

THE GROSS ESTATE

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I. INTRODUCTION.

Sections 2033 through 2046 identify the interests includible in the gross estate for purposes of the federal estate tax. This outline omits discussion of Sections 2039 and 2042, which are dealt with in other portions of the program.

II. SECTION 2033. PROPERTY IN WHICH THE DECEDENT HAD AN INTEREST.

Code Section 2033 requires that there be included in the gross estate the value of all property to the extent of the decedent's interest therein.

The estate includes the value of property in which a decedent has a beneficial interest, even though title or possession is held by another person, such as a trustee or pledgee. Treas. Reg. § 20.2033-1(a). See Private Letter Ruling 9338011 (assets in personal account were actually subject to a trust, and thus excluded from estate).

The decedent must also have had an interest which survives his death in the sense that it can be transmitted to others by his will or through intestacy laws. Treas. Reg. § 20.2031-1(a)(1).

A. ROUTINE INCLUSIONS.

In many cases the applicability of the section is not questionable.

1. All real property owned by the decedent at death and situated in the U.S. is included.
2. The gross estate of a U.S. citizen or resident includes foreign real estate. Corporate stock and bonds are included in the decedent's gross estate to the extent that he had a beneficial interest in the stock and bonds at his death. All personal property owned whether tangible or intangible and whether located within or without the U.S. is includible.
3. Bank deposits are included. Report the net balance in the account after deducting the amount of checks outstanding at the time of death if (1) checks were given in discharge of bona fide legal obligations and (2) the checks are subsequently honored and (3) the obligations are not claimed as deductions from the gross estate. Uncashed checks to charitable donees have been held deductible by the Tax Court. Uncashed checks to non-charitable donees have been held by the Seventh Circuit to be includible. (Daniel F. McCarthy v. U.S. 11/24/86, CA-7.)

B. DIVIDENDS PAID AFTER DEATH.

The inclusion of dividends paid after death on stock owned by a decedent at death depends on the date of death in relationship to the declaration date, or to the record date if that is later than the declaration date. The declaration date is the date on which the dividend is declared.

The record date is the date on which the record owner of the stock becomes entitled to receive the dividend, even though he may transfer his stock before the dividend is actually paid.

1. Dividends payable after death of a decedent who was a stockholder of record on or before the date of his death are part of his estate. Treas. Reg. § 20.2033-1(b).
2. Where the record date is later than the declaration date, the dividend is included in the estate if death occurs on or after the record date. Treas. Reg. § 20.2033-1(b). The dividend is excluded if death occurred before the record date even though this death may have occurred after the declaration date. Rev. Rul. 54-399, 1954-2 C.B. 279; Sharp v. Com'r., (1935) 33 B.T.A. 290, aff'd, (CA3) 91 F.2d 802, rev'd on other issue 303 U.S. 624, 82 L. Ed. 1987; Est. of Lockie, (1935) 21 T.C. 64.
3. Therefore, the determining date is actually the record date. If decedent dies before record date, the dividend is excluded. If he dies on or after record date, the dividend is in the estate.

C. TAX-EXEMPT BONDS, OTHER PROPERTY AND PROPERTY INTERESTS.

Nothing in any provision of law, which exempts any property or any interest in property from income taxation will exempt such property or property interest from estate, gift and generation-skipping transfer taxes. Sec. 641(2), PL 98-369, 7/18/84. This rule of law applies to estates of decedents dying after June 18, 1984. Sec. 641(b)(1), P.L. 98-369, 7/18/84.

D. PARTNERSHIP INTERESTS AND POST-MORTEM PAYMENTS.

The estate includes the value of the decedent's interest in a partnership that is transmitted at his death. Most of the courts have held that a deceased partner's estate also includes the right of his estate to share in post-mortem profits. McClennen v. Com., 131 F.2d 165 (1st Cir. 1942); Est. of Riegelman v. Com., 253 F.2d 315 (2d Cir. 1958), aff'g 27 T.C. 833; Est. of Lincoln, T.C. Memo., 12/24/42; Est. of Cannon, (1954) 21 T.C. 1073.

E. ACCRUED INCOME.

The estate includes all income of the decedent that had accrued at the date of death, but not income that accrued thereafter. Income accrued at the date of death includes:

1. Income that is earned even though its payment does not become due until a date after decedent's death. Treas. Reg. § 20.2033-1(b).
2. Undistributed trust income accrued at the death of the life beneficiary of a trust who was entitled to receive the entire net income of the trust and to have it distributed to her in monthly installments.

F. SELF-CANCELLING NOTES.

The question whether to include the balance due on notes that are cancelled by their terms on the death of the obligee has not been uniformly answered. The Tax Court held that when a note contains a cancellation at death of the payee provision as part of the terms agreed upon for its issue, and the underlying sale was made at arm's length and for adequate consideration, there is no interest remaining in the decedent-payee at his death and the notes are not includible in his estate. *Est. of Moss*, 74 T.C. 1239 (1980). The Seventh Circuit also excluded notes on similar facts. *Com'r. v. Austin*, 72 F.2d 758 (7th Cir. 1934), aff'g 26 B.T.A. 1216. But the Tax Court included notes in another case in which the decedent retained control of the entire debt until his death and could at any time have revoked his decision to cancel the debt at his death. *Est. of Buckwalter*, 46 T.C. 805 (1966). Relying on *Buckwalter*, the Court of Claims has also included a self-canceling note, stating that in the absence of clear evidence of intent to enforce the debt, intra-family loan transfers will be deemed gratuitous. *Est. of Musgrove v. U.S.*, 33 Cl. Ct. 657 (1995).

The recent case of *Frane v. Com'r.*, 998 F.2d 567 (8th Cir. 1993), affirms the excludability of self-canceling installment notes from the gross estate. For income tax purposes, however, the gain must be reported as Section 691 income on the estate's fiduciary return. Since the note is excluded from the estate, no offsetting deduction is available for estate taxes paid.

Premium for Self-Canceling Note: The IRS requires the buyer to pay a premium for the self-canceling feature, but the rules governing the premium are not entirely clear. The buyer could pay a premium on the purchase price, in which case the Seller would realize more capital gains on the sale. In the alternative, the premium could be built into the interest rate, which would result in the Seller recognizing more ordinary income.

G. NOTES TO HEIRS.

Notes that were really advances to heirs were not included in the estate where it was evident that there was no intention that the notes were to be paid. *Est. of Rosenbaum*, T.C. Memo., 8/29/44; *Farwell v. Com.*, 38 F.2d 791 (2d Cir. 1930).

H. TAX REFUND CLAIMS.

The decedent's estate includes a refund due the decedent for a tax overpayment even if the refund claim is not filed until after his death by his executor. *Security-First National Bank of Los Angeles*, 35 B.T.A. 815 (1937); *Bank of California National Assn. (Barneson Est.) v. Com.*, 133 F.2d 428 (9th Cir. 1943).

I. CLAIMS FOR WRONGFUL DEATH.

"Wrongful death" proceeds are excluded from an estate unless it can be established that the wrongful death proceeds represent damages to which the decedent became entitled during lifetime (such as for pain and suffering and medical expenses) rather than damages for his premature death. The value of "lifetime" damages will be includible. *Rev. Rul. 75-127*, 1975-1 C.B. 297; *Rev. Rul. 75-126* 1975-1 C.B. 296; *Rev. Rul. 83-44*, 1983-11 IRS 6.

J. COMPENSATION PAID AFTER DEATH.

The estate includes compensation earned before death, but not paid until after death. Est. of McGlue, 41 B.T.A. 1199 (1940); Est. of McKitterick, 42 B.T.A. 130 (1940), pet. rev. dismissed, 6/27/42, CA-2. The Tax Court and the Service have said an estate can exclude after-death payments if the deceased employee had no rights to them at the time of his death, but result instead from discretionary action of the employer after death. Est. of Messing, T.C. Memo., 8/18/48. Rev. Rul. 65-217, 1965-2 C.B. 214, amplified on another point by Rev. Rul. 68-124, 1968-1 C.B. 389.

K. DEFERRED COMPENSATION PAID AFTER DEATH.

The estate includes the value of after-death payments of deferred compensation even though the right to receive them is contingent on performance of an agreement to render advisory services to an employer, or an agreement not to compete with his employer's business, etc. The payments are valued at death without the contingency, since the contingency was removed at death and the right became absolute. *Goodman v. Granger*, 243 F.2d 264 (3d Cir. 1957).

L. ATTORNEY'S CONTINGENT FEES PAID AFTER DEATH.

An attorney's estate includes his right to receive a portion of any legal fees under a contingent fee agreement. Rev. Rul. 55-123, 1955-1 C.B. 443. Earlier Tax Court memorandum decisions excluded contingent fees. Est. of Nemeror, T.C. Memo. 1956-164.

M. POST-DEATH EMPLOYMENT BENEFITS.

Employment benefits are includible under Section 2033 if the estate has a right to payment, while Section 2039 frequently captures benefits payable to a beneficiary. On the other hand, voluntary payments under employee benefit plans to a deceased employee's estate or beneficiary have been excluded. *Morrow*, 19 T.C. 1068 (1953).

N. SOCIAL SECURITY ACT.

Under the Social Security Act, an employee has no control over the designation of beneficiaries or the amounts payable to them and has no property interest in the funds at the time of his death. Thus, such benefits are not includible.

O. LIFE INSURANCE.

Insurance on the life of another person who survives the owner-decedent is includible in the estate as property in which the decedent had an interest when he died. I.R.C. § 2033; Est. of Dupont, 18 T.C. 1134 (1952), aff'd, 233 F.2d 210 (3d Cir.), cert. den. 352 U.S. 878, 1 L. Ed. 79.

P. TENANCY IN COMMON INTERESTS.

The fractional interest of a tenant in common is transmitted on death to his heirs and therefore includible in the gross estate.

Q. LIFE ESTATES.

1. A life estate terminates with the death of the life tenant and neither the life estate nor the related property is included in the life tenant's estate under Section 2033. Rev. Rul. 66-86, 1966-1 C.B. 216; *Helvering v. Safe Deposit & Trust Co. of Baltimore*, 121 F.2d 307 (4th Cir. 1941), rev'd on other grounds 316 U.S. 56, 86 L. Ed. 56; *Helvering v. Est. of Rhodes*, 117 F.2d 509 (8th Cir. 1941); *Frew v. Bowers*, 12 F.2d 625 (2d Cir. 1926); *Est. of Billings*, T.C. Memo., 12/6/49; *Williams v. U.S.*, 41 F.2d 895 (1st Cir. 1930).
2. A life estate reserved by the holder in property owned when the property was transferred (subject to the reserved life estate) to another for adequate and full consideration in money or money's worth is not included in the life tenant's estate under Section 2033. The question of the adequacy of the consideration to avoid inclusion under Section 2036 is discussed elsewhere.
3. If a life estate is measured by the life of another or for any other term of years not fixed with reference to the holder's death then the value of the unexpired portion of the life estate at the holder's death is included in his estate. *Millard v. Maloney*, 121 F.2d 257 (3d Cir. 1941).

R. FUTURE INTERESTS.

In general, future interests are included in the estate where the interest is not extinguished by the holder's death and will pass to his heirs.

1. Vested Remainder. Once a remainder is vested, it survives the death of the remainderman and is includible in his gross estate if he dies before he obtains possession or enjoyment of the property. *Est. of Frazer v. Com.*, 162 F.2d 167 (3d Cir. 1947), aff'g 6 T.C. 1255.
2. Vested Remainder Subject to Divestment. If the condition which divests the remainderman of his interest is his failure to survive, nothing is included in his estate at death. If the divesting condition has not occurred at time of death, the interest will be included. *Est. of Field*, 22 B.T.A. 915 (1931).
3. Contingent Remainders. Most contingent remainders are dependent on the remainderman's survival, so that his death before obtaining the property extinguishes his interest and nothing is includible in his estate. Rev. Rul. 55-438, 1955-2 C.B. 601; *Est. of Williams*, 62 T.C. 400 (1974); *Com. v. Rossner*, 64 F.2d 631 (3d Cir. 1933); *Hamlin v. U.S.*, 66 Ct Cl 501; *Davis v. U.S.*, (1939, DC NY) 27 F. Supp. 698; *McElroy v. Hinds*, 5/5/54, DC Okla.

Illustration: W creates a trust with income paid to her spouse, B, during his lifetime and on his death principal paid over in equal shares to such of their children as are then living. If a child dies before B, nothing is included in the child's estate since death extinguishes his contingent remainder.

4. Reversionary Interests. If the reversionary interest survives the decedent's death and passes to his heirs, it is includible in the estate. *Adriance v. Higgins*, 113 F.2d 1013

(2d Cir. 1940), aff'g (DC NY) 930 F. Supp. 70; Dixon, *exr v. U.S.*, (DC NY) 319 F. Supp. 719 (1970).

S. INCOMPLETE OR VOID TRANSFERS BEFORE DEATH.

The estate includes property the decedent attempted to transfer before his death if the gift was incomplete or void. *Est. of Smith v. Com.*, 140 F.2d 759 (3d Cir. 1944). See *Est. of Cummins v. Com'r*, 66 T.C.M. 1232 (1993) (irrevocable letter of instructions to broker insufficient to effectuate transfer prior to death).

T. DECEDENT'S INTEREST IS DETERMINED BY LOCAL PROPERTY LAW.

The Supreme Court has held that the decision of a state court on a question involving state law does not bind IRS or federal courts when the U.S. was not a party to the state proceeding and there is no decision by the highest court of the state on the matter. The federal authorities can make their own interpretation of state law, giving "proper regard" to relevant rulings of lower state courts. *Com'r v. Est. of Bosch*, 387 U.S. 456 (1967), 18 L. Ed. 2d 886, rev'g and rem'g 363 F.2d 1009 (2d Cir.); *Second Nat'l Bank of New Haven v. U.S.*, 387 U.S. 456, 18 L. Ed. 2d 886, aff'g 351 F.2d 489 (2d Cir.).

Observation: The pre-*Bosch* rule under which state court decisions in adversary, noncollusive proceedings were held to be binding for estate tax purposes appears to be no longer applicable. Under *Bosch*, the federal court must find how the highest court of the state would decide the local law question, and the lower state court's decision would merely be treated as part of the evidence to be considered in making that finding. Whether the decision was adversary or nonadversary would appear to affect only the weight to be given to the decision.

U. RESULTING TRUSTS.

Service rejects claim by decedent's companion that half the value of the home the couple shared should be excluded from estate based on resulting trust. *Estate of Horstmeier v. Commissioner*, 226 F.3d 871 (7th Cir. 2000). Under applicable state law (Illinois), a resulting trust is created at the time legal title is initially taken if a person other than the titleholder provides consideration and the parties intend that the contributing non-titleholder is to have a beneficial interest in the property. The Tax Court had found that there was insufficient credible evidence of the elements of a resulting trust, and the Seventh Circuit held that those findings were not clearly erroneous.

III. SECTION 2034. DOWER, CURTESY OR SIMILAR INTERESTS.

Section 2034 states that a decedent's gross estate should not be reduced by the value of a survivor's dower or curtesy or similar interest in the decedent's property.

This section, forbidding the exclusion of a surviving spouse's dower or curtesy or similar interest from the gross estate, does not necessarily mean that such interest will fully enter into the final determination of the estate's tax liability. When such an interest takes effect it is treated as "passing" to the surviving spouse and so, subject to detailed considerations, may be removed from the taxable estate by way of the marital deduction allowed under Section 2056. I.R.C. § 2056(d)(3).

A. DOWER, CURTESY, AND SIMILAR INTERESTS OF SURVIVING SPOUSE DO NOT REDUCE DECEDENT'S ESTATE.

No exclusion may be made from the value of the deceased spouse's property for the dower, curtesy or similar interest of the surviving spouse. The entire value of the property must be included in the gross estate of the deceased spouse. I.R.C. § 2034; Treas. Reg. § 20.2034-1.

B. ANTENUPTIAL AGREEMENTS IN LIEU OF DOWER.

Under an antenuptial agreement, payment in lieu of dower was treated as the equivalent of the dower right where, under the agreement, the wife's right to the payment arose only on the death of the husband. The amount payable was not excludible from the husband's gross estate at his death. *Empire Trust Co (Est. of Hamilton) v. Com.*, 94 F.2d 307 (4th Cir. 1938).

A surviving spouse's right to continue the use of the couple's residence under an agreement did not reduce the value in the decedent's estate. *Est. of Carli*, 84 T.C. 649 (1985). Note that the rules under Section 2053, relating to the adequacy of consideration to support deduction of a claim against the estate, are consistent in treating release of marital claims grounded in dower and curtesy as inadequate consideration, unless arising in context of divorce. See *Est. of Herrmann v. Com'r*, 96-1 U.S.T.C. ¶660,232 (2d Cir. 1996).

IV. SECTION 2035. ADJUSTMENTS FOR GIFTS MADE WITHIN 3 YEARS OF DECEDENT'S DEATH.

With certain exceptions, property that a decedent transferred by gift before his or her death (even if the gift was made within the 3 years preceding his or her death) will not be included in the donor's gross estate provided he or she died after 1981. I.R.C. § 2035(d).

A. INCLUSION OF CERTAIN GIFTS MADE WITHIN 3 YEARS OF DEATH IN ESTATES OF DECEDENT'S DYING AFTER 1981.

The estate includes gifts made within 3 years of death where the gift was of an interest in property otherwise included in the gross estate under I.R.C. §§ 2036, 2037, 2042.

1. Inclusion of such gifts is required whether or not a gift tax return was required to be filed with respect to the transfer. I.R.C. § 2035(d)(2). Property included in the donor's estate under these rules is included at its estate tax value without reduction for the amount of the annual gift tax exclusion. Gen'l Explanation of the Economic Recovery Tax Act of 1981, Joint Comm. Staff, p. 262.
2. A relinquishment of a retained interest or power or a gift of life insurance within 3 years of death will not avoid inclusion of the property. Gifts within those exceptions to which the 3-year rule applies get a step-up or step-down in basis.
3. The rule originally applied also to general powers of appointment. Sec. 424(a), PL 97-34. I.R.C. § 2035(d)(2) was changed retroactively by the 1982 Technical Corrections Act.

