243.

274. See *id.*

275. See *Magnin*, 71 T.C. Memo (CCH) at 1861, T.C. Memo (RIA) at 244-45.

276. See *Magnin*, 71 T.C. Memo (CCH) at 1861, T.C. Memo (RIA) at 245.

277. *Magnin*, 71 T.C. Memo (CCH) at 1862, T.C. Memo (RIA) at 246.

278. See *Magnin*, 71 T.C. Memo (CCH) at 1863, T.C. Memo (RIA) at 247.

reversed and remanded, holding per *D'Ambrosio* and *Wheeler* that the “full consideration” requirement would be met if the estate could establish that the consideration received (i.e., the one-half life income interest and voting control in his father’s stock) equaled or exceeded the present value of the *remainder* interest decedent agreed to transfer to his children.²⁷⁹ Note that if the estate makes this showing, decedent and his estate will escape all transfer tax on decedent’s transfers to his children.

Both the Tax Court and the Circuit Court applied a “fragmented” approach to the case. Unfortunately, neither court considered possible application of the *Lehman* “unitary” approach. The fragmented approach views a transaction like this exclusively in terms of an exchange of a remainder interest in one party’s property in return for a life interest in the other party’s property. Each party is viewed as indifferent to, and unaffected by, whatever other disposition the other party makes of his property; thus the balance of his disposition is viewed as irrelevant in determining the tax effects of the transaction. This assumption of indifference is rarely true in a spousal election, and does not appear to have been the case in *Magnin*.

Consider father’s situation. Was his sole interest in the transaction to protect his grandchildren? Was he indifferent, or even antagonistic, to his son’s continuing control of the business? The facts tell a different story. Even before their agreement, the father had provided in his will for his stock to pass in trust for the benefit of his son and his son’s children; his son was also to serve as sole trustee thereby assuring him of continuing control of the business.²⁸⁰ The agreement merely precluded him from revoking this provision; in other words, it continued the status quo.²⁸¹ Was he opposed to having his son operate the business? Although the father and son had different ideas as to how the business should be operated, the father had turned operating control over to his son almost 15 years before their agreement.²⁸² It thus appears likely that the father—from love, a sense of paternal obligation, or both—*wanted* his son to retain control of the business provided the rights of his grandchildren were protected. Indeed, if he opposed his son’s continued control of the business and was solely motivated by his grandchildren’s welfare, he might better have achieved these objectives by leaving his shares outright to his grandchildren.

279. *Estate of Magnin v. Commissioner*, 184 F.3d 1074 (9th Cir. 1999).

280. See *Magnin*, 71 T.C. Memo (CCH) at 1859, T.C. Memo (RIA) at 242.

281. See *id.*

282. See *Magnin*, 71 T.C. Memo (CCH) at 1857, T.C. Memo (RIA) at 240. The father turned operation of the business over to his son in 1937; the agreement was made in 1951. See *id.* After 1937, the father concentrated his efforts on a successful factoring business he had started. See *id.*

Was the son's sole interest in the transaction to obtain voting control of his father's shares? Was he indifferent, or even antagonistic, to his children receiving his father's shares upon his death? There was no evidence of this. Although the court made no finding to this effect, one might *surmise* some tension existed between the decedent and his children since they disliked his second wife.²⁸³ But there is nothing to suggest that the son disliked his children, or objected to their receiving his father's shares after the son's death.²⁸⁴ On the contrary, his children had worked with him in the business from early in their lives and apparently continued to work with him in the business during the rest of decedent's life.²⁸⁵ Decedent appointed his oldest son executor of his estate, suggesting a relationship of trust and love.²⁸⁶ Most likely, the decedent was attracted to a solution where his father's shares would "remain in the family" and ultimately pass to his children. Indeed, his agreement with his father benefited his children by *obligating* his father to leave one-half of his shares in trusts for their benefit.