B. VOTING RIGHTS OF CONTROLLED CORPORATION STOCK.

The relinquishment or cessation of a previously retained right to vote shares of stock of a controlled corporation shall be treated as a transfer of property made by the decedent for purposes of the 3-year rule. I.R.C. § 2036(b)(3).

C. LIFE INSURANCE TRANSFERS WITHIN 3 YEARS OF DEATH.

The 3-year rule continues to apply to gifts of life insurance. H Rept to PL 97-34, p. 187. If a donor, within 3 years before his death, transfers an incident of ownership in a life insurance policy to a third party, the entire amount of the proceeds is included in his gross estate. Gen'l Explanation of the Economic Recovery Tax Act of 1981, Joint Comm. Staff, p. 262.

1. Inclusion of gifts of life insurance is required whether or not a gift tax return was required to be filed with respect to the transfer. I.R.C. § 2035(d)(2). Therefore, if a donor makes a present interest gift of a life insurance policy worth \$11,000 or less and is not required to file a gift tax return reporting the gift, the full amount of the insurance proceeds payable at his death will be includible in his estate if he dies within three years of making the gift.
2. A transfer of incidents of ownership in a life insurance policy by a corporation in which decedent owned 80% of the stock to an individual for nonbusiness reasons required the inclusion of the policy proceeds in the gross estate, when death occurred within three years of the transfer. Rev. Rul. 82-141, 1982-2 C.B. 209. Relinquishment of corporate control by the insured within three years of death also leads to inclusion of a company-owned policy. Rev. Rul. 90-21, 1990-1 C.B. 172.
3. Payment by a decedent of premiums on a whole life or term policy on his life that was owned by another for more than three years before death was not a transfer of an interest in the policy. No part of the proceeds of the whole life or term policy were includible in the estate when he died. Rev. Rul. 71-497, 1971-2 C.B. 328, revoking Rev. Rul. 67-463, 1967-2 C.B. 327. Accord, Est. of Glade, T.C. Memo. 1978-316; Est. of Chapin, T.C. Memo. 1970-7; Est. of Coleman 52 T.C. 921 (1969); Gorman, exrx, v. U.S., (DC Mich) 288 F. Supp. 225 (1968); Nance, exrx, v. U.S., 4/5/68, DC Ariz. The Service has also indicated that the payment of a premium at the time of a policy's renewal did not create new rights, nor was such payment a repurchase of insurance. The payment of the renewal premium was not a new transfer of insurance coverage for purposes of the three-year rule, and the proceeds of the insurance were not includible in the gross estate. Rev. Rul. 82-1, 1982-1 C.B. 132.
4. The Service will no longer attempt to assert that a policy purchase instigated and paid for by the decedent within three years of death constitutes a transfer, if the decedent at no time held actual incidents of ownership in the new policy. A.O.D. 1991-012. This decision is in response to court rulings against the Service on that issue in Est. of Leder v. Com'r, 893 F.2d 237 (10th Cir. 1989); Est. of Headrick v. Com'r, 90-2 USTC ¶ 60,049 (6th Cir. 1991); and Perry Est. v. Com'r, 91-1 USTC ¶ 60,064 (5th Cir. 1991).
5. In TAM 9323002, decedent applied for life insurance as "proposed insured," using an application explicitly stating that no policy would take effect until the first full premium was paid and the policy was issued to the owner. Later, she completed a

“Supplementary Application,” requesting that the policy be split into two policies to be owned equally by her two children. Still later, one of the children wrote a check for the first premium on the two policies, which were then issued to the two children as owners and beneficiaries. Decedent died within three years of the issuance of the policies. The proceeds were not includible in her gross estate, since she had never held any incidents of ownership. The mere fact that the initial application locked in a favorable premium rate did not constitute a transfer of incidents of ownership upon her completion of the supplementary application. Critical to the ruling was the determination that the contract between the parties explicitly provided that no insurance was effective until the premium was paid and a policy was issued to the owner.

6. Where group term insurance has been effectively assigned, the issuance of a replacement policy will not generally necessitate a new transfer. See, e.g., PLR 9436036.
7. Where the transfer of insurance is for full and adequate consideration, the three-year rule is avoided. PLR 9413045.

D. SOME POST-1981 GIFTS MADE WITHIN 3 YEARS OF DEATH ARE STILL INCLUDED FOR CALCULATIONS.

Post-1981 gifts within 3 years of death are included for the following purposes under Code Section 2035(d)(3):

1. To determine whether the value of stock meets the percentage requirements of a Section 303 redemption.
2. To qualify for Section 2032A.
3. To determine eligibility under Section 6166. The 35% of adjusted gross estate test of I.R.C. § 6166(a)(1) is met only if the estate meets such requirements both with and without the application of the three-year inclusion rule. I.R.C. § 2035(d)(4).

Gifts within 3 years of death, which do not exceed the annual gift tax exclusion or which qualify for the unlimited gift tax exclusion for certain medical and tuition payments, do not have to be included in the donor-decedent’s estate for the above-specified purposes. The full value of gifts over \$11,000 within 3 years of death will be included.

E. ADJUSTMENTS FOR CERTAIN GIFTS MADE WITHIN 3 YEARS OF DECEDENT’S DEATH

Deathbed commutation of GRIT ineffective to exclude assets from estate.

Technical Advice Memorandum 199935003. The grantor of a grantor retained interest trust (“GRIT”) was to receive the trust income for a term of ten years. The remainder would then pass to her three children. The trust agreement authorized the trustee to terminate the grantor’s interest in the trust at any time by distributing to her the fractional share of the trust principal that represented the present actuarial value of her income interest. The trustee

exercised this commutation power one day prior to the grantor's death from cancer. When she died, the grantor had no interest in the trust. In ruling that the entire value of the trust principal was includible in the grantor's gross estate nevertheless, the Service noted (i) that the commuted amount paid to the grantor was not full and adequate consideration for purposes of the §2035 bona fide sale exception, and (ii) that the timing and the facts indicated that the parties were clearly not dealing in an arm's length transaction. In the alternative, the grantor made a gift to her children at the time her interest was commuted by the trustee. The transfer constituted a gift because at the time of the transfer the grantor's death was clearly imminent. Therefore, her remaining income interest in the GRIT had little or no value, whereas the right of reversion (to receive all of the GRIT principal in the event she did not survive the ten-year term) had a value equal to the entire amount of the trust principal. (9/99)

F. GIFT TAXES PAID WITHIN 3 YEARS OF DEATH

Under section 2035(b), the amount of the decedent's gross estate shall be increased by the amount of any taxes paid by the decedent or his estate on any gift made by the decedent or his spouse within 3 years of the decedent's death.

Step-Transaction Inclusion of Gift Taxes Paid:

Brown v. United States, 329 F.3d 664 (9th Cir. 2003). Decedent created a life insurance trust to own life insurance on his wife's life. Decedent gave his wife \$3,100,000 in cash to fund the insurance trust. The decedent and his wife filed gift tax returns electing split-gift treatment. The gift tax liability for the gift was \$1,415,732. Decedent gave his wife two checks to cover the gift tax liability. She deposited the checks in her account, and wrote a check the next day in payment of the gift tax liability. Decedent died within three years of payment of the gift tax liability. The Service claimed that the gift tax liability was properly attributed to decedent under the step-transaction doctrine. The Ninth Circuit agreed, holding that the gift tax paid was included in decedent's estate under section 2035.

G. NET GIFT DOCTRINE.

Estate of Armstrong v. United States, 277 F.3d 490 (4th Cir. 2002). Decedent made gifts of common stock in a closely-held company to his children and grandchildren in 1991 and 1992. The children executed a transferee liability agreement in which they agreed to pay additional gift taxes if the IRS adjusted the value of the gifts and the decedent's grantor trust did not have the ability to pay. Decedent died in 1993, less than three years from the date of the gifts. The service found that the gifts had been undervalued and assessed additional gift taxes, which were paid by the decedent's trust. The estate had no funds remaining to pay the estate taxes due on the additional gift taxes, and the Service assessed the donees for the deficiency. Both the estate and trust argued that gift tax refunds should be issued based on the net gift doctrine, because the donees' payment of additional gift and estate taxes reduced the value of their gifts. The Fourth Circuit which upheld the lower court's denial of the taxpayers' claim, concluding that the donees' obligation to pay additional gift taxes and their potential liability for estate taxes on gift taxes owed was too speculative and illusory to reduce the value of the gifts using the net gift doctrine.

V. SECTION 2036. TRANSFERS WITH RETAINED LIFE ESTATE.

2036(a)(1): Includes property in the decedent's estate when the decedent retained possession or enjoyment of, or the right to income from, property previously transferred by the decedent prior to his or her death.

2036(a)(2): Includes property in the decedent's estate when the decedent retained the right, either alone or in conjunction with another, to designate the persons who shall possess or enjoy the property, or the income therefrom.

Section 2036 is designed to prevent a person from transferring property with a retained right to use the property, to receive the income from the property or to control the beneficial enjoyment of the property without having his estate suffer any estate tax liability with respect to the property upon his death. In general, this section includes in the gross estate the entire value of property so transferred by the decedent.

A. EXCLUDED TRANSFERS.

1. Section 2036 is inapplicable to transfers made before certain dates. It never applies to a transfer made before March 4, 1931, and it may be inapplicable to transfers made between March 3, 1931 and June 7, 1932. I.R.C. § 2036(c).
2. 2036 NOT applicable to Bona Fide Sale for an Adequate and Full Consideration in money or money's worth.
 - a. Consideration in the form of income from other property has been found to be full and adequate. *Klein v. Halpin*, 2/8/57, DC Iowa.
 - b. Arguably, the question whether consideration is sufficient to negate Section 2036 should be tested against the value of the transferred interests that would be included in the gross estate if there were no consideration paid. Thus, if X transfers property to Y, retaining a life estate, a payment of full consideration for Y's remainder should defeat the section. Payment of full consideration for Y's remainder should likewise defeat the section if X creates an intermediate life estate in Z preceding his retained interest, because it is still only the remainder interest that is potentially includible under Section 2036.
 - c. However, in *Gradow v. United States*, 87-1 U.S.T.C. 13,711 (Cl. Ct. 1987), the Court of Claims required the consideration to be for the value of the entire fee interest, instead of just the value of the remainder, in order to remove the assets from the estate. Many commentators have criticized the *Gradow* rule, but it has been upheld by other courts in recent years. See, e.g., *Pittman v. U.S.*, 878 F.Supp. 833 (E.D.N.C. 1994); *Est. of D'Ambrosio v. Com'r*, 105 T.C. 252 (1995).
 - d. Ninth Circuit follows Third and Fifth Circuits in holding that adequacy of consideration for transfer of a remainder interest should be measured by the actuarial value of the interest at the time of the transfer. *Estate of Magnin v. Commissioner*, 184 F.3d 1074 (9th Cir. 1999).
 - e. Transfer of Property for Life Annuity: The Tax Court found that there was a valid annuity arrangement where decedent transferred two farms on the

same day he entered into annuity contracts with the transferee. The annuity was paid monthly in amounts approximately equal to the amounts of the rent. The Court held this was not a transfer with a retained life estate. *Est. of Bianchi*, T.C. Memo. 1982-389.

The Ninth Circuit held that a transfer of assets to a trust in return for a private annuity was a valid sale and not a retained life estate. The Service and the Tax Court had maintained that a grantor had set up a trust with a retained life estate. *Rev. Rul. 79-94*, 1979-1 C.B. 296; *Est. of Schwartz*, 9 T.C. 229 (1947); *Udike v. Com.*, CA8 88 F.2d 807 (8th Cir. 1937), cert. den. 301 U.S. 708; *Lazarus*, 513 F.2d 824 (9th Cir. 1975), aff'g 58 T.C. 854.

**See Section V.F. of this outline (Inclusion of Property Transferred to a Family Limited Partnership) for a further discussion of the Bona Fide Sale for Full and Adequate Consideration Exception as it applies to the transfer of assets to a Family Limited Partnership in exchange for a partnership interest.

B. PERIOD FOR WHICH INTEREST IS RETAINED.

1. The decedent must have retained an interest in the property for a specified period. A threefold test is applied. Has he retained an interest:
 - a. For his life? or
 - b. For a period not ascertainable without reference to his death? or
 - c. For a period that does not in fact end before his death?
2. The first of the three tests is met if the decedent transfers property in trust providing for income to be paid to himself “for his life,” and at his death, the corpus to be distributed to others.
3. For an example of the second test, assume decedent creates a trust under which he is entitled to the income payable quarterly for his life, but the trust agreement specifies that he is to receive none of the trust income for the calendar quarter in which he died. Technically, the decedent would not be entitled to the income “for his life.” Nevertheless, the period for which he was entitled to the income would not be “ascertainable without reference to his death.” *Treas. Reg. § 20.2036-1(b)(1)*. This language also catches a situation in which another interest intervenes. An example is a transfer by A to B for life, then to A for life, remainder to children. Even if A predeceases B, the value of the property, reduced by the value of B’s life estate, is included in A’s estate. *Treas. Reg. § 20.2036-1(b)(1)(ii)*.
4. For an example of the third test, assume a decedent at age fifty creates a trust under which he retains the income for five years. At the end of that period the trust terminates and the corpus is distributed to the decedent’s son or the son’s estate. If the decedent then died within the five-year period, he would have retained an interest for a period that did “not in fact end before his death,” although he had not retained an interest “for his life.”

5. An exception to the retained life estate rule applies in the case of a secondary life estate reserved by a donor spouse in a qualified terminable interest property (“QTIP”) trust. Treas. Reg. §25.2523(f)-1(d)(1).

Illustration: W creates a lifetime QTIP trust which will pay all its income to her husband, H, during his lifetime. The trust agreement provides that if H dies before W, the trust income will, upon H’s death, be paid to W for the rest of her life. If W dies before H, her retention of the secondary life estate will not result in the inclusion of the QTIP trust in her estate. If she survives H, the property will not be includible because H is treated as the transferor of the property at his death under Section 2044.

C. RETAINED INTEREST.

1. Under 2036(a)(1), a decedent’s gross estate includes the value of property transferred if the decedent reserved or retained for one of the three periods described in the preceding section the use, possession, right to the income, or other enjoyment of the transferred property.

The mere fact that the grantor of a trust is subject to income tax on the trust income during his lifetime because he is considered to possess economic control or ownership of the property under the grantor trust rules does not require inclusion in his estate. There is no necessary correlation between Section 2036 and the grantor trust rules.

2. Exceptions:

- a. Unlimited Discretion in the Trustee:

It was held that no part of a trust was includible when the provisions of the trust permitted an independent trustee, in his uncontrolled discretion, to pay the income to the grantor. Est. of Wells, 42 T.C.M. 1305. However, the property will nevertheless be included if it is determined or inferred that actual enjoyment was retained by reason of an implied agreement or understanding, or if, under state law, the decedent’s creditors could have reached the fund. Est. of Paxton, 86 T.C. 785.

- b. Trustee’s Payment of Income Taxes:

Trustee’s payment of grantor’s income taxes allocated to trust does not constitute retained income interest. Private Letter Ruling 199922062. A United States citizen proposed to create an irrevocable living trust under the laws of a foreign country, using a corporate trustee, for the benefit of third-party individuals. Neither the grantor nor his spouse had any interest in or power over the trust. A provision in the trust agreement required the trustee to distribute directly to the Service the incremental U.S. income taxes payable by the grantor by reason of his creating the trust. The Service ruled that this tax-payment provision did not constitute the retention of the right to income under subsection 2036. Note, however, that the grantor would have retained an income interest for purposes of subsection 2036 if the

trustee had been required to make distributions to reimburse the grantor for any tax liability not attributable to the trust (e.g., income tax on his personal salary, or capital gains on his personal investments).

c. Transfer of Life Estate:

When a retained life estate (or retained power to designate) is terminated by the transferor prematurely through relinquishment or inter vivos divestment other than a sale or gift within three years of his death, the transferred property is not includible in the estate of a transferor. *Marks v. Higgins*, 213 F.2d 884 (2d Cir. 1954); *Heasty, exr v. U.S.*, (DC Kan) 239 F. Supp. 343 (1965), aff'd, 370 F.2d 525 (8th Cir.).

The gift of or sale of a retained life estate within three years of death does not avoid inclusion of the property in the gross estate except to the extent of consideration received. *U.S. v. Allen*, 293 F.2d 916 (10th Cir.), cert. den., 368 U.S. 944 (1961).

D. RESERVATION OF RIGHT TO DESIGNATE BENEFICIARIES.

Under Section 2036(a)(2), the estate of a decedent also includes property if the decedent reserved any power, exercisable up to the time of his death, to designate who shall possess or enjoy the property or any income derived from it. A power to designate beneficiaries operates to include the transferred property in the decedent's estate whether the power is reserved to the decedent alone or jointly with another, whether or not the other party's interests would be adversely affected by exercise of the power. 2036(a)(2) is very similar to Section 2038 since 2038 also includes property transferred by the decedent in the decedent's estate when the decedent retained the power to control the enjoyment of the property transferred, or the income therefrom.

1. Exceptions. The following reserved powers have not resulted in inclusion in gross estate under Section 2036(a)(2):
 - a. Powers over the transferred property itself which do not affect the enjoyment of the income received or earned during the decedent's lifetime, such as a power exercisable solely by will. Such powers may, however, lead to the application of Section 2038.
 - b. Powers held solely by a person other than the decedent, except if the decedent had the unrestricted power to substitute himself for that person. *Treas. Reg. § 20.2036-1(b) (3)*.
2. Powers to Invade Principal and Accumulate Income. The courts have treated the reservation by the grantor of a power to invade principal or to accumulate income as a reserved right to change (designate) beneficiaries, thereby causing inclusion. *Est. of McDermott*, T.C. Memo. 4/30/53, aff'd on other issue, 222 F.2d 665 (7th Cir.); *Industrial Trust Co. v. Com.*, 165 F.2d 142 (1st Cir. 1947), aff'g on this issue *Est. of Budlong*, 7 T.C. 756.
3. Fiduciary Powers. The mere fact that powers are held in a fiduciary capacity is not sufficient to avoid the operation of Section 2036.

- a. Attribution due to power to appoint self as Trustee. A grantor's reserved right to name a successor trustee who had discretionary distributing powers over trust principal was sufficient to include the trust in the grantor's estate. The grantor in this case could not remove a trustee, but neither the trust instrument nor state law barred her from naming herself as a successor trustee if a vacancy occurred. Est. of Farrel, 4/20/77, Ct. Cl. See also Est. of Alexander, 81 T.C. 757 (1983).
- b. Attribution due to power to remove and replace Trustee. See discussion infra under Section 2038, VII.F.3 of this outline.
- c. Managerial powers. The combination of several powers such as the authority to allocate receipts and disbursements as between income and principal, or the authority to invest or reinvest in property which produces no income, which may by themselves be no more than a means of facilitating sound and flexible management for the benefit of all concerned, may amount, in effect, to an overall power to decide from time to time who shall receive how much, and whether the benefits should flow primarily to the income beneficiary or to the remainderman. Reserved managerial powers that add up to a power to designate who shall enjoy income or possession may cause inclusion of the trust property in the grantor's estate. However, it appears that this theory will not lead to inclusion where the powers are subject to fiduciary standards. Old Colony Trust Co. v. U.S., 423 F.2d 601 (1st Cir. 1970). Reserved powers of the grantor to divide the trust property to facilitate trust termination and to allocate expenditures between income and principal accounts were not enough to require inclusion. Est. of Pardee, 49 T.C. 140 (1967). The power to sell or exchange trust property did not require inclusion. Est. of Ford, 53 T.C. 114 (1969), aff'd, 450 F.2d 878 (2d Cir.). The fact that the decedent had broad authority to direct the nature and scope of the trust investments did not require the inclusion. Est. of Rolin, 68 T.C. 919 (1977).
- d. Fiduciary powers subject to ascertainable standard. The courts have not included any part of the property subject to a reserved power to invade principal in favor of the life beneficiary if the trust reserves no real discretion but clearly establishes an ascertainable standard under which a court of equity could enforce the beneficiary's right to have the property invaded in his favor. Est. of Budlong, 7 T.C. 756 (1946), rev'd on other issues sub nom. Industrial Trust Co. v. Com., 165 F.2d 142 (1st Cir.); Est. of Frew, 8 T.C. 1240 (1947). The following retained powers were found to be sufficiently limited by standards and did not require inclusion:
- (1) power to invade where necessary for the beneficiary's support, maintenance and education. Est. of Wier, 17 T.C. 409 (1951).
 - (2) power to invade if in the opinion of the trustee the beneficiary (1) shall be in need of funds. . .for support, maintenance, education, welfare and happiness..." Est. of Ford 53 T.C. 114 (1969), 450 F.2d 878.

e. Fiduciary powers not subject to ascertainable standard. These powers required inclusion in the grantor's estate:

- (1) "...use and benefit" Est. of Rott v. U.S., (DC Mo) 321 F. Supp. 654 (1971).
- (2) "...best interests" Est. of Yawkey, 12 T.C. 1164 (1949); Biscoe v. U.S., (DC Mass) 148 F. Supp. 224 (1947); Est. of Nettleton, 4 T.C. 987 (1945).

E. INCLUDIBLE AMOUNT.

If the retained life estate relates to all of the property transferred, the entire value of the property is includible, less only the value of any outstanding income interest held by another person. If the retained life estate relates to only part of the transferred property, only a corresponding part of the property is includible. Treas. Reg. §20.2036-1(a).

F. INCLUSION OF PROPERTY TRANSFERRED TO FAMILY PARTNERSHIPS

1. Background: The Service has shifted its attack on Family Limited Partnerships from valuation issues under Chapter 14 of the Code to Section 2036 whereby the Service has sought to include partnership assets in the decedent's estate. In response to this new line of attack, courts have been looking beyond the question of whether the formalities of the partnership agreement have been followed to determine whether the decedent retained the economic benefit of the assets, or the ability to control the beneficial enjoyment of the assets after they have been contributed to the partnership.
2. Bona Fide Sale for Adequate and Full Consideration: In most of the cases to be discussed below, a key issue was whether or not the lifetime transfer of assets to the partnership by the decedent in exchange for an interest in the partnership satisfied the "Bona Fide Sale for Adequate and Full Consideration" exception to section 2036 (see also Section V,A of this outline). According to the courts in Harper, Thompson and Strangi, the transfer of assets to the partnership qualifies for the Adequate and Full Consideration exception if:
 - i) The exchange of assets for an interest in the partnership is an arms length, bona fide sale; and
 - ii) The partnership interest received is adequate and full consideration for the assets transferred to the partnership.

In the cases discussed below, factors that help establish "Adequate and Full Consideration" were i) meaningful negotiation by all of the partners during the course of establishing the partnership; ii) a substantial business purpose for establishing the partnership; iii) a pooling of assets by all of the partners and not just the decedent; and iv) the decedent retained sufficient assets outside of the partnership to provide for his or her own financial needs.

Factors that hurt efforts to establish “Adequate and Full Consideration” were i) the decedent’s ability to remove the general partner and appoint a new one; ii) the transfer of a majority of the decedent’s assets to the partnership (especially where a primary residence is transferred); iii) the finding of an implied agreement that the decedent would retain enjoyment of his assets after they have been transferred to the partnership; and iv) a finding that no meaningful change in the decedent’s relationship to his assets occurred after the transfer of the assets to the partnership.

3. Inclusion of Partnership Assets in the Decedent’s Estate under Section 2036(a)(1): Partnership assets may be included in the decedent’s estate under section 2036(a)(1) if it is established that the decedent retained possession, use or enjoyment of the assets after they were transferred to the partnership. To determine whether partnership assets should be included in the decedent’s estate under section 2036(a)(1), the courts have looked very closely at whether the decedent’s relationship to his or her assets changed after the transfer of assets to the partnership. The key factors in the analysis of this issue were:

- i) Did the decedent transfer a majority of his or her assets to the partnership to the point that he or she did not retain sufficient assets outside of the partnership to cover his or her financial needs?
- ii) Was the General Partner passively involved in the investment management of partnership assets?
- iii) Was there only minimal change in the decedent’s economic benefit from the assets after they were transferred to the partnership?
- iv) Was the decedent at an advanced age or in poor health at the time the assets were transferred to the partnership?

4. Inclusion of Partnership Assets in the Decedent’s Estate under Section 2036(a)(2): Assets may also be included in the decedent’s estate under section 2036(a)(2) if it is established that the decedent retained the right to control the beneficial enjoyment of the assets after they were transferred to the partnership. To determine whether partnership assets should be included in the decedent’s estate under section 2036(a)(2), the courts have looked very closely at whether the decedent, or his attorney-in-fact, had the power during his lifetime to remove the general partner and appoint himself as general partner where the partnership agreement gave the general partner the power to control distributions.

5. Summary of Recent Cases and Rulings: The following is a summary of recent cases and a TAM dealing with the issue of whether assets transferred by the decedent to a family partnership should be included in the decedent’s estate under Section 2036:

Technical Advice Memorandum 199938005. General partner’s right to vote closely held stock held in family limited partnership led to inclusion of the stock value in estate. Decedent owned 50% of the common stock of a closely held company, and his brother owned the balance. Decedent and his brother transferred equal amounts of the stock to a newly formed family limited partnership, taking back general and limited partnership units. Decedent then transferred some of his limited partnership units to his children. The partnership agreement provided that the general partners have complete discretion in voting the company stock held in the partnership; if they are unable to agree, each may vote his proportional number of shares. The Service

ruled that the transfer of the stock to the partnership was for less than adequate consideration because the gifts of limited partnership units to the children were part of an integrated transaction. When the steps of the transaction were collapsed, the decedent received only the general partner units and the remaining limited partner units in exchange for his transfer of all of the stock. The Service specifically stated that the amount of time separating the steps of the transaction was not a critical factor in reaching this conclusion. Since decedent had the right to vote the stock as general partner, the entire value of the stock is included in his estate under §2036(b). The fact that he shared voting rights with his brother was not relevant; even if the partnership agreement did not give him the unilateral right to vote the shares he transferred, the statute is broad enough to reach powers held in conjunction with others.

Estate of Reichardt v. Commissioner, 114 T.C. No. 9 (2000). Wife, a Texas resident, died, leaving husband her interest in community property outright, and a life interest in her separate property, with the remainder to the couple's two children. Husband was expressly given the power to consume the property subject to the life interest. Two years later, husband created a revocable trust, naming himself and the children as trustees, and transferred to it most of the assets of wife's estate, including her separate property. Each trustee was given the power to act alone. Concurrently, husband established a family partnership, with the trust as the general partner and husband as the limited partner. Husband transferred virtually all of his remaining assets to the partnership, and caused the trust to transfer most of its assets to the partnership. Husband then gave each child a 30.4% limited partnership interest and reported the gifts on a federal gift tax return. Although adjusting entries were made in the partnership's records to classify income and expenditures between husband and the partnership, all assets continued to be used and managed just as before the transfers. After husband's death, the Service asserted that the entire partnership, including the interests transferred to the children, was included in husband's estate. The Tax Court agreed. Based on husband's management of the partnership, commingling of funds, rent-free use of the residence and use of income from partnership assets, the court held that there had been an implied agreement that husband would retain enjoyment of all of the partnership assets. In addition, husband's transfer of nearly all of his assets to the partnership indicated that there was an implicit understanding that he could continue to use the assets. Since the documentation of husband's transfers of wife's separate property did not appear limited to a life estate, the court concluded that husband had used his power to consume the assets by transferring them to the trust and partnership. The undiscounted fair market value of all partnership property was included in husband's estate pursuant to §2036.

Church v. United States, 268 F.3d 1063 (5th Cir. 2001). The Fifth Circuit has affirmed the decision of the district court holding that the decedent's interest in a partnership formed two days prior to her death was taxable under only section 2033, and was excepted from the special valuation rules of §2703 and from inclusion of the property transferred to the partnership under section 2036 and 2038. The lower court focused on the fact that the formation of a partnership 2 days before the decedent's death was a bona fide business transaction, and rejected the Service's arguments that decedent had made a gift on formation and that her interest in the property contributed to

the partnership was brought back into the estate at full value, either as a transfer subject to retained powers under § 2036 and 2038 or because the partnership agreement must be disregarded under §2703. The fact that the documentation for the partnership, including filing of the certificate of limited partnership was not completed prior to the decedent's death was deemed irrelevant.

Estate of Harper v. Commissioner, T.C. Memo 2002-121, 83 T.C.M. (CCH) 1641 (2002). Decedent created the limited partnership in 1994, naming his children as the general partners and his self-trusteed revocable living trust, which was supposed to contribute assets to the partnership, as the limited partner. Within a few weeks after the creation of the partnership, and long before funding was complete, Decedent transferred to his two children a portion of his limited partnership interests. After Decedent's death, which occurred within a year after the creation of the partnership, the Service argued that section 2036(a) applies because of the Decedent's retention of economic benefits in the assets. The Tax Court concluded that §2036(a) was applicable. The court found commingling of assets between the partnership and the revocable trust, disproportionate distributions that favored Decedent's trust, and an implied agreement that Decedent would retain the economic benefit of the assets transferred to the partnership. The court found a lack of involvement and concern for formal partnership structure by those involved and little to no change in the decedent's relationship to his assets after the partnership was formed.

Estate of Thompson v. Commissioner T.C. Memo 2002-246. The Tax Court agreed with the I.R.S. that the assets transferred by the decedent to two limited partnerships should be included in his estate under section 2036(a). Even though the Tax Court held that the limited partnerships were valid under state law, it found an implied agreement that the partnership assets would be available for the decedent's needs during the decedent's lifetime

The decedent transferred the bulk of his assets to the partnerships and died within two years. Because the decedent had transferred virtually all of the assets he needed for his own support to the partnerships, the Tax Court found an implied understanding to provide for the decedent from the partnership for as long as he lived. There was little change in the investment portfolio after it was transferred to the partnership and distributions from the partnership matched the decedent's expenses.

In discussing whether the decedent's transfer to the partnership constituted a na fide sale for adequate and full consideration within the meaning of Section 2036(a), the Tax Court concluded that the decedent's receipt of partnership interests in exchange for assets does not constitute full and adequate consideration where the partnership was simply a change in form in which the decedent owned his property.

Strangi v. Commissioner T. C. Memo 2003-145 (May 20, 2003). As with Thompson, Mr. Strangi's son-in-law attorney-in-fact created and funded the Partnership with almost all of Mr. Strangi's wealth in exchange for a 99 percent limited partnership interest. The attorney-in-fact then purchased a 47 percent interest in Stranco, a family owned corporation created by Mr. Strangi's attorney-in-fact to be the general partner of the Partnership. Stranco

then hired Mr. Strangi's attorney-in-fact to manage the day-to-day affairs of Stranco. Mr. Strangi died two months after creation of the Partnership. Prior to this death, the Partnership made distributions to Mr. Strangi for his living expenses. After his death, the Partnership also made distributions to enable his estate to pay for his funeral, estate administration expenses, debts and a specific gift under his Will to his sister. Over \$3 million was distributed from the Partnership to pay the estate taxes. Pro rata distributions were also made to the general partner, Stranco. At the time of Mr. Strangi's death, the Partnership held assets valued at approximately \$11 million. The estate reported the value for Mr. Strangi's 99 percent limited partnership interest at \$6.5 million after discounts.

When this original Strangi case was brought before the Tax Court, the court rejected the position of the IRS that restrictions imposed by the partnership agreement should be disregarded under Section 2703. The Tax Court suggested that a 2036 argument from the IRS may have been appropriate if it had been timely raised. On appeal, the 5th Circuit Court of Appeals affirmed the Tax Court's ruling on the 2703 issue, but remanded the case to the Tax Court to consider inclusion of the partnership assets in the decedent's estate under 2036. Upon remand, this case became known as Strangi II.

On remand (Strangi II), the Tax Court held that 99 percent of the net assets of the Partnership and 47 percent of the value of assets held by Stranco should be included in Mr. Strangi's estate pursuant to section 2036(a)(1) because it found an implied agreement at the time of the transfer of the assets to the Partnership and Stranco that Mr. Strangi would retain enjoyment of the income of the property. Since Stranco (the general partner) shareholders had delegated management authority to Mr. Strangi's attorney-in-fact and the general partner had sole discretion over distributions, there were no restrictions on Mr. Strangi receiving distributions from the partnership or from Stranco.

The Tax Court also found that inclusion was proper under section 2036(a)(2) because Mr Strangi retained the right to designate the persons who possessed or enjoyed the property. The Tax Court rejected the estate's argument that Mr. Strangi's rights under the Partnership and Stranco were severely limited by the fiduciary duties imposed on his attorney-in-fact as manager of Stranco and on the directors of Stranco. The Court concluded the fiduciary's obligations cannot be enforced in circumstances where there is no independent oversight.

Finally, the Tax Court found that the transfer was not a bona fide arms-length transaction for adequate and full consideration, which is an exception under 2036. The Court concluded there could be no full and adequate consideration where all that occurred was a change in form that had no meaningful impact on Mr. Strangi's beneficial interest in the property, and under circumstances where the partnership structure was set up and funded by Mr. Strangi's attorney-in-fact. The court paid particular attention to the fact that most of Mr. Strangi's wealth, including his personal residence, was transferred to the partnership, and he could not have survived without income from the partnership.

Estate of Stone v. Commissioner, TC Memo 2003-309. Mr. and Mrs. Stone, both residents of South Carolina, had built successful sports apparel businesses during their lifetime. Mr. and Mrs. Stone established five family limited partnerships in

1996 as a partial settlement of litigation among their children over management of the family business and investment interests. A limited partnership was established for the benefit of each child with family assets that the child had an interest in managing. Mr. Stone was the controlling general partner with the child. A fifth partnership was established in which all children held a general partnership interest. Mr. Stone died in 1997 and Mrs. Stone died in 1998.

Their estates sought significant discounts for their partnership interests, but the IRS sought to include the partnership assets at the undiscounted pro rata value under section 2036(a)(1) as it had done in Harper, Thompson and Strangi II. The Tax Court rejected the IRS's argument on the grounds that the transfer of property to the partnerships in exchange for pro rata partnership interests constituted a transfer for full and adequate consideration. Therefore, the value of the undiscounted assets of the partnerships could not be included in the estates of Mr. and Mrs. Stone under section 2036(a)(1). In reaching this decision, the court looked at factors that indicated a business purpose for the partnerships. These factors were the arm's-length negotiations among the partners in creating the partnerships, the fact that Mr. and Mrs. Stone did not transfer assets to the partnerships that would be necessary for their own needs, respect for the partnership structure and the lack of commingling of personal assets with partnership assets.

Kimbell v. United States, 371 F.3d 257 (5th Cir. 2004). With facts similar to the Harper and Strangi cases, this case involved a deathbed creation of a limited partnership with an LLC as the general partner. The decedent's revocable trust owned a 99% limited partnership interest and 50 percent of the LLC. Decedent's son and daughter-in-law owned the balance of the LLC. The District Court, relying on Estate of Harper v. Commissioner, T.C. Memo 2002-121, granted the Government's motion for summary judgment and included the partnership's assets in decedent's estate under 2036(a) because decedent could remove the sole general partner and appoint herself as general partner.

The Fifth Circuit reversed the District Court decision. The Fifth Circuit found there was full and adequate consideration for decedent's exchange of assets for an interest in the partnership. The court ruled there was a valid business purpose for establishing the partnership (the need for active and experienced management of oil and gas interests), and rejected the Government's argument that family members cannot enter a bona fide transaction. The District Court's decision was vacated and the case has been remanded.