These facts suggest the presence of both donative and bargaining elements in the transaction. The Tax Court seems to have recognized this when it found the transaction involved merely "some" bargained-for consideration, or as it expressed the thought elsewhere, "an element of" bargained-for consideration.²⁸⁷

Since donative impulses were almost certainly present, the *Lehman* "unitary" approach provides a better way of characterizing the transaction. Father and son were bargaining. The father wanted a solution that would allow his son to continue *running the business but at the same time would protect his grandchildren*. The son wanted to assure his continued control of the business but probably also wanted his children to have an interest in the business following his death. The father proposed a package deal: "I will leave my shares so that you can vote them during your lifetime and so they will pass to your children upon your death. In return, you will continue to own your shares subject

283. See *Magnin*, 71 T.C. Memo (CCH) at 1858, T.C. Memo (RIA) at 240. The father also disliked decedent's second wife. See *id.*

284. The decedent *may* have preferred to leave some or all of *his own* shares to his second wife, at least for the period she survived him. As far as the opinion reveals, no evidence was presented on how he wanted to leave his own shares. However, there is no reason to suppose he was unhappy about *his father's shares* passing to his children after his (i.e., the son's) death. Indeed, as the text develops, the circumstances suggest he would have wanted his children to have an interest in the business following his death.

285. See *Magnin*, 71 T.C. Memo (CCH) at 1858, T.C. Memo (RIA) at 240. The opinion states that his children continued working in the business during their adulthood, except that his daughter reduced her day-to-day activities following her marriage. Her husband entered the business and was ultimately placed in charge of store operations. See *id.*

286. See *Magnin*, 71 T.C. Memo (CCH) at 1856, T.C. Memo (RIA) at 239.

287. *Magnin*, 71 T.C. Memo (CCH) at 1862, T.C. Memo (RIA) at 246.

to some restrictions on their transfer but will leave them to your children on your death." Each party's package was designed to appeal to the other and induce his acceptance. Consequently, the father "bought and paid for" the son's disposition of his shares and the son "bought and paid for" the father's disposition of his shares. The decedent should therefore have been treated as the transferor of his father's shares, and to the extent his father's disposition gave him a life income interest, it should have been included in his gross estate pursuant to section 2036.²⁸⁸

Since the normal desire of every parent is to benefit his children, there should be a strong presumption in these cases that the parent's decision to enter the agreement was motivated, in part, by the benefits it conferred on his offspring. Otherwise, the danger that such agreements will be used as cover for making a tax-free, donative transfer to one's children is too great. In *Magnin*, the estate fell far short of overcoming this presumption.

V. CONCLUSION

In a simple sale of a remainder, the actuarial value of such remainder should be treated as "consideration" for gift and estate tax purposes. The contrary position of the IRS and some courts is erroneous and should be abandoned. Perhaps, this erroneous view was borne out of concern that taxpayers could manipulate a transfer so that the actuarial value of a remainder would understate its true economic worth. If so, the enactment of section 2702 removes any possible justification for continued adherence to that position.

A spousal election should normally be analyzed under the "unitary approach" of *Lehman*. Under this approach, *H* will be treated as establishing *W Trust* and *W* as creating *H Trust*. Consequently, *W* will be subject to a gift tax on the full value of the remainder passing in *H Trust* to *C* and, unless *W's* retained interest is a "qualified interest," on the full value of the property passing to that trust. Since this approach views *W* as "retaining" a life estate in *H Trust*, the full value of that trust will be included in her gross estate pursuant to section 2036. Under this approach, neither *W* nor her estate will qualify for a section 2512(b) gift tax offset or a section 2043 estate tax offset.

288. Since his father's disposition, which the *Lehman* analysis treats as having been made by the decedent, gave the decedent a life estate in only one-half of his father's shares, only that portion would be included in decedent's gross estate. His father's disposition gave the decedent voting control of all his shares, but § 2036(b)—which treats a retention of voting power in a controlled corporation as a retention of beneficial enjoyment—would not apply because father's transfer occurred prior to June 22, 1976. See Revenue Act of 1978, Pub. L. No. 95-600, § 702(i)(3), 92 Stat. 2763, 2931 (1978). The agreement was made in 1951 and the father died in 1953. See *Magnin*, 71 T.C. Memo (CCH) at 1858-59, T.C. Memo (RIA) at 241-42.

However, the fragmented approach of current law should apply if *W* and her estate establish by clear and convincing evidence that *W*'s decision to allow her property to pass under *H*'s will was uninfluenced by *H*'s designation of *C* as remainderman. Where this showing is made, *W* will be liable for a gift tax only on the amount, if any, by which the value of the remainder she surrenders exceeds the actuarial value of the life estate she receives in *H Trust*. *W Trust* should be included in *W*'s gross estate under section 2036 only if her life estate in *H Trust* is worth less than the remainder in *W Trust* on the date of the election, and even then, *W*'s estate should be permitted to reduce *W*'s gross estate by the value of the life estate on the day of election.