G. STOCK TRANSFERRED AND RETENTION OF VOTING RIGHTS (ANTI-BYRUM RULE) AND USE OF UNDERLYING ASSETS.

1. Where the property transferred is stock of a "controlled corporation," I.R.C. §2036(b)(1) specifies that the retention of the right to vote (directly or indirectly) the stock is considered a retention of enjoyment of the transferred property and causes inclusion in the gross estate.
2. A corporation is controlled if at any time after the transfer of the property and during the 3-year period ending on the date of decedent's death, the decedent

either owned (with the application of the attribution rules under I.R.C. §318), or had the right (either alone or in conjunction with any person) to vote, stock possessing at least 20% of the total combined voting power of all classes of stock. I.R.C. §2036(b)(2).

3. The Service will examine the substance over the form of the transaction to determine whether voting rights have been retained. In TAM 9518002, the Service looked through an apparent sale to an unrelated party, and determined that in substance the decedent had transferred his stock to his children for less than adequate consideration, with retained voting control.

H. RETAINED TIMBER RIGHTS.

The Service says that reserved timber rights make the entire value of the property includible in the estate. PLR 7746004.

I. TRANSFER TO PRE-EXISTING TRUST.

If a trust beneficiary transfers property to an existing trust of which he is the income beneficiary, the question arises as to what is included in the beneficiary's estate. If the contribution is specifically identifiable at the beneficiary's death, then the date-of-death value of the specific property will be included. Rev. Rul. 78-74, 1978-1 C.B. 287; Est. of Kinney, 39 T.C. 728 (1963). If the trust's assets have been sold, commingled and replaced, so that the beneficiary's property can no longer be identified, then the estate will include the same percentage of the trust assets that his contribution originally amounted to. Est. of Karagheusian, 23 T.C. 806 (1955), rev'd on another issue, 223 F.2d 197 (2d Cir.).

J. USE RETAINED FOR LIMITED PERIODS.

Decedent transferred a home to his children, reserving the use during one month of each year. The Service said that the value of such a retained interest was determined by multiplying the total date-of-death value of the property by a fraction equal to the rental value for one month over the total rental value for the year. Rev. Rul. 79-109, 1979-1 C.B. 297.

K. O'MALLEY RULE.

The principal of a trust will be includible in the gross estate of a transferor who has retained the power to distribute trust income or to accumulate it and add it to principal if that power of accumulation will affect the ultimate identity of the income recipient. Thus, for example, if the trust provides for payments to A for life, remainder to B, a power of accumulation retained by the trust grantor can be exercised so as to shift enjoyment of the income from A to B. If the accumulated income is also subject to the continued power of accumulation, it will also be included, even though, in a technical sense, it was never transferred by the trust grantor. The mere fact that the grantor's exercise of his retained power caused the accumulated income to remain within his continued control is sufficient to lead to includibility. U.S. v. O'Malley, 383 U.S. 627 (1966), 16 L. Ed. 2d 145.

L. DISCHARGE OF SUPPORT OBLIGATIONS.

Trust property is includible if the income “is to be applied” to discharge the grantor’s support obligation. Treas. Reg. § 20.2036-1(b)(2).

1. If the transferor dies after the obligation terminates (e.g., because a minor child comes of age), the reserved right terminates before death and does not cause inclusion. *Townsend v. Thompson*, 7/24/50, DC Ark.
2. Only the portion necessary to generate sufficient income to satisfy the obligation will be includible. *Est. of Pardee v. Com’r*, 49 T.C. 140.
3. The risk of inclusion is minimized where broad discretionary language is used. *Com’r v. Douglass’ Est.*, 143 F.2d 961 (3d Cir. 1944). However, consistent use of trust income to provide for support items could provide evidence of an implied arrangement or agreement. *Cf.*, *Est. of Uhl v. Com’r*, 241 F.2d 864 (7th Cir. 1957).
4. Where decedent had the power as Trustee to make distributions of trust principal to his wife for her support if necessary after considering other resources, the Tax Court held that a portion of the corpus was includible in his estate. *Sullivan v. Com’r*, 66 T.C.M. (CCH) 1329 (1993).

M. CASES INVOLVING FARMS.

It has been held that the decedent retained a life interest in a farm, requiring inclusion of property in the gross estate in the following cases:

1. Transfer where the donor continued to receive and report the income. The fact that a gift tax return was filed did not matter. *Tubbs v. U.S.* 472 F.2d (5th Cir. 1973), aff’g (DC Tex) 348 F. Supp. 1404.
2. The donor continued to manage and operate the activities on the land, and to collect and report the income. *Est. of Douglas*, T.C. Memo. 1973-2.
3. Donor continued, until his death, to live on the property rent-free, to collect farm income and pay farm expenses. *Est. of Garner*, T.C. Memo. 1982-481.

It was held that property was not includible in the gross estate when the donor gave farm property to his children who then leased it back to him for a portion of the crops, the customary rental for tenant farmers. *Est. of Barlow*, 55 T.C. 666 (1971).

N. IMPLIED RESERVATION OF LIFE ESTATE.

A reservation of a right to the income for life has been implied from the facts surrounding a transfer, even without a specific reservation in the instrument of transfer. An oral agreement or understanding is sufficient, even if not enforceable under local law. *Est. of McNichol*, 29 T.C. 1179 (1958), aff’d, 265 F.2d 667 (3d Cir.), cert. den. 361 U.S. 829, 4 L. Ed. 2d 71; *Harter v. U.S.*, 12/29/54, DC Okla.

A pre-arrangement that a grantor would retain control of a trust was inferred from the fact that trust corpus was applied to a joint account of the grantor’s and that trust provisions as to principal withdrawals were ignored. *Est. of McCabe v. U.S.*, 475 F.2d 1142 (1973).

O. TRANSFER OF RESIDENCE TO CHILDREN.

If a parent transfers a residence to a child and thereafter continues to live in the residence, the Service includes the value of the residence in the parent's gross estate when the parent dies if it is found that there was an implied agreement. The Service takes this position whether or not the parent occupied the residence exclusively.

1. The Tax Court has found such implied agreements in cases in which the donor-parent retained exclusive occupancy. *Est. of Linderme, Sr*, 52 T.C. 305 (1969); *Est. of Kerdolff*, 57 T.C. 643 (1972); *Est. of Honigman*, 66 T.C. 1080 (4th Cir. 1976); *Guynn, exrx, v. U.S.*, 437 F.2d 1148 (4th Cir. 1971), rev'g and rem'g 309 F. Supp. 233.
2. Two district courts found no agreement allowing the parent to continue living in the residence and therefore, held that the residences were not includible. *Diehl v. U.S.* 10/18/67, DC-Tenn.; *City National Bank of Connecticut v. U.S.* 6/27/77.
3. In *Est. of Maxwell v. Com'r*, 3 F.3d 591 (2d Cir. 1993), affirming 98 T.C. 594 (1992), Decedent sold her home to her son and daughter-in-law for \$270,000, forgiving \$20,000 of the purchase price simultaneously with the transfer, and taking back a \$250,000 mortgage. Decedent continued to reside in the home under a five-year lease arrangement. Each year, the son and daughter-in-law made interest payments, which were roughly similar to the rental payments flowing back to them. The decedent made annual gifts by canceling \$20,000 of the outstanding debt each year. The remaining debt was forgiven under her will at her death two years later. Relying on the Tax Court's finding of fact that the decedent's occupancy of the home was founded not on the lease, but rather on an implied agreement between the parties, the court held that the value of the home was includible in the estate. The lease agreement was disregarded as mere window dressing. *Barlow v. Com'r*, 55 T.C. 666 (1971), was distinguished because the rent in *Barlow* was fair and customary and was not offset by receipt of interest from the family lessor. The mortgage note was likewise disregarded because of the parties' understanding that it would be forgiven.
4. Decedent's continued use of real property after transfers to her children was not a retained life estate. *Wineman v. Commissioner*, 79 T.C.M. (CCH) 2189 (2000). Decedent personally retained a 51% interest in the homestead property, while an additional 25% was owned by a trust of which she was the life beneficiary. The Tax Court refused to include the entire value of the homestead property in Decedent's gross estate under §2036. Since she had transferred only a minority interest in the property, her continued personal use of the property was consistent with the ownership interests, particularly since the children also made partial use of the property.

P. RECIPROCAL TRUSTS.

If the decedent and some third party set up "reciprocal trusts," each retaining a life interest in the trust established by the other, these trusts may be "uncrossed," leading to inclusion of all or a portion of the trust in which the decedent holds an interest in his gross estate.

1. Basic Rule -- Grace. The Supreme Court in *U.S. v. Est. of Grace* ruled that application of the reciprocal trust rule “...requires only that the trusts be interrelated, and that the arrangement leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries,” regardless of the fact that the trusts were created as “consideration” for each other, or with or without tax avoidance motives. *U.S. v. Est. of Grace*, 395 U.S. 316 (1969), 23 L. Ed. 2d 332.
2. Example. Example: X sets up an irrevocable trust for the benefit of Y for life, with remainder to Z and conversely Y sets up a trust for the benefit of X for life with remainder to Z. X and Y will each be treated as if each had set up the trust nominally created by the other and reserved a life interest in the trust property.
3. Amount Included. The value to be included will be determined with reference to the trust in which the decedent actually had an interest. However, only the proportion of that trust that can be attributed to funds actually transferred by decedent (into the reciprocal trust) will be included. *Est. of Oliver*, T.C. Memo. 4/28/44, aff’d, 148 F.2d 210 (3d Cir.); *Est. of Hanauer v. Com.*, 149 F.2d 857 (2d Cir. 1945), cert. den. 326 U.S. 770, 90 L. Ed. 465. Decedent was treated as transferor of the trust created by the other Grantor, not the trust he nominally created. *Est. of Cole v. Com.*, 140 F.2d 636 (8th Cir. 1944).
4. Different Terms. The reciprocal trust rule did not apply in a Tax Court case where one trust gave the spouse a special power of appointment and the other did not. *Est. of Levy*, T.C. Memo. 1983-453.
5. Reciprocal Powers. The grant of reciprocal powers to modify a trust or to designate beneficiaries created under a reciprocal trust arrangement may also result in inclusion of the trust property in the gross estate, *Lehman v. Com.*, 109 F.2d 99 (2d Cir. 1940), cert. den. 310 U.S. 637, 84 L. Ed. 1406; *Est. of Durant*, 41 B.T.A. 462 (1940); *Est. of R.G. Woodward*, 64 T.C. 999, except where such powers are vested in an independent trustee. *Dravo*, 40 B.T.A. 309 (1939), aff’d, 119 F.2d 97 (3d Cir.). However, in *Est. of Green v. U.S.*, 68 F.3d 151 (6th Cir. 1995), the Sixth Circuit held that the *Grace* doctrine does not apply where there is no retained economic benefit in either trust. In this case, husband and wife each created identical trusts for the benefit of a grandchild and named their spouse as Trustee. The Trustee was given discretion to reinvest income and distribute income and principal until the grandchildren attained the age of 21. The court held that the limited fiduciary powers did not meet the *Grace* requirement, and therefore did not cause inclusion.

VI. SECTION 2037. TRANSFERS TAKING EFFECT AT DEATH.

A. TAXABLE TRANSFERS.

Under Section 2037, a decedent’s gross estate includes the value of property or of an interest in property transferred by the decedent whether in trust or otherwise, if all three of the following conditions exist:

1. Possession or enjoyment of the property can be obtained by the donee through ownership of the transferred interest only by surviving the decedent.
2. The decedent retained a reversionary interest in the transferred property. If the transfer was made before October 8, 1949, the reversionary interest must have arisen by the express terms of the instrument. For transfers after October 7, 1949, the reversionary interest can arise expressly or by operation of law.
3. The value of the reversionary interest immediately before the decedent's death exceeded 5% of the value of the transferred property immediately before the decedent's death.

B. EXCLUDED TRANSFERS.

This section is expressly made inapplicable to a bona fide sale for an adequate and full consideration in money or money's worth and also does not apply to a transfer made on or before September 7, 1916.

C. EXAMPLES PROVIDED IN REGULATIONS.

The regulations, Treas. Reg. §20.2037-1(e) provide the following examples of the operation of Section 2037:

“Example (1). The decedent transferred property in trust with the income payable to his wife for life and, at her death, remainder to the decedent's then surviving children, or if none, to the decedent or his estate. Since each beneficiary can possess or enjoy the property without surviving the decedent, no part of the property is includible in the decedent's gross estate under Section 2037, regardless of the value of the decedent's reversionary interest. (However, see Section 2033 for inclusion of the value of the reversionary interest in the decedent's gross estate.)

Example (2). The decedent transferred property in trust with the income to be accumulated for the decedent's life, and at his death, principal and accumulated income to be paid to the decedent's then surviving issue, or, if none, to A or A's estate. Since the decedent retained no reversionary interest in the property, no part of the property is includible in the decedent's gross estate, even though possession or enjoyment of the property could be obtained by issue only by surviving the decedent.

Example (3). The decedent transferred property in trust with the income payable to his wife for life and with the remainder payable to the decedent, or if he is not living at his wife's death, to his daughter or her estate. The daughter cannot obtain possession or enjoyment of the property without surviving the decedent. Therefore, if the decedent's reversionary interest immediately before his death exceeded 5 percent of the value of the property, the value of the property, less the value of the wife's outstanding life estate, is includible in the decedent's gross estate.”

D. SURVIVORSHIP REQUIREMENT.

If the transferee of a property interest might get possession or enjoyment while the decedent transferor is living, Section 2037 does not apply. The transferred property is not included if

possession or enjoyment of the property could have been obtained by any beneficiary either by surviving the decedent or the occurrence of some other event (such as the expiration of a term of years), even though the other event has not in fact occurred at the decedent's death. However, if the alternative event is "unreal," such as the expiration of a long period of time when the grantor is very elderly, and the decedent actually dies before its occurrence, it is ignored and the beneficiary is deemed only to be required to survive the decedent in order to obtain the property.

E. EFFECT OF GENERAL POWER OF APPOINTMENT.

The transferred property will not be included in the decedent's estate if its possession or enjoyment could be obtained by a beneficiary (other than the decedent) who could exercise a general power of appointment over the property immediately before the decedent's death. The power does not have to be actually exercised; it is sufficient if it is exercisable immediately before his death. I.R.C. §2037(b)(2); Treas. Reg. §20.2037-1(b).

F. REVERSIONARY INTEREST REQUIREMENT.

The second requirement under Section 2037 is that the decedent retained a reversionary interest in the transferred property. Treas. Reg. §20.2037-1(c)(1). A reserved interest includes the possibility that the property transferred by the decedent may return to him or his estate as well as a possibility that the property may become subject to a power of disposition by him. Treas. Reg. §20.2037-1(c)(2).

1. A grantor's power to designate beneficiaries of an irrevocable trust should he survive two of the named beneficiaries is a reversionary interest. *Costin v. Cripe*, 8/22/55, DC Ind aff'd, 235 F.2d 162 (7th Cir.); *Est.*, 297 F.2d 894 (2d Cir.); *Robinson v. U.S.*, (DC-CA) *Arents* (1978), 3.4 T.C. 274 (1960), rev'd on other grounds 454 F. Supp. 1160, aff'd, 632 F.2d 822 (9th Cir. 1980).
2. A trust provision that the principal be paid over to trustees under the settlor's will, should certain contingencies occur, created a reversionary interest. *Bank of New York, (Thaw Will) v. U.S.*, (DC NY) 141 F. Supp. 364 (1956).
3. The following are not reversionary interests:
 - a. A right to income only after the death of another person (but this may be included under other rules).
 - b. The possibility that the decedent might have received an interest by inheritance from the estate of another person.
 - c. The statutory elective right of a spouse. Treas. Reg. §20.2037-1(c)(2).

G. THE 5% VALUE REQUIREMENT.

Transferred property is not includible unless the value of the reversionary interest exceeds 5% of the value of the transferred property immediately before the decedent's death. The moment before death is the controlling date. Treas. Reg. §20.2037-1(c)(3). The Service requires its tables be used to determine whether the reversionary interest exceeds 5%,

notwithstanding the facts of decedent's death or the facts surrounding his death. Rev. Rul. 66-307, 1966-2 C.B. 429. *Robinson v. U.S.* 632 F.2d 822 (9th Cir. 1980); 88 F.2d 807 (8th Cir. 1937), cert. den. 301 U.S. 708; *Lazarus*, 513 F.2d 824 (9th Cir. 1975), aff'g 58 T.C. 854.

H. AMOUNT INCLUDED IN GROSS ESTATE.

Under Section 2037, the value of the entire property on the decedent's death (or alternate valuation date) is included in the decedent's gross estate. I.R.C. §2037(a); Treas. Reg. §20.2031-1(b).

I. LIFE ESTATE OUTSTANDING AT DECEDENT'S DEATH.

The value of the included property is reduced by any outstanding life estate in the property at decedent's death. Treas. Reg. §20.2037-1(e); Rev. Rul. 76-178, 1976-1 C.B. 273; Rev. Rul. 82-24, 1982-1 C.B. 134.

J. REVERSIONARY INTEREST RELINQUISHED BEFORE DEATH.

A reversionary interest in property does not result in inclusion unless the decedent held the interest immediately before his death. A reversionary interest surrendered or renounced by the donor in his lifetime removes the "string." I.R.C. §2037(a); *Est. of Miller*, 40 B.T.A. 138 (1939). However, if the transferor relinquished the reversionary interest within three years of death, the provisions of Section 2035 would be invoked to make Section 2037 applicable.

U.S. v. Allen, 293 F.2d 916 (10th Cir. 1961). Presumably, the relinquished reversionary interest would have to be reconstructed and artificially valued at death for purposes of applying the 5% test.

VII. SECTION 2038. REVOCABLE TRANSFERS.

A. INTRODUCTION.

Section 2038 is not limited to decedent's lifetime transfers that may be recalled or which are "revocable." A better name for the section might be "alterable transfers." A decedent's power to change the enjoyment of transferred interests may invoke the section, even though the power cannot be exercised for his own benefit. If the enjoyment of property transferred by a decedent was subject to any change at the date of the decedent's death through the exercise by him of a power to alter, amend, revoke or terminate, the property is included in the gross estate. It does not matter whether the right was exercisable by the decedent alone or in conjunction with any other person. I.R.C. §2038(a)(1); Treas. Reg. §20.2038-1(a). The property is includible whether the power was reserved at time of transfer or created later. I.R.C. §2038(a)(1); however, for pre-June 23, 1936 transfers, the powers must be reserved. Treas. Reg. §20.2038-1(c).

B. PROPERTY NOT INCLUDED.

The regulations state that the property is not includible in the decedent's gross estate:

1. to the extent that the transfer was for an adequate and full consideration in money or money's worth;

2. if the decedent's power was exercisable only with the consent of all parties having an interest (vested or contingent) in the transferred property and the power adds nothing to the rights of the parties under local law, Treas. Reg. § 20.2038-1(a); *Helvering v. Helmholtz*, 296 U.S. 93 (1935), 80 L. Ed. 76; *Nagle v. U.S.*, 8/4/54, DC Pa rev'd on other ground 222 F.2d 663 (3d Cir.); or
3. if the power was held solely by a person other than the decedent and the decedent was not in a position of control so as to remove or discharge that person (for instance, a trustee) without cause and appoint a substitute, including himself.

C. “REVOCABLE TRANSFERS”.

Powers to alter, amend, revoke or terminate are generally referred to as revocable transfers. However, any power affecting the time or manner of enjoyment of property or its income, even though the decedent could not benefit from its exercise and even though the identity of the beneficiary is unaffected is included. Treas. Reg. §20.2038-1(a).

D. EXERCISE OF POWER ONLY AFTER NOTICE OR EVENT.

Where a power to alter, amend, revoke, or terminate may be exercised only after the giving of notice, or where its exercise takes effect only after the lapse of a specified time, the power is deemed to have existed at the time of decedent's death, whether or not at the date of death notice had been given or the power had been exercised. I.R.C. §2038(b); Treas. Reg. §20.2038-1(b). The value of the property included in the gross estate is discounted for the time required to elapse between the date of death and the date upon which the alteration, amendment, revocation, or termination could take effect. Treas. Reg. §20.2038-1(b).

E. POWER NEED NOT BENEFIT DECEDENT.

1. Power of Termination or Power to Accumulate Income: Inclusion results with any power affecting the time or manner of enjoyment of property or its income, even though the decedent does not benefit from the exercise and even though the identity of the beneficiary is not affected. I.R.C. §2038(a); Treas. Reg. §2038-1(a). This includes a power to terminate where the corpus will be distributed to the beneficiaries. *Mellon v. Driscoll*, 117 F.2d 477 (3d Cir. 1941), cert. den. 313 U.S. 579, 85 L. Ed. 1536; *Est. of Coulter*, 7 T.C. 1280 (1946). Also included is a “right at any time” to shift economic benefits of a trust, existing on the date of decedent's death. *Florida Nat'l Bank of Jacksonville, Florida, co-exr (Est. of Ballard), v. U.S.*, 336 F.2d 598 (3d Cir. 1964), cert. den. 380 U.S. 911, 13 L. Ed. 2d 797. “For example, section 2038 is applicable to a power reserved by the grantor of a trust to accumulate income or distribute it to A, and to distribute corpus to A, even though the remainder is vested in A or his estate, and no other person has any beneficial interest in the trust.” Treas. Reg. § 20.2038-1.
2. Discretionary Power: The grantor must not only give up all right to revest himself with the property, but any power to change the rights of others under the trust as well. Where a decedent reserved discretionary power to pay over any part of the corpus for the benefit of any one of his three children, who otherwise were given a one-third interest each, it was held to be a power to diminish or even extinguish the

interest of the other children and therefore made the trust disposition revocable. *Est. of Grossman*, 27 T.C. 707 (1957).

3. Limited Power of Appointment Retained by Decedent: Even where the grantor restricts the naming of beneficiaries to a small specified group, inclusion may result. *Cook v. Com.*, 66 F.2d 995 (3rd Cir. 1933), cert. den. 291 U.S. 660. The reservation of the right to change the proportionate shares of the beneficiaries without changing the beneficiaries also triggers Section 2038. *Treas. Reg. § 20.2038-1(a)*; *Com. v. Chase Nat'l Bank of N.Y. (Est. of Beresford)*, 82 F.2d 157 (2d Cir. 1936), cert. den. 299 U.S. 552; *Com. v. Est. of Hager*, 173 F.2d 613 (3d Cir. 1949). The decedent's estate included trust property where he reserved to himself the right to designate beneficiaries by will. It did not matter that the power could be exercised only within a limited class and that he did not exercise the reserved right, *Brown*, 40 B.T.A. 934 (1939), 41 B.T.A. 582, rev'd on other issue 119 F.2d 983 (7th Cir.).
4. A specific trust provision barring the exercise of the decedent's power to alter or amend, etc. in favor of himself or his estate will not serve to prevent inclusion of the property transferred in his estate. *Porter v. Com.*, 288 U.S. 436 (1933), 77 L. Ed. 880; *Mead v. Welch*, (DC Cal) 13 F. Supp. 981 (1936), rev'd on other issue 95 F.2d 617 (9th Cir.); *First Trust Co. of St. Paul v. Kelm*, (DC Min) 105 F. Supp. 667 (1952).

F. FIDUCIARY POWERS.

The mere fact that a power is held in a fiduciary capacity does not prevent inclusion under Section 2038. However, certain fiduciary powers may not trigger inclusion. The rules with respect to fiduciary powers under Section 2038 are comparable to those applicable with respect to Section 2036.

1. Accelerated Enjoyment. A grantor's retained power to accelerate enjoyment of trust principal by the income beneficiary is enough to cause inclusion. The Tax Court applied this rule to a grantor-trustee whose discretionary powers over trusts for his minor children could not be exercised after the beneficiaries reached 21. The power to accelerate the enjoyment of the principal before the beneficiaries became 21 was a sufficient power of termination to make the corpus includible in his estate. *Est. of Varian*, 47 T.C. 34 (1966), aff'd, 396 F.2d 753 (9th Cir.).
2. Management Powers. General administrative powers normally found in trust instruments have been held not to add up to a power to revoke. A purely managerial power to direct or influence the trustee's investment policy was held not to be a power of revocation. *Est. of Downe*, 2 T.C. 967 (1943) pet. rev. dismissed 6/1/44, CA2; *Est. of Wilson*, 13 T.C. 869 (1949), aff'd, 187 F.2d, 145 (3d Cir.). Similarly, a reserved power to substitute other property of equal value for property already held by the trust was not a power to alter, amend or revoke. *Est. of Jordahl*, 65 T.C. 92 (1976). The First Circuit held that a settlor's broad powers of management and investment as trustee may add up to a right to shift benefits between trust beneficiaries. *State Street Trust Co., exr (Est. of Cushing), v. U.S.*, 263 F.2d 635 (1st Cir. 1959). But the same court later held otherwise where slightly less broad powers were involved. *Old Colony Trust Co., exr (Est. of Cunningham), v. U.S.*,

423 F.2d 601 (1st Cir. 1970), aff'g (DC Mass) 300 F. Supp. 1032. Nevertheless, broad management powers may be considered a power to accelerate enjoyment of trust principal and on that ground require inclusion if not sufficiently restricted by fiduciary standards.

3. Attribution of Third Party Trustee Powers. If the decedent reserved to himself the power to revoke or amend, the interest subject to his power is includible in his estate even though he could exercise the power only as trustee. I.R.C. § 2038(a). However, where the decedent is not serving as trustee, control over the selection of the trustee normally does not result in inclusion.
 - a. The reservation by the decedent of the power merely to name the trustees was not a power to revoke or amend. Est. of Wier, 17 T.C. 409 (1951); Est. of Stettenheim, T.C. Memo. 1955-158. The right to appoint one or more individual co-trustees to act with a bank trustee was not a power to alter, amend, revoke or terminate where the grantor could not name himself as co-trustee. *Durst, exrx v. U.S.*, 7/7/77, CA3, aff'g 409 F. Supp. 1046. The power to appoint a successor trustee only under limited conditions, which conditions in fact did not exist at the time of the decedent's death, was not a power to revoke or amend. Treas. Reg. § 20.2038-1(a); Rev. Rul. 55-393, 1955-1 C.B. 448; Est. of Want, 29 T.C. 1223 (1958).
 - b. If grantor-decedent has the unrestricted power at any time to remove or discharge a trustee and appoint a new trustee, including himself, he would be charged with whatever powers were given to the trustee. Treas. Reg. § 20.2038-1(a); Est. of Loughridge, 11 T.C. 968 (1948), aff'd, 183 F.2d 294 (10th Cir.); Est. of Rlauber, 34 T.C. 968 (1960). However, attribution of the trustee's powers will not cause inclusion if the powers are so limited that they would not cause inclusion if reserved directly by the grantor (for example powers limited by an ascertainable standard as discussed in paragraph 4 below). Est. of Wilson, 13 T.C. 869 (1949), aff'd, 187 F.2d 145 (3d Cir.).
 - c. The Service formerly took the position that where a trust instrument gave the trustee the power to distribute or accumulate trust income, the grantor's retention of the right to remove the corporate trustee without cause and appoint another corporate trustee causes the corpus to be included in the grantor's gross estate, even though the trust is irrevocable, the grantor is specifically barred from appointing himself as trustee, and at the grantor's death the original corporate trustee was still serving. Rev. Rul. 79-353, 1979-2 C.B. 325. Many commentators disagreed with this ruling, and several courts rejected its premise. Est. of Wall v. Com'r, 101 T.C. 300 (1993); Est. of Vak v. Com'r, 973 F.2d 1409 (8th Cir. 1992).
 - d. In light of the *Wall* and *Vak* cases, the Service has revoked Revenue Ruling 79-353, and modified related rulings. In Rev. Rul. 95-58, IRB 1995-36, the Service has announced that it will no longer assert that Trustee powers will be attributed to a grantor or another person having the unrestricted right to remove and replace a Trustee, provided that the person holding the power of removal may not appoint himself or a related or subordinate party (as

defined in Section 672(c) of the Code) to serve in lieu of the removed Trustee.

4. Powers Limited by Ascertainable Standards. An ascertainable standard that effectively limits the exercise of a power eliminates its discretionary element and prevents inclusion of the property in the gross estate. Est. of Wilson, 13 T.C. 869 (1949), aff'd, 187 F.2d 145 (3d Cir.).

a. Powers which have been held to be so limited:

- (1) Amend merely to clarify, Theopold v. U.S., 164 F.2d 404 (1st Cir. 1947).
- (2) Increase trust principal. Central Trust Co. (Est. of Baur) v. U.S., 167 F.2d 133 (6th Cir. 1948).
- (3) A reserved power to invade principal in the event of prolonged illness. Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947).
- (4) A discretionary power in the grantor-trustee to pay income or invade corpus for the beneficiaries' education, maintenance, medical expenses, or other needs occasioned by emergency. Est. of Pardee, 49 T.C. 140 (1967).
- (5) A power in a grantor to substitute himself as trustee where the trustee was required to turn over principal to a daughter on request subject to the approval of the income beneficiary. No request was made, and, since there was no discretion, there was no retained power. Est. of Wurts, T.C. Memo. 1960-102.
- (6) "All or any part of the corpus which (the grantor) may deem necessary for her support, maintenance, health, education and comfortable living." Est. of Rlafter, T.C. Memo. 1973-230.

b. Insufficiently limited reserved powers do not exclude the property from the transferor's estate.

- (1) The trustee to act for the "best interest" of the beneficiary. Est. of Yawkey, 12 T.C. 1164 (1949).
- (2) A power exercisable by decedent in conjunction with co-trustees to distribute all or part of the corpus for the purpose of providing the beneficiary with funds for a home, business, or for any other purpose believed by the Trustees to be for the beneficiary's benefit. Est. of Bell, 66 T.C. 729 (1976).

G. AMOUNT INCLUDIBLE IS VALUE OF INTEREST SUBJECT TO POWER.

The amount includible is the value of the interest, which is subject to the power, as of the applicable valuation date. Treas. Reg. §20.2038-1(a); Industrial Trust Co. v. Com'r, 165

F.2d 142 (1st Cir. 1947); *In re Est. of Inman*, 203 F.2d 679 (2d Cir. 1953). The power to accelerate principal distribution to the income beneficiary was sufficient ground to include the trust principal in decedent's estate, *Lober v. U.S.*, 346 U.S. 335 (1953), 98 L. Ed. 15, aff'g (Ct C1) 108 F. Supp. 731. Where the trustee could terminate the trust through accelerated distribution of principal, the grantor's right to substitute herself as trustee required inclusion of the trust corpus in the grantor's estate. *Walter, exrx, v. U.S.*, 295 F.2d 720 (6th Cir. 1961).

H. CUSTODIAN ACCOUNTS.

The Service applies to custodian accounts in the custody of the donor the same rule as is applicable to trusts and requires the custodian account to be included in the gross estate if the donor is the custodian or successor custodian and dies while acting in that capacity before the minor attains majority. Rev. Rul. 57-366, 1957-2 C.B. 618. The same rule is applied by the Service to gifts under the Uniform Gifts to Minors Act and the Model Gifts of Securities to Minors Act. Rev. Rul. 59-357, 1959-2 C.B. 212; Rev. Rul. 70-348, 1970-2 C.B. 193. Where the transferor-custodian is also the person responsible for the support of a minor and custodial funds may be used for that purpose, inclusion may be sought on the additional ground of retained use of income. I.R.C. §2036. There is no inclusion if custodian is not the transferor. Rev. Rul. 74-556, 1974-2 C.B. 300.

I. SAVINGS BANK ("TOTTEN") TRUSTS.

An account "in trust for" a child or other relative is not considered as a completed transfer, but rather as revocable at will, unless and until the depositor permanently delivers the passbook to the beneficiary or through some other unequivocal act or declaration makes the gift irrevocable or the power to revoke terminates through the depositor's death. Inclusion is usually based upon retained life estate, power to revoke or both. *Eichstedt (Sawyer), exrx v. U.S.*, 10/5/72, DC-Calif.

J. POWER EXERCISABLE AFTER CONDITIONS.

A power exercisable by the decedent only after conditions or contingencies have happened does not result in inclusion if at the time of the decedent's death they have not occurred, and are not within the decedent's control. Treas. Reg. §20.2038-1(b). The power to transfer principal to a beneficiary once he has reached 30 years of age is disregarded if at the time of the decedent's death all beneficiaries were under 30. *Est. of Yawkey*, 12 T.C. 1164 (1949).

K. INCOMPETENCY OF POWER HOLDER.

The existence of the power is sufficient to warrant inclusion of the property in the transferor's estate regardless of mental incompetence. *Hurd v. Com.*, 160 F.2d 610 (1st Cir. 1947).

L. POWER IN CONJUNCTION WITH OTHERS.

A reserved power to alter, amend, revoke, or terminate only in conjunction with another person or other persons will cause inclusion whether or not the joint powerholders had a

substantial adverse interest. *Helvering v. City Bank Farmers Trust Co (James Trust)*, 296 U.S. 85 (1935), 80 L. Ed. 62; *Schuster*, 32 T.C. 998 (1959), aff'd and rev'd on other issues, 312 F.2d 311 (9th Cir.); *Englert*, trans, 32 T.C. 1008 (1959); *First Western Bank & Trust Co.*, 32 T.C. 1017 (1959).

If such a power may be exercised only with the consent of all the parties having an interest in the property, and gives no rights to the parties which the law does not confer upon them, the property thus transferred is not included in the decedent's estate. *Treas. Reg. §20.2038-1(a)*; *Helvering v. Helmholtz*, 296 U.S. 93 (1935), 80 L. Ed. 16.

M. RELINQUISHMENT OF POWER.

If the power was relinquished prior to the date of death the property is generally not includible. However, the relinquishment (after 1976) of a power to alter, amend or revoke is disregarded if it is made within the three-year period ending on the decedent's death. *I.R.C. §§ 2035; 2038(a)*.

N. GIFTS MADE BY ATTORNEY-IN-FACT.

Where an attorney-in-fact makes gifts on behalf of the principal without specific authority to do so, the gifts may be voidable under state law, causing the gifted property to be included in the gross estate as a revocable transfer. *See, e.g., Townsend v. U.S.*, 95-1 U.S.T.C. ¶60,192 (D. Neb. 1995). *Compare Est. of Ridenour v. Com'r*, 36 F.3d 332 (4th Cir. 1994)(gifts were not voidable due to implied authority based on facts and circumstances and validating state law). Note, however, that North Carolina law specifically authorizes gifts by attorneys-in-fact if certain requirements are met. *N.C.G.S. §32 A-14.1 (Session Laws 1995)*.

Estate of Swanson v. United States, 2001-1 U.S.T.C. 60,408 (Fed.Cir.2001). The Federal Circuit affirmed the decision of the lower court holding that 38 checks written by decedent's attorney-in-fact were includible in the Decedent's gross estate because the Decedent's power of attorney did not contain an express written authorization to make gifts. Under applicable state law (California), gifts by an attorney-in-fact must be expressly authorized in the power of attorney. Decedent's acquiescence in the Gifts was not sufficient to ratify the attorney-in-fact's actions. The court also refused to imply a power to make gifts, asserting that gifts for tax planning purposes are never in the best interests of the principal, but only benefit the beneficiaries of the principal's estate.

Estate of Hubberd v. Commissioner, 76 T.C.M. (CCH) 963 (1998). Voidable transfers of limited partnership interests by attorney-in-fact were includible in gross estate. During the years 1989 through 1993, decedent's attorney-in-fact made gifts of the decedent's limited partnership interests to various family members who were also the sole beneficiaries of the decedent's residuary estate. It was conceded by the estate and the Service that the transfers by the decedent's attorney-in-fact were voidable transfers under applicable (Texas) law. Prior to the decedent's death, neither the decedent nor her attorney-in-fact took any steps to void the transfers. Further, following the decedent's death, neither the executor (who was the attorney-in-fact) nor his successor executors took any steps to void the transfers. The Service issued a deficiency notice increasing the value of the decedent's estate by the value of the voidable transfers. The estate argued that under Texas law a voidable transfer vests title in the transferee until the transfer is successfully voided. The court disagreed, stating that the estate's focus on the transferee's legal title is misplaced under §2033. The court ruled that if

the transfers were voidable, the decedent had the right to regain title to the property transferred. Thus, §2038(a)(1) renders the transfers includible since the transferee's enjoyment of the property was subject to revocation at the decedent's death.

Technical Advice Memorandum 199944005. Decedent executed a durable power of attorney designating her husband as her primary agent and her daughter as her successor agent. The power of attorney did not specifically grant the attorney-in-fact the power to make gifts, and the state Supreme Court had not yet ruled on whether or not such a power must be specifically granted in the power of attorney. Decedent's spouse predeceased her. The decedent's daughter made gifts as attorney-in-fact for the decedent. The Service determined that the state court would likely determine that the gifts made by the attorney-in-fact on behalf of the decedent were authorized under the power of attorney based on the following factors: (1) the language of the power of attorney was sufficiently broad to make it a general power of attorney; (2) the value of the gifts were small relative to the value of the decedent's estate; (3) the decedent was not economically or otherwise disadvantaged by the gifts; (4) the gifts were consistent with the intent expressed by the decedent in her will; and (5) the gifts were consistent with the decedent's history of gift giving.

O. GIFTS MADE BY GUARDIANS.

Transfers made by guardian pursuant to state court order not included in ward's estate as revocable transfers. Private Letter Ruling 9839018. Decedent established a revocable trust. The guardian and trustees of decedent's trust proposed to seek authority from a local state court pursuant to the state statutes to make annual exclusion gifts to decedent's seventeen grandchildren and great grandchildren. The state statute set forth a procedure where the heirs and distributees of the incompetent individuals were notified of a hearing at which the court would determine the amounts, recipients and proportions of any gifts. The Service ruled that if annual exclusion gifts were made following the state hearing procedure, the gifts would be completed gifts and would not be included under Section 2038 in decedent's gross estate.

VIII. SECTION 2040. JOINT INTERESTS

A. TENANTS IN COMMON.

An ordinary interest as tenant in common is something that a decedent can pass along to others the same as any interest in property solely owned by the decedent. The decedent's interest as tenant in common is included under Section 2033.

B. JOINT OWNERSHIP WITH SURVIVORSHIP RIGHTS.

Code Section 2040 applies to survivorship forms of joint interests including:

1. joint tenancies;
2. tenancies by the entirety; and
3. joint bank accounts.

The estate tax rules on joint tenancy with right of survivorship or tenancy by the entirety do not apply if property was held by spouses as joint tenants or tenants by the entirety, and the

spouses are subsequently divorced, if state law provides that the divorce converts the previous form of ownership into a tenancy in common. If state law states that the property continues to be held by the parties as joint tenants with right of survivorship after divorce, the jointly-held property rules apply to determine the amount includible in the estate of the first to die. Rev. Rul. 80-241, 1980-2 C.B. 273.

C. INCLUDIBILITY WHERE ACQUIRED BY GIFT.

If the property was acquired by the joint owners from a third person by gift, devise, bequest or inheritance, only the decedent's fractional share of the property is included. I.R.C. §2040; Treas. Reg. §20.2040-1(a)(1); Treas. Reg. §20.2040-1(c)(7); Treas. Reg. §20.2040-1(c)(8).

D. CONSIDERATION FURNISHED TEST.

1. When joint ownership is created by one or more of the co-owners, the amount includible is determined under a "consideration furnished" test, unless the only joint tenants are a married couple, in which case a special marital joint property rule applies.
2. Under the "consideration furnished" test, the entire value of the property is included in the deceased co-owner's estate, except for the part which the executor can prove is attributable to consideration in money or money's worth furnished by the other joint owner or owners. I.R.C. §2040; Treas. Reg. §20.2040-1(a)(2).

Estate of Concordia. T.C. Memo 2002-216. Mrs. Concordia died in 1996 with a will that left everything equally to her two nieces. Mrs. Concordia owned a residence and some rental property. Mrs. Concordia entered into an agreement with her niece, Mrs. McReady, under which Mrs. Concordia would deed her residence to Mrs. McReady in exchange for Mrs. McReady managing her rental property. In addition, it was understood that Mrs. Concordia could live in the home with Mr. and Mrs. McReady. Mrs. Concordia executed a deed conveying her residence to herself and to her niece, Mrs. McReady, as joint tenants with right of survivorship. At the time of Mrs. Concordia's death, the residence had a fair market value of \$270,000. The Estate reported one-half of that value on her estate tax return. The I.R.S. maintained that the entire value of the residence had to be included in her estate. The estate argued that Mr. and Mrs. McReady gave adequate consideration for one-half of the property in the form of property management services with respect to the decedent's rental property in addition to providing living accommodations to the decedent. The Tax Court agreed with the estate after evidence was presented to establish the fair market rental value for the decedent's being allowed to live with Mr. and Mrs. McReady. Only one-half of the value of the jointly owned property was includable under section 2040.

Estate of Van Tine v. Commissioner, 76 T.C.M.(CCH) 530 (1998). Estate not entitled to exclude one-half of property held jointly with decedent's daughter because estate did not prove amount of daughter's consideration. Prior to his death, decedent conveyed certain real property to himself and his daughter as joint tenants in recognition of daughter's services rendered to decedent's construction business

throughout her life. Beginning in elementary school, daughter performed various services for decedent's construction business, including actual construction work, cleaning, landscaping, supervision of construction sites. Daughter never received a salary for her work. Daughter also performed services for a family friend and sold real property. The court ruled that although daughter rendered substantial services to decedent's business, the estate failed to establish the consideration decedent and his wife paid to buy and improve the properties at issue. Because it was not shown what part of the value of the properties was attributable to the consideration daughter furnished with her services to the business, the estate may not exclude one-half of the value of the properties on decedent's death tax return.

3. Exclusion of property traceable to the survivor is mandatory under the consideration furnished test. The Tax Court found that Congress had not intended to give taxpayers an election to include or not to include the property in the deceased joint owner's estate and required exclusion to the extent of the consideration furnished by the survivor. *Madden v. Com'r*, 440 F.2d 784 (7th Cir. 1971), aff'g 52 T.C. 845; *Normoyle*, T.C. Memo. 1969-199.
4. The attribution is made on a proportionate basis, taking into account the total cost of acquisition and capital additions. Treas. Reg. §20.2040-1(a)(2).
5. Estate of Fratini v. Commissioner, 76 T.C.M. (CCH) 342 (1998). Credit permitted for money and services rendered by joint owner. Decedent and his partner acquired CD's and bank accounts in their joint names, and purchased a number of real estate parcels jointly. Several other properties were originally in the name of decedent, who re-titled them in joint names with his partner. The estate argued that the partner provided management services that constituted a contribution toward the value of these properties sufficient to allow exclusion of one-half of their value from the estate. Testimony and records were offered to demonstrate the nature and quality of the service, which the court found persuasive. However, the expert testimony regarding their value was deemed conclusory; instead of granting a one-half credit, the estate was limited to credits of approximately 21%, the amount originally reflected on the estate tax return. The court sustained the Service's restriction of mortgage deductions on the joint properties to 50% of the outstanding balance, even where a larger percentage was included in the estate; since the decedent and his partner were equally obligated on the notes, only his share of the debt could be deducted. (9/98)
6. Income from Joint Accounts: Joint accounts holding income received from the jointly owned properties were deemed attributable to equal contributions from the parties, regardless of the source of consideration for the underlying assets. *Estate of Fratini v. Commissioner*, 76 T.C.M. (CCH) 342 (1998).

E. WHO FURNISHED THE CONSIDERATION?

The surviving co-owner is deemed to have furnished only that portion of the consideration contributed by him, which is not attributable to money or other property acquired from the decedent for less than a full and adequate consideration in money or money's worth. I.R.C. § 2040; Treas. Reg. § 20.2040-1(a)(2). Any portion attributable to property or funds

received by way of gift from the decedent is treated as furnished by the decedent and is therefore not excludible.

1. Appreciation in Previously Gifted Property. Subsequent appreciation of property originally gifted to the co-owner by the decedent, that was then used by the co-owner as his contribution, was viewed as the surviving co-owner's contribution to the jointly-owned account. Rev. Rul. 79-372, 1979-2 C.B. 330. Here the Service conceded that appreciation in the value of gift property is considered as the donee's contribution to a subsequent joint tenancy with the donor.
2. Income from Previously Gifted Property. Income from gifted property that is used to create a joint tenancy is not considered acquired from the donor. Treas. Reg. §20.2040-1(c) (5); Harvey v. U.S., 185 F.2d 463 (7th Cir. 1950); Swartz, exr, v. U.S., (DC Mass) 182 F. Supp. 540 (1960); First Nat'l Bank of Kansas City, exr (Est. of Cline), v. U.S.1 (DC Ha) 223 F. Supp. 963 (1963).
3. Stock Dividends on Previously Gifted Property. Stock dividends that do not change the proportionate interests in the corporation are not considered income. Therefore, when the stock was thereafter used as consideration by the surviving co-owner, the full value of the assets was included. Rev. Rul. 80-142, 1980-1 C.B. 197.
4. Release of Marital Rights is Not Consideration. A spouse's release of marital property rights is not full and adequate consideration for the interest in jointly held property. I.R.C. §2043(b). However, the relinquishment of support rights by the spouse was regarded as adequate consideration. Rev. Rul. 68-379, 1768-2 C.B. 414.
5. Personal Liability on Mortgage as Consideration. Where tenants by the entirety assumed an existing mortgage on the property, for which each was personally liable, each was treated as having made an original contribution to the extent of one-half the mortgage. Bremer v. Luff, (DC NY) 7 F. Supp. 148 (1933). However, payments on the mortgage by one co-owner are treated as that person's contribution. At the death of a co-owner, the surviving co-owner's contribution is computed by adding actual payments plus one-half of the outstanding mortgage indebtedness.

F. SPOUSES' JOINTLY-OWNED PROPERTY: ESTATES OF DECEDENTS DYING AFTER 1981.

1. For the estates of married decedents dying after 1981, the gross estate of the first spouse to die includes 50% of the value of real or personal property owned by the decedent and his spouse as tenants by the entirety or as joint tenants with right of survivorship, if the decedent and his spouse are the only joint tenants. I.R.C. §2040(b). The 50% rule applies regardless of which spouse furnished the original consideration. H Rept No. 97-201, PL 97-34, p. 163.

Action On Decision 2001-06. The Service has agreed to follow the decision Hahn v. Commissioner, 110 T.C. 140 (1998), in which the Tax Court held that the 50% inclusion rule of § 2040(b)(1) does not apply to spousal joint interests created before January 1, 1977. The Service had argued in Hahn that the 1981 amendment to §2040(b)(2) expressly or impliedly repealed the effective date of §2040(b)(1). In acquiescing in the Hahn decision, the Service noted that other courts examining the

issue, including the Fourth and Sixth Circuits, had reached the same result as the Tax Court. Accordingly, the Service stated that it will no longer assert that §2040(b)(1) applies to joint interests created before January 1, 1977 where the deceased joint tenant died after December 31, 1981.

2. The new rule applies only to joint tenancies created after 1976. For those created prior to that time, the old consideration-furnished test continues to apply. *Gallenstein v. U.S.*, 975 F.2d 286 (6th Cir. 1992); *Patten v. U.S.* 96-1 U.S.T.C. ¶60,231 (W.D. Va. 1996); *Anderson v. U.S.* 96-2 U.S.T.C. ¶60,235 (D.Md. 1996).
3. In PLR 836040, the Service looked through a joint trust funded with jointly owned securities, jointly revocable, which granted the survivor only a life estate, and found that only one-half of the principal was includible.

IX. SECTION 2041. POWERS OF APPOINTMENT.

A. INTRODUCTION.

The donor of a power of appointment empowers the donee to dispose of property. When the donee of the power dies, the issue is whether the property subject to the power is includible in the donee's estate. The outcome depends upon the scope of the power. Normally, only a general power of appointment will cause inclusion in the donee's estate (see definition of General Power of Appointment on next page under paragraph B3 of this Section IX). A power, which is not general, (referred to as a nongeneral, special or limited power) will not cause inclusion in the donee's estate. Thus the estate tax effects depend first of all upon whether or not the donee had a general power of appointment.

Once it is determined that the donee had a general power of appointment, there are different rules for the inclusion of property, depending on when the power was created:

1. A general power created after Oct. 21, 1942, causes the property subject to the power to be included in the donee's estate even though the power is merely possessed by the donee at the time of his death or where it is either exercised, released or permitted to lapse. I.R.C. § 2041(a)(2). The one exception to the rule that only a general power of appointment is includible occurs when the donee exercised a post-Oct. 21, 1942 nongeneral power to create a second power.
2. A power created before Oct. 22, 1942, causes only the value of property with respect to which the power was actually exercised to be included in the donee's estate. I.R.C. § 2041(a)(1)

B. POWERS OF APPOINTMENT.

1. Definition. A power of appointment is created when the donor confers upon the donee by will, trust, or other instrument, the right to designate who is to receive certain specific property or an interest in it at some future time. It does not include a power over property reserved by a decedent for himself (although such power may cause inclusion in the decedent's estate under Section 2036 or Section 2038). Under the regulations, "power of appointment" includes:

- a. A power to invade, consume, or appropriate the corpus of a trust to affect the beneficial enjoyment of a trust by altering, amending, revoking, or terminating the trust. A power to amend only the administrative provisions of a trust is not a power of appointment. Treas. Reg. §20.2041-1(b)(1).
 - b. A merely managerial power such as a power of investment, custody of assets or allocation of receipts and disbursements as between income and principal, without power to enlarge or shift beneficial interests, is not considered a power of appointment. Treas. Reg. §20.2041-1(b)(1).
2. Power Over Property. Unless the property was in existence before a decedent's death, there is no power of appointment for purposes of Section 2041. For example, a decedent's spouse took out and owned a life insurance policy on the decedent's life and named as beneficiary a revocable trust created by the decedent. Here, the decedent's right to revoke the trust was not a taxable power of appointment over the policy or its proceeds, because there was not "any property" to which the power attached. The decedent had a power over an expectancy. Est. of Margrave, 71 T.C. 13 (1978) aff'd, 618 F.2d 34 (8th Cir. 1980).
3. "General". A power of appointment is "general" if the power is exercisable in favor of the decedent personally, his estate, his creditors, or the creditors of his estate. I.R.C. §2041(b)(1). Any one of the four groups of appointees specified qualifies the power as general. A power qualifies as a general power of appointment even when the donee can appoint the property only inter vivos and not by will. The donee's inability to make appointments either to his estate or to the creditors of his estate is irrelevant. Jenkins, Jr., exr, v. U.S., 428 F.2d 538 (5th Cir. 1970), rev'g (DC Ga) 296 F. Supp. 203, cert. den. 400 U.S. 829, 27 L. Ed. 2d 59.
- a. In Letter Ruling 8049011, the Service ruled that a widow had a general power of appointment over a residuary trust in her husband's will when the will provided that upon the widow's death, the trustee was to satisfy any claims against her estate to the extent her own estate was insufficient to satisfy such claims. "Thus, if the decedent had lived beyond her means or had to bear the burden of a long and expensive illness prior to death, the assets of her residuary trust were there for the executor to use if her estate were insolvent or lacking in assets sufficient to satisfy such claims." PLR 8049011.
 - b. Ascertainable Standard Not General Power: If the donee's power to consume, invade, or appropriate property is limited by an ascertainable standard relating to the donee's health, maintenance, support or education, the power will not be considered general even though it is exercisable in the donee's own favor. I.R.C. §2041(b)(1)(A). See also Section 5 below.
4. Non-general/Special/Limited Powers. A nongeneral power includes the following:
- a. A power exercisable only in favor of one or more designated persons or classes other than the decedent, his creditors, the decedent's estate or the creditors of his estate, or

- b. A power expressly not exercisable in favor of the decedent, his creditors, or the decedent's estate or the creditors of his estate. Treas. Reg. §20.2041-1(c)(1). All four categories must be made ineligible. Est. of Edelman, (1962) 38 T.C. 972.
 - c. Testamentary power held by trust grantor's son to appoint to "grantor's issue" did not include power to appoint to himself. Private Letter Ruling 199938024. A trust agreement establishes a trust for the benefit of the grantor's son and his issue. Upon termination of the trust after the son's death, the assets will be distributed as the son appoints by his will among the grantor's issue and the spouses of the grantor's issue. Since this is a testamentary power, it cannot be used to benefit the son during his lifetime, and was interpreted by the Service as being restricted to exclude the son's estate or his creditors after his death.
5. "Ascertainable Standard". A power to invade, consume, or appropriate income or corpus, or both, for the donee's personal benefit is not to be regarded as "general" if it is limited by an ascertainable standard relating to the donee's health, education, support, or maintenance or any combination of these. I.R.C. §2041(b)(1)(A); Treas. Reg. §20.2041-1(c)(2).
- a. Trustee who is also a beneficiary of a trust that permits Trustee to make distributions to himself does not hold a general power of appointment over the trust if his power to make distributions is limited to an ascertainable standard. Private Letter Ruling 200042019. (10/00)
 - b. There is no ascertainable standard with regard to powers which may be exercised for the donee's "comfort," "welfare" or "happiness." Treas. Reg. §20.2041-1(c)(2). However, the Seventh Circuit held that a power to invade corpus for "maintenance, comfort and happiness" was a power limited by an ascertainable standard. *Brantingham v. U.S.*, 631 F.2d 542 (7th Cir. 1980). The Service has indicated it will not follow *Brantingham*.
 - c. The Service ruled that a power of invasion exercisable in case of "emergency", without reference to the donee's needs for health, education, support or maintenance, is not within the statutory exception. PLR 7841006. The Tenth Circuit disagreed and said an "emergency" is a special and sudden event that calls for immediate action and is an ascertainable standard. *Est. of Sowell v. Com.*, 708 F.2d 1564 (10th Cir. 1983) rev'g 74 T.C. 1001.
 - d. Whether the donee is required first to exhaust his other sources of revenue is of no significance in determining whether a power is limited by an ascertainable standard. Treas. Reg §20.2041-1(c)(2).
 - e. Judicial modification of power of appointment was effective. Private Letter Ruling 199936029. When a husband died, he left a Will that created a residual trust, naming his widow as trustee and as beneficiary. As trustee, the widow had the discretion to distribute principal to herself if she considered the trust income to be insufficient. Since this failure to limit the

invasion of principal to an ascertainable standard was due to a “scrivener’s error,” a state court order modified the trust terms so as to allow the trustee to distribute principal to herself only for her health, maintenance, support and education. When the widow died, the assets of the trust were not included in her estate.

6. Imputing the Trustee’s Powers to the Beneficiary. If a trustee’s power of invasion not limited by an ascertainable standard can be imputed to a decedent-beneficiary of a trust, then the beneficiary will be treated as holding a general power of appointment.
 - a. The Service has ruled that an independent trustee’s power to invade principal in its sole and unfettered discretion cannot be imputed to the beneficiary and will not be considered a general power of appointment taxable to the decedent-beneficiary’s estate. Rev. Rul. 76-368, 1976-2 C.B. 271.
 - b. Where a husband granted his spouse a lifetime income interest in all his property and appointed his son as trustee giving the trustee the sole and exclusive right to manage the estate, and the trustee also had the power to invade corpus when the spouse’s income was insufficient to comfortably and adequately support her, the Tax Court ruled that neither the words in the will nor the extrinsic evidence indicated an intent to grant the spouse a power of invasion. Est. of Cox, 59 T.C. 825 (1973).
 - c. An unrestricted power to remove and replace the trustee holding the power will not be sufficient to cause the trustee’s powers to be imputed to the beneficiary, provided that the beneficiary’s power to appoint a new trustee is limited to those who are not “related or subordinate parties” as defined in Section 672(c). Rev. Rul. 95-58; PLR 9607008.
7. Fiduciary Powers. When state law prohibits a trustee from exercising a power under a trust instrument to appoint trust corpus to himself, the trustee will not be considered as holding a general power of appointment. When state law allows a beneficiary of a trust to be a trustee of the trust, a power of appointment that is limited by an ascertainable standard relating to the beneficiary’s maintenance and health is not regarded as a general power of appointment even though the power is possessed by the beneficiary as sole trustee of the trust. Rev. Rul. 78-398, 1978-2 C.B. 237. Since a beneficiary’s power to make distributions to herself was restricted under N.C. Gen. Stat. §32-34(b), she was held not to have a general power of appointment over trust property. PLR 9516051.

C. DOCTRINE OF CONSISTENCY

Technical Advice Memorandum 200407018. Under the husband's will, his wife was given a life estate in certain personalty including all oil paintings owned by the husband. In addition, the husband's will gave the wife the power to use, consume, sell or otherwise dispose of other tangible personal

property (other than the oil paintings) during her lifetime. On the husband's estate tax return, Schedule F included a pastel painting along with other items of household furniture, art work and miscellaneous personal property. The estate claimed that the pastel qualified for the estate tax marital deduction under section 2056(b)(5). At wife's death, the painting in question was sold. At that time it was determined that the painting was in fact an oil painting rather than a pastel. Based on this discovery, the wife's estate maintained that she never possessed a general power of appointment over the painting and that the painting should be excluded from her estate. The Service ruled that pursuant to the doctrine of duty of consistency a painting for which an estate tax marital deduction was claimed and allowed in the husband's estate must be includable in the wife's gross estate at her subsequent death under section 2041.

Estate of Posner v. Commissioner T.C. Memo 2004-112. Husband predeceased his wife leaving a will that created a trust that expressed husband's intent that it qualify for the marital deduction. The will was poorly drafted, however, and it failed to include provisions naming income beneficiaries, remaindermen, or powers of appointment. Nonetheless, the husband's estate filed its estate tax return claiming a marital deduction for the value of the trust. The IRS audited the estate and allowed the marital deduction. After the wife died, her estate initially included the value of the trust in her estate on the basis the wife had a general power of appointment. A suit was brought in state court to determine the proper interpretation of the husband's will. The state court determined that the husband's will did not give the wife a general power of appointment. The wife's estate then filed a claim for refund of estate taxes paid. The Tax Court concluded that the husband's will did not create a general power of appointment in his wife. In addition, the Court held the doctrine of consistency did not require the wife's estate to include the value of the trust in her estate because both parties had been equally mistaken in concluding the husband's will did give a general power of appointment to the wife.

D. JOINT POWERS.

1. Joint Powers Created After October 21, 1942. A power of appointment created after Oct. 21, 1942 and exercisable by the donee only with the consent or joinder of another person is not general if the other person either:
 - a. is the donor of the power (although the donor may have inclusion in his estate because of the reserved power), or
 - b. has with respect to the appointive property a substantial adverse interest to any exercise in favor of the donee, the donee's estate, the donee's creditors, or the creditors of the donee's estate. I.R.C. §2041(b)(1)(C); Treas. Reg. §20.2041-3(c).
2. "Adverse Interest". A co-holder who is designated by the donor as beneficiary if the donee of the power should fail to exercise his power (for instance, a taker in default) has an adverse interest, as does a person who after the donee's death could appoint the property to himself, his estate, or creditors. I.R.C. §2041(b)(1)(C), Treas. Reg. §20.2041-3(a).

- a. A co-holder has an adverse interest where he may possess the power after the decedent's death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate. Treas. Reg. §20.2041-3(c).
Private Letter Ruling 200150020. Decedent, who has two children but no grandchildren; had created an irrevocable trust sometime before 1977 for the benefit of his future grandchildren. The children have the power, acting jointly, to close the class of the grandchildren at any time, at which time the trust will terminate and the trust assets will be distributed in equal shares to grandchildren, if any, otherwise to the Decedent's then living intestate heirs. The children's cousin has a contingent interest in the trust in the event that the children both die without issue before the trust terminates. The cousin was unaware of the existence of the trust or that he had any interest therein. The children propose to release their joint power to close the class of Decedent's grandchildren, and their cousin wishes to execute a disclaimer of his interest. The Service found that because each child had the potential to receive a general power of appointment should he survive the other, the children's interests in the trust were adverse to each other. Therefore, their joint power was not a general power of appointment and no part of the assets of the trust would be included in the estate of either of them by reason of its release, nor would they incur any gift tax liability.
- b. A corporate trustee does not have a substantial adverse interest merely because of its fiduciary duty to protect the interest of the remainderman. Est. of Towle, 54 T.C. 368 (1970). A corporate trustee does not have a substantial adverse interest because of its right to compensation for its services. Miller, Jr., co-exr, v. U.S., 387 F.2d 866 (3d Cir. 1968). Where the donee of a power had to notify the remaindermen of a trust if the donee proposed to exercise the power and if they disagreed, submit the matter to a bank trustee for resolution, the bank trustee did not have an adverse interest and the donee had a general power. Rev. Rul. 82-156, 1982-2 C.B. 216.
- c. It has been held that even though decedent was required to obtain the probate court's consent before selling or conveying property, she had a general power of appointment over the property because the court could not obtain any personal benefit from the trust and thus did not have an adverse interest. Picciano v. U.S., (DC Ohio) 532 F. Supp. 246 (1981).
- d. A guardian of the life beneficiary does not have a substantially adverse interest to defeat a general power of appointment. Est. of Gilchrist, 69 T.C. 5 (1977), rev'd on another issue 630 F.2d 340 (5th Cir. 1980).
- e. The substantial adverse interest must be created concurrently with the general power, rather than after its creation. Est. of Witkowski v. U.S., 451 F.2d 1249 (5th Cir. 1971), aff'g 4/22/71, DC-Tex, cert. den. 409 U.S. 891, 34 L. Ed. 2d 148.
3. "Substantial". An adverse interest is considered substantial if its value in relation to the total of the property subject to the power is not insignificant. Treas. Reg.

§20.2041-3(c).

4. Joint Power with Nonadverse Co-holder who is Permissible Appointee. If a nonadverse co-holder is a permissible appointee, the law takes some account of the fact that the permissible appointee must join in the exercise. The donee is considered as holding a general power only over a fractional part of the entire appointive property, depending on the number of co-holders eligible as appointees. If there is only one such potential appointee who must join in the exercise, the fraction is one-half, if there are two, it is one-third, etc. I.R.C. §2041(b)(1)(C) (iii); Treas. Reg. §20.2041-3(c)(3).
5. Joint Powers Created Before October 22, 1942 (No Adverse Interest Required). If the donee may exercise a power created before Oct. 22, 1942, only with the consent or joinder of another person, the power is not deemed general, even though the donee may appoint himself and the other person has no reason or intention to oppose the donee's exercise (no substantial adverse interest is required). I.R.C. §2041(b)(1)(a); Treas. Reg. §20.2041-2(b).

E. WHEN IS THE POWER CREATED?

1. Power Created by Will. The date of creation of a power under a will is the date of the testator's death. Treas. Reg. §20.2041-1(e). However, a power created by will executed before Oct. 22, 1942 is deemed to have been created before that date if the testator died before July 1, 1949, without having republished the will by codicil or in any other way.
2. Power Created Under Inter Vivos Trust. The date of creation of a power under an inter vivos trust, whether revocable or irrevocable, is the date which the trust took effect through execution and delivery of the trust instrument and transfer of the trust property to the trustee. Treas. Reg. §20.2041-1(e). A substantial amendment after that date may be treated as creation of a new power, however. TAM 9428001.

F. REIMBURSEMENT OF ATTRIBUTABLE TAX BY RECIPIENT.

Unless the donee's will provides to the contrary, the executor of the donee's estate is entitled to recover from the recipient of the appointable property the portion of the estate tax paid by the donee's estate which is allocable to the property. The portion is so much of the total tax paid by the estate as the value of the appointable property bears to the taxable estate. I.R.C. §2207.

G. EXCEPTION AS TO CERTAIN NONGENERAL POWERS.

There is one exception to the rule that only general powers are taxable. This exception makes taxable a nongeneral power of appointment created after October 21, 1942 if both of the following conditions are met:

1. the donee exercises the power by will, or by exercise taking effect at death, and
2. the power is exercised by creating another power of appointment which can be exercised so as to postpone the vesting of the property for a period which is

ascertainable without regard to the date of the creation of the first power.

I.R.C. §2041(a) (3); Treas. Reg. §20.2041-3(e)

Example. A donee has a power to appoint by will the sum of \$50,000 to a group of permissible appointees consisting of his children and grandchildren and exercises the power by making an outright appointment of \$35,000 and by granting another appointee a power to appoint the remaining \$15,000. Here, only \$15,000 will be includible in the donee's gross estate. But if the donee appoints the income from the trust to a beneficiary for life with power in the beneficiary to appoint the remainder by will, the entire \$50,000 will be includible in the donee's estate.

H. TAXATION OF POST-OCTOBER 21, 1942 POWERS.

Property subject to a post-October 21, 1942 power is generally included in the donee's gross estate whether or not he exercised it. Even release of the power will not ordinarily result in exclusion of the appointive property. Prompt disclaimer or renunciation of the power will result in exclusion of the appointive property. Property subject to a post-October 21, 1942, non-general power also will be included in the donee-decedent's gross estate if he exercises the nongeneral power to create a second power. Property subject to a post October 21, 1942 general power of appointment is included in the donee's gross estate if any one of the following conditions is satisfied:

1. The decedent possessed the power at the time of his death. I.R.C. §2041(a)(2).
2. The decedent exercised or released the power during his lifetime in such a way as would cause inclusion of the property in his estate had he made a direct transfer of it. I.R.C. §2041(a) (2).
3. A lapse is treated as a release of the power, but only to the extent its value exceeds the greater of \$5,000 or 5% of the value of the total property from which the exercise of the power could have been satisfied. A release of a power may cause inclusion of the property released in the holder's estate if the holder has a retained interest in the property so released (see section J below).

I. POWER OVER PORTION, INTEREST, OR SUBJECT TO CONTINGENCY.

If the power of appointment is only over a portion of the property or an interest in the property, the donee's estate includes only that portion or interest. Treas. Reg. §20.2041-1(b)(3).

1. Example: The provisions of a trust state that income is to be paid to A for life, then to B for life. A is also the donee of a power to appoint the remainder by will. In default of appointment by A the remainder passes to B's estate. If A dies before B, the value of the remainder interest excluding B's life estate is included in A's estate. If the power were only over one-half the remainder interest, only one-half the value of the would be includible in A's estate.

2. Whether the donee has to give notice before exercising the power or whether the power does not take effect until the expiration of a stated period after the exercise is not relevant. The power is deemed to have existed on the date of the donee's death, whether or not the notice or period has been set in motion by exercise of the power. I.R.C. §2041(a)(2).
3. A general power is taxable even though its exercise is operative only upon the occurrence of a contingent event, provided that at the time of donee's death the event either has occurred or may yet occur, for example, the death of A occurring before the death of B, assuming that both A and B survive the donee. However, if a power is exercisable only upon the occurrence during the donee's lifetime of an event or contingency which did not in fact occur during such time, the power is not in existence at his death and therefore isn't taxable, such as a power which could not be exercised unless the donee had reached a certain age, and at his death, he had not yet attained that age. Treas. Reg. §2041-3(b).

J. EXERCISE OR RELEASE OF GENERAL POWER BEFORE DONEE'S DEATH.

Property subject to a general power of appointment created after October 21, 1942 is includible in the donee's gross estate even though he did not possess the power at the time of death, if the donee exercised or released the power during his lifetime in such a manner that if it were a transfer of property owned by him the property would have been includible in his estate under the lifetime transfer rules. I.R.C. §2041(a)(2); Treas. Reg. §20.2041-3(d)(1). The donee's estate includes the value of the appointive property if the exercise or release was:

1. Within three years of death before '82; or
2. With a retained life interest in the appointive property; or
3. With a retained reversionary interest in the appointive property; or
4. With a retained power to alter, amend, revoke or terminate.

K. INEFFECTIVE RELEASE.

A release of a power of appointment may be ineffective if carried out while the donee is incompetent and without joinder of a guardian. Est. of Halpern v. Com'r, 70 T.C.M. (CCH) 229 (1995). The Service has also ruled that a general power of appointment was not cut off when the trustees of a trust made unauthorized distributions from the trust to the donee of the power in order to permit her to make gifts to family members. TAM 9337001. The Tax Court has rejected that argument in at least one case, holding that the trust distributions were authorized under the broad authority granted under the trust instrument, and that the general power of appointment had been effectively extinguished when the assets were distributed and then gifted to others by the decedent. Est. of Hartzell v. Com'r, 68 T.C.M. (CCH) 1243 (1994).

L. LAPSE OF POWER TREATED AS RELEASE.

If the failure to exercise a general power of appointment created after Oct. 21, 1942 results in a lapse of the power, the lapse is treated as a release of the power and causes the appointive property to be included in a decedent-donee's gross estate in the same circumstances that a release does.

1. The lapsed power rule applies where a life beneficiary under a trust, life insurance settlement, or similar arrangement fails to exercise a power to invade the principal for his own use and benefit up to a certain amount annually and noncumulatively, that is, without carryover of any amounts not withdrawn under the power in earlier years.
2. For example, a life beneficiary may have the noncumulative annual right to withdraw income, and income not so withdrawn is accumulated and added to corpus. Since the income so accumulated will pass to those entitled to the remainder at the life beneficiary's death, each annual lapse may cause any income not withdrawn to be included in his gross estate. If the life beneficiary's power were cumulative (that is, if the power did not lapse at the end of each year but lapsed only on the life beneficiary's death), the total income accumulations which the life beneficiary chose not to withdraw before his death would be includible in his gross estate as a power of appointment. *Treas. Reg. §20.2041-3(f), Example (2); Rev. Rul. 66-87, 1966-1 C.B. 217; Fish, admr (Blagen Est.) v. U.S., (1968, DC Or) 291 F. Supp. 59, aff'd, 432 F.2d 1278 (9th Cir.).*
3. The lapse of a power during any calendar year is considered a release only to the extent that the value of the property that could have been appointed by exercise of the lapsed power exceeds the lapsed power exclusion. The lapsed power exclusion is the greater of:
 - . . . \$5,000, or
 - . . . 5% of the aggregate value, at the time of the lapse, of the assets out of which the exercise of the lapsed power could have been satisfied. *I.R.C. §2041(b)(2); Treas. Reg. §20.2041-3(d)(3).*
4. Each lapse is normally treated as though the donee had transferred property to the trust. Therefore, the value of the trust property that could have been withdrawn by the donee, to the extent it exceeds the greater of \$5,000 or 5% of the trust principal at the time of the lapse, is includible in the donee's estate if the donee had a life interest or other reserved powers causing includibility of transferred property. An example of this would be the holder of a withdrawal right under an Irrevocable Life Insurance Trust if the lapse exceeds the greater of \$5,000 or 5% of the trust principal in a particular year.
5. The value of that proportion which is includible in the decedent's estate is determined as follows:
 - a. The taxable proportion of the property over which the power lapsed must be determined at the date of the lapse.

- b. The value of that taxable proportion must be ascertained as of the decedent's estate tax valuation date in accordance with any of the rules, which apply to the particular case.
- c. "For example, if the life beneficiary of a trust had a right exercisable only during one calendar year to draw down \$50,000 from the corpus of a trust, which he did not exercise, and if at the end of the year the corpus was worth \$800,000, the taxable portion over which the power lapsed is \$10,000 (the excess of \$50,000 over 5 percent of the corpus), or 1/80 of the total value. On the decedent's death, if the total value of the corpus of the trust (excluding income accumulated after the lapse of the power) on the applicable valuation date was \$1,200,000, \$15,000 (1/80 of \$1,200,000) would be includible in the decedent's gross estate. However, if the total value was then \$600,000, only \$7,500 (1/80 of \$600,000) would be includible." Treas. Reg. §20.2041-3.

M. QUALIFIED DISCLAIMER OF GENERAL POWER.

The law permits the donee of a general power to escape gift, estate and generation-skipping transfer tax consequences by a qualified disclaimer of the power. Such a disclaimer of a power created after 1976 is not considered as a release. Ways and Means Conf. Rept., HR 14044, p.67.

A disclaimer of a general power created before 1977 avoids the gift and estate tax consequences if the disclaimer generally meets the tests of state law, even though the disclaimer does not meet the Code requirements of a qualified disclaimer. The disclaimer must, however, have been made within a reasonable period after the donee learned of the existence of the power, it must be unequivocal, and effective under the applicable local property law. Treas. Reg. §20.2041-3(d) (6).

N. TAXATION OF PRE-OCTOBER 22, 1942 POWERS.

If a general power of appointment was created before October 22, 1942, and was not reduced to a nongeneral power before November 1, 1951, the property related to such a power is included in the donee's gross estate only if the decedent exercised it. The mere fact that the decedent possesses a general power of appointment at his death will not cause the related property to be included in the donee's gross estate. I.R.C. §2041(a)(1); Treas. Reg. §20.2041-2(a). If the donee only partially exercised his general power of appointment, his estate includes the appointive property only to the extent exercised. Treas. Reg. §20.2041-2(f); Rev. Rul. 54-59, 1954-I C.B. 183.

- 1. "Exercise" of a Power by Disposition of Residuary Estate. Under the applicable state law a testamentary disposition of the residuary estate may be construed as a merger of the donee's property with the appointive property, that is, as an implicit exercise of the power, if the testator describes his residuary estate so as to include, according to local law, the appointive property. Treas. Reg. §20.2041-1(d); Rev. Rul. 55-486, 1955-2 C.B. 605; Keating v. Mayer, (DC Pa) 136 F. Supp. 286 (1955), aff'd, 236 F.2d 478 (3d Cir.); Thompson v. U.S., (DC Pa) 148 F. Supp. 910 (1957). But where, under state law, the residuary clause of a will does not serve to exercise a power of appointment unless the power is specifically mentioned, there is no

exercise when the testator does not specifically refer to the power in his will. *White, admr (Est. of Townsend) v. U.S. (DC Ind) 511 F. Supp. 570 (1981), aff'd, (1982, CA7) 680 F.2d 1156 (7th Cir. 1982).*

Estate of Sarah W. Greve et al. v. Commissioner T.C. Memo 2004-91. In 1933 Sarah Greve's grandmother died leaving a will creating a testamentary trust for the benefit of her children and their heirs, granting them testamentary general powers of appointment. Sarah Greve's father died in 1974, and Sarah began receiving a one-sixth share of the income from the trust. In 1993 Sarah Greve executed her will giving the residue of her estate in equal shares to her six children. Following her death, Greve's executors disclaimed the power of appointment granted Greve under her grandmother's trust. The executors argued that Greve was unaware she had a power of appointment under the grandmother's trust and that the executors' disclaimer of the power was proper. The Tax Court rejected the estate's argument concluding that the language in the testamentary trust granted Greve a general power of appointment, which she exercised under the residuary clause of her will.

2. Beneficiary's petition to divide trust and designate trust beneficiaries results in exercise of general power of appointment over pre-1942 trust. Private Letter Ruling 199924014. The Service relied on *Stewart v. U.S.*, 512 F.2d 269 (5th Cir. 1975), which states that there are three circumstances in which an exercise of a general power of appointment in a pre-1942 trust will be found: (1) if the beneficiary makes specific reference to the power, (2) if the beneficiary specifically refers to the property that is subject to that power of appointment or (3) if a provision in question would otherwise have no meaning unless interpreted as an exercise of the power. The Service found that in this situation the beneficiary's act of asking the court to divide the trust and designate the beneficiaries was sufficient to exercise his power of appointment.
3. Non-exercise or Release of Power. Neither failure to exercise nor complete release of a pre-October 22, 1942 power is deemed an exercise of such a power. I.R.C. §2041(a)(1).
4. Partial Release and Conversion into Nongeneral Power. If a pre-October 22, 1942 general power of appointment has been partially released so that it is no longer a general power, its release is not deemed to be the exercise of a general power. This rule applies only if the partial release was made before Nov. 1, 1951, or not later than the day after the expiration of 6 months following the termination of a legal disability of the decedent that existed on Oct. 21, 1942. I.R.C. §2041(a)(1); Treas. Reg. §20.2041-2(e).

X. SECTION 2043. TRANSFERS FOR INSUFFICIENT CONSIDERATION.

A. INTRODUCTION.

The interest and powers in property described in Sections 2035 through 2038 and Section 2041 are not included in the gross estate if made, created, exercised, or relinquished in a transaction which constituted a bona fide sale for an adequate and full consideration in money or money's worth. If the price was less than such a consideration, the excess of the fair market value of the property as of the applicable valuation date over the price received by the decedent is included in ascertaining the value of his gross estate. Treas. Reg. §20.2043-1.

For example, if the decedent retained a life estate, causing inclusion under Section 2036, and sold the remainder interest having a value of \$50,000 at the date of sale for consideration of \$49,999.99, and if the property has a value at the date of the decedent's death of \$100,000.00, then the decedent's gross estate will include \$50,000.01, which is the excess of the value of the property at the decedent's death over the consideration paid in connection with the sale. This example shows that unintended estate tax results may occur purely as a result of the possible undervaluation of property. Subsequent additions and improvements made by the transferee are not included.

B. TIME FOR DETERMINING ADEQUACY OF CONSIDERATION.

Where property is transferred, the date of the transfer should be used in determining if "adequate and full" consideration was received. *Smith, co-exrx (Thomson, Jr., Est.), v. U.S.*, 277 F. Supp. 583 (D. Va. 1967).

C. TRANSFER IN EXCHANGE FOR MARITAL PROPERTY RIGHTS.

A relinquishment or promised relinquishment of dower, curtesy, or of a statutory estate created in lieu of dower, curtesy, or other marital rights in a decedent's property or estate, is generally not to any extent a consideration in "money or money's worth." I.R.C. §2043(b); Treas. Reg. §20.2043-1(b). There are several exceptions and qualifications to this rule, however.

1. Support Rights. The Service and the courts have drawn a distinction between support rights and marital inheritance rights. Renouncing support rights has been held to be consideration; renouncing marital inheritance property rights has been held no consideration. *Rev. Rul. 68-379, 1968-2 C.B. 414; D. of C. v. Lewis, exrx, 288 F.2d 137 (1961), cert. den. 368 U.S. 818; Converse, (1945) 5 T.C. 1014, aff'd, on other grounds (CA2) 163 F.2d 131; Est. of Davis, 51 T.C. 361 (1968), rev'd and rem'd on another issue, 440 F.2d 896 (3d Cir. 1971); Smith, co-exrx (Thomson, Jr., Est.), 7. U.S., (DC Pla) 227 F. Supp. 583 (1967).*
2. The Harris Rule. A transfer of property in exchange for a release of marital property rights is deemed to be full and adequate consideration where the exchange was approved and made part of a court decree. *Harris v. Com'r, 340 U.S. 106 (1950); Com'r v. Maresi, 156 F.2d 929 (2d Cir. 1946); Est. of Watson 20 T.C. 386 (1953), aff'd, 216 F.2d 941 (2d Cir.).* Where pursuant to decree, a decedent reserved a life estate for himself and gave a secondary life estate to his wife on his death (or on his failure to pay alimony), the value of the wife's secondary life estate was excluded from his gross estate since it was required by the divorce decree and therefore deemed for a full and adequate consideration. *Est. of Keller, 44 T.C. 851 (1965).*

3. Trust established incident to divorce was includible in grantor's estate under §2036(a), but interest passing to former spouse is deductible under §2053.

Technical Advice Memorandum 9826002. As part of a divorce settlement, an ex-husband established a trust to secure his obligations to his ex-wife. So long as the ex-husband paid his alimony on a timely basis, he would receive all of the trust income; if he defaulted, the trust would cover the payments so long as the default continued. The ex-husband remained primarily liable for alimony. If his ex-wife remarried, the he would no longer be entitled to income from the trust as it would instead become payable to the ex-wife. The ex-wife would also receive distributions of principal in the discretion of the trustee. At the ex-husband's death, the insurance proceeds would be used to pay the monthly support obligation, and the trust would also pay income to the ex-wife for life, with discretionary distributions of principal and a testamentary general power of appointment for the ex-wife. If the ex-husband survived the ex-wife, the trust would be held for his benefit for life, and at his death would pass to the couple's child. At the death of the ex-husband, survived by the ex-wife, the Service ruled in technical advice that the trust principal is fully includible in his estate under §2036(a), due to his retained rights to income. The settlement of marital property rights does not constitute full and adequate consideration for purposes of §2036. However, the value of the ex-wife's interest in the trust is deductible from the estate. The result is that the trust assets receive a full step-up in basis but do not increase the taxable estate.

4. Written Separation Agreements. Section 2043(b)(2) provides a special rule covering transfers pursuant to written separation agreements meeting the requirements of Section 2516. Although on its face this provision is restricted in applicability to questions arising under Section 2053, it should apply as well to exclude transfers includible under other provisions of the Code.

EXHIBIT A

TRANSFERS WITH RETAINED INTERESTS AND POWERS

All §§ Assume property transferred by decedent for less than adequate consideration

§ 2036 Include full value of transferred property if decedent retained right, possession or enjoyment of the property or income, or right to control the beneficial enjoyment of property or income, for one of three periods: for life, for period not ascertainable without reference to death, or for period not in fact ending before death

§ 2037 Include value of any transferred interest the enjoyment of which will ONLY be enjoyed after decedent's death, IF decedent retained a reversionary interest in the property; reversionary interest itself is not included under § 2037

§ 2038 Include value of any transferred interest subject to control by decedent as of time of death, including a power to affect the time or manner of beneficiary's enjoyment

Special Rules Applicable to All Sections

Joint powers. Powers held by the decedent are taken into account even if they can only be exercised jointly with others (including others who may be adversely affected by the exercise of the power) and even if the decedent has only a power to veto action that must be instituted by others. The only exception is that powers that are exercisable only with the consent of all interested parties are disregarded if the power does not add to the powers existing by law -- eg., the power of a grantor to terminate a trust with the consent of all of the beneficiaries.

Administrative powers. Purely administrative powers exercisable in a fiduciary capacity are generally disregarded, even though they may give donor significant ability to influence distributions. This rule has been extended to powers exercisable in a business context by a controlling shareholder.

Ascertainable standards. Powers exercisable in a fiduciary capacity are disregarded if they are subject to an ascertainable standard. The standard need not follow the "health, education, support and maintenance" formula applicable under § 2041.

Third party powers. Powers exercisable solely by a third party, without participation by the decedent, are disregarded, unless they can be attributed to decedent. Attribution will occur if decedent has a power to appoint himself as trustee, and IRS contends attribution applies if decedent can remove and replace third party trustees at will, or if decedent is in a position to influence trustee by means of reciprocal or "crossed" trust.

Reciprocal transfers. These provisions cannot be avoided by making reciprocal transfers. Eg., if X and Y each create similar trusts, with X having a prohibited power or interest in Y's trust, and Y having the same power or interest in X's trust, the trusts will be "uncrossed" and Y's trust will be included in X's estate at death, at least to the extent of mutual value.

Legal obligations. Discharge of a legal obligation (including an obligation of support) is treated as a distribution to or for the benefit of the decedent.

Sections 2036 and 2038 -- Special Issues

Retention. Under § 2036, the interest or power must be "retained" by the decedent, but retention can be implied based on later behavior of the parties. A "retention" question also arises where the decedent's interests are not satisfied out of the transferred property, but may be treated as separate -- eg., transfer of an income-producing asset to children in exchange for a private annuity or self-canceling note under which payments are closely tied to the income of the transferred asset.

Adequacy of Consideration. It is unclear whether a remainder interest may be "sold" at its actuarial value without causing the asset to be included in the seller's estate under § 2036 because of the retained life interest. The IRS contends that the consideration must equal the entire value of the underlying asset. This issue has become crucial in a string of recent cases involving family limited partnerships where the IRS has sought inclusion of partnership assets in the decedent's estate under § 2036 on the grounds that the decedent retained use, possession or enjoyment of the partnership assets or the right to control the beneficial enjoyment of the partnership assets.

Discretionary Trusts. If distributions to the decedent can be made only in the absolute discretion of a third party trustee, § 2036 may be avoided. However, the requisite "enjoyment" or "right to income" may be found if there is a pattern of distributions to the decedent, if the decedent's creditors could have had access to the funds in the event of insolvency, or if the distribution standards would have given decedent some power to force distributions in certain circumstances.

Contingent Interests or Powers. Contingent interests or powers can lead to includibility under § 2036 unless the contingency is very remote. Thus, retention of a secondary life estate brings the property into the estate even if never enjoyed by the decedent, as does a contingent power held by decedent to appoint himself as trustee. By contrast, contingent powers will not cause includibility under § 2038 unless the contingency is within the decedent's own control.

Nonbeneficial Powers. A mere power to affect time or manner of beneficiary's enjoyment of any interest triggers § 2038, while § 2036 will apply only if decedent could control who enjoys the income or possession of the property during his lifetime.

Section 2037--Special Issues

Survivorship Requirement. The only interests includible under § 2037 are those that can be enjoyed only after decedent's death. An important example is a death benefit payable under an employment contract. It is the "after I'm gone" element that triggers this section.

Reversionary Interest. The requirement of a reversionary interest is just a threshold test, designed to ensure that there was some continuing link to the property. The reversionary interest may be one that would have been enjoyed by the decedent only if he had lived -- eg., D transfers to A for life, reversion to D if living, otherwise remainder to B. If D dies before A, the value of B's interest is included under § 2037 because it could only be enjoyed after D's death. D's reversion is extinguished by his death and is not included. The reversionary interest must be worth at least 5% of the total value of the property if valued just before death.

THE GROSS ESTATE

CASE STUDY – THE BEASLEY FAMILY

You have an appointment for the first time with a Mr. Malcolm Beasley to discuss the administration of his father's estate. The decedent, Mr. Goober Beasley, did not seek your advice before his death, but assured his son, Malcolm, that everything was taken care of because he had done one of "them Revocable Trusts".

Malcolm, who lives in another city, realized that he would need assistance in administering his father's estate. He heard from local friends that you were an expert in this area, and called you for an appointment.

At the meeting, you quickly review the "fill-in-the blank" revocable trust and pour-over will and discover that the plan provides for all of the estate and trust assets to be distributed outright to Malcolm.

During the interview with Malcolm you learn the following:

Goober's **revocable trust** owned a brokerage account with a few publicly traded stocks, including Microsoft, Dell Computer, and America Online. The market value of the account is now **\$1,000,000**.

Goober had also set up a **joint bank account** with Malcolm so that the account will pass to Malcolm automatically upon his death. Malcolm did not contribute anything to the account, which was worth **\$400,000** at the date of death.

Goober owned a **personal residence** worth **\$100,000**.

In addition to the personal residence, Goober still owned his original **gas station** and general store as a tenant in common with his brother, Elmer. The property is located at a busy intersection and is worth **\$600,000**.

Goober also had inherited a **life estate** in a farm, **Green Acres**. At Goober's death, the farm passes to Malcolm. The farm is worth **\$200,000**.

In addition, you learn that, several years ago, Goober deeded a **fishing cabin** and land to Malcolm, however, Malcolm never knew about it and has never used the property. Goober continued to use it with his fishing buddies. At the time of the transfer, the fishing cabin and land had a nominal value, but a new highway is coming through the area and prices have skyrocketed. The property is now worth **\$250,000**.

Goober has been making annual gifts to **UTMA accounts** for each of Malcolm's two minor

children for several years. Goober, thinking that Malcolm might spend the money, named himself as custodian of the accounts. The market value of the accounts is now **\$150,000**.

Many years ago, he also purchased two **life insurance policies** on his own life naming the grandchildren as beneficiaries. Two years ago, his life insurance agent suggested that he transfer the policies to the grandchildren to get them out of his estate. He did so, naming his wife as UTMA custodian. The face amount of both policies is **\$300,000**.

The assets described are summarized below:

Revocable Trust	\$1,000,000
Joint Bank Account	400,000
Personal Residence	100,000
Gas Station (1/2 interest)	300,000
Green Acres Life Estate	200,000
Fishing Cabin	250,000
UTMA Accounts	150,000
Life Insurance	300,000

Right before he died, Goober had told Malcolm that none of the revocable trust assets would be taxable and that the joint bank account would pass to Malcolm tax free. He also said that he had “already given” the fishing cabin property to Malcolm. He also confessed that he had secretly made gifts to Malcolm’s children’s accounts that he had also transferred his life insurance to a UTMA for the grandchildren. Malcolm has heard that up to \$1,500,000 can pass tax free to the heirs.

Malcolm is excited that his father’s planning worked out so well. He has made some rough calculations and thinks that no estate tax will be due, and that he will end up with \$2,250,000, and his children will get \$450,000. Malcolm has made the following calculations:

Malcolm’s Calculations (Wrong!)

<u>Gross Estate Assets</u>	<u>Malcolm</u>	<u>Children</u>
Personal Residence	\$100,000	
Gas Station (1/2)	\$300,000	
Green Acres	<u>\$200,000</u>	
Subtotal “taxable”	\$600,000	
(below \$1,500,000)		

Other Assets Passing “Tax Free”

Revocable Trust	\$1,000,000	
Joint Bank Account	400,000	
Fishing Cabin (already deeded)	250,000	
UTMA Accounts	0	\$150,000
Life Insurance	<u>0</u>	<u>300,000</u>
Total	\$2,250,000	\$450,000

What is really includible in the gross estate? Will the estate be taxable? Is Malcolm in for a rude awakening?

Goober Beasley

Actual Gross Estate Worksheet

<u>Asset</u>	<u>Estate Asset</u>	<u>Excluded Asset</u>
Revocable Trust	_____	_____
Joint Bank Account	_____	_____
Personal Residence	_____	_____
Gas Station (1/2)	_____	_____
Green Acres Life Estate	_____	_____
Fishing Cabin	_____	_____
UTMA Accounts	_____	_____
Life Insurance	_____	_____
Total:	_____	_____