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Edward R. Smith

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THE DRAFTSMAN VIS-A-VIS THE WIDOW'S ELECTION AND ITS TAX CONSEQUENCES

by

Edward R. Smith*

THE DRAFTSMAN considering a widow's election will must answer the pragmatic question, "Will it work?" An understanding of the issues, probabilities and potential consequences, good and bad, inherent in the widow's election vehicle is essential. The objective of this Article is to discuss these factors with a view, insofar as the draftsman is concerned, to utilizing with a minimum of risk those principles which have thus far evolved.

Traditionally and typically, the widow's election is presented where a husband's will purports to dispose of the entire community property, leaving a life estate to the widow with remainder thereafter to their children. The widow, in order to obtain the income from his half, must "elect" to accept the disposition he makes of her interest in the community. The widow need not receive a life estate; it is sufficient that she receive any benefit to which she was not otherwise entitled.¹

Of course, the wife's will can similarly put the widower to an election, and the principles discussed herein apply equally to such situation.

I. THE ISSUES

The following are presented as the significant issues around which the intelligent use of the widow's election should be planned:

1. What is the effect of a widow's election provision on the marital deduction?
2. Is the widow's property, which passes by election under the husband's will, included in the husband's estate for estate tax purposes?
3. What are the gift tax consequences of a renunciation by the widow?
4. If the widow accepts under the will, is there a gift tax, and, if so, how is it calculated?
5. What are the effects of a provision for invasion of corpus or minimum distributions upon the gift tax and upon the estate tax deduction under section 2043 of the Internal Revenue Code?²
6. Can the gift tax liability be avoided, and, if so, how?
7. Does the widow recognize taxable gain or loss upon the exercise of her election?

* B.S., Midwestern University, Wichita Falls, Texas; LL.B., Southern Methodist University, Attorney-at-Law, Lubbock, Texas.

¹ E.g., an annuity out of the husband's property. *Wright v. Wright*, 154 Tex. 138, 274 S.W.2d 670 (1955); 5 W. PAGE, *WILLS* 594 (3 Bowe-Parker ed. 1962). For substantive law background and treatment of some of the tax aspects of the widow's election, see Comment, *The Widow's Election—A Study in Three Parts*, 15 Sw. L.J. 85 (1961).

² INT. REV. CODE OF 1954, § 2043. See note 105 *infra*.

8. Can the widow amortize the cost of her "purchased" life estate (or annuity)?

9. Can the widow sell her reserved life estate as a capital asset? Can she deduct her basis from the proceeds? Can the purchaser amortize his cost therein? Can such sale be in the form of a private annuity?

10. Does the husband's estate anticipate income under the *Lake*³ doctrine upon exercise of the election, and, if so, can it claim a basis offset against the proceeds?

11. Will an annuity in lieu of a life estate eliminate the *Lake* problem?

12. During the administration of the husband's estate, is income from the widow's property, which passes by election under the husband's will, taxed to the estate?

13. Does the widow's estate receive an estate tax deduction under section 2043, and, if so, how is it calculated?

14. Will a remarriage clause reduce the section 2043 deduction?

15. What is the effect of a provision for invasion of corpus upon the section 2043 deduction?

16. What is the effect upon the section 2043 deduction of avoiding gift taxes upon the election?

17. What are the estate tax consequences of a sale by the widow of her retained life estate?

II. THE PROBABILITIES

When common sense indicates severe consequences from misjudgment, the draftsman looks for feasible alternatives. When the consequences of misjudgment appear slight or remediable, the draftsman can relax accordingly. This philosophy prevails in the following discussion of the probabilities relating to the stated issues.

1. *What Is the Effect of a Widow's Election Provision on the Marital Deduction?* A client whose estate includes separate property may avail himself of the marital deduction by making a bequest to his surviving spouse.⁴ This deduction, which may range upward in value to one-half of his "adjusted gross estate," is subject to certain restrictions. The restrictions to be aware of in using a widow's election provision are those pertaining to "terminable interests" and conditional gifts.

Gifts of "terminable interests" in property do not qualify for the marital deduction.⁵ Generally, a terminable interest is one which terminates upon the happening of a stated event, causing the property to pass to another person. A life estate is a "terminable interest" and, therefore, does not qualify for the marital deduction. Thus, if the client has separate property and desires to secure the marital deduction, he should make disposition to his spouse of sufficient property to secure such deduction in one of the acceptable non-life estate methods.

³ *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958).

⁴ INT. REV. CODE OF 1954, § 2056.

⁵ *Id.* § 2056(b).

The other restriction pertinent to the use of both a widow's election and a marital deduction in the same will is that pertaining to conditional gifts. If a gift to the spouse is conditioned on her accepting the disposition of her property, the marital deduction will be allowable for such gift only to the extent that the total gift to the spouse exceeds the value of what she must relinquish to take under the will.⁶ The main precaution here is to see that any gift which is to qualify for the marital deduction is in no way made conditional upon the acceptance by such surviving spouse of the terms of the will.

2. *Is the Widow's Property, Which Passes by Election Under the Husband's Will, Included in the Husband's Estate for Estate Tax Purposes?* The question quite naturally arises, if one's will purports to dispose of the property of another who consents to such disposition, does not such decedent's taxable estate include all of the property so disposed of by his will? This question appears to have been early answered in the negative.⁷

3. *What Are the Gift Tax Consequences of a Renunciation by the Widow?* Gift tax consequences plague many lawyers even without an election-type will. Most typically the problem occurs where the spouses have drawn wills leaving everything to each other. Originally the wills were quite satisfactory, the estate then having been modest. With the passage of time, however, the spouses make more progress in accumulating an estate than in planning its disposition. And finally, upon the death of one, the lawyer must ponder the question of whether the survivor's refusal to accept under the will results in the making of a taxable gift to her children.

The problem generally does not occur in a widow's election will for two reasons: first, the plan is more carefully drawn and will generally be accepted by the surviving spouse; and secondly, the value of what the surviving spouse surrenders in order to take under the will is generally greater than the value of what she is to receive. For instance, in a wholly community estate, assuming no estate taxes on the decedent's half, the life estate in the husband's portion for a widow who is over fifty years old is worth less than the value of the remainder in her half that she surrenders. The more the decedent's half is reduced by estate taxes the younger the surviving spouse has to be to receive a life estate worth as much as the remainder given up. Thus, unless the widow is very young or a considerable separate estate of the husband is involved, the problem simply does not exist. Of course, in special situations, such as where the election only requires the survivor to relinquish a small portion of her property, it is still material.

What then is the effect of a renunciation of the will by the widow where the bequest that she renounces is of greater value than the remainder she would have had to surrender? Applicable regulations state:

⁶ *United States v. Stapf*, 375 U.S. 118 (1963).

⁷ *Pacific Nat'l Bank*, 40 B.T.A. 128 (1939); *Coffman-Dobson Bank & Trust Co.*, 20 B.T.A. 890 (1930); INT. REV. CODE OF 1954, § 2033; G.C.M. 7773, IX-2 CUM. BULL. 426 (1930).

Where the law governing the administration of the decedent's estate gives a beneficiary, heir, or next-of-kin a right to completely and unqualifiedly refuse to accept ownership of property transferred from a decedent (whether the transfer is effected by the decedent's will or by the laws of descent and distribution of intestate property), a refusal to accept ownership does not constitute the making of a gift if the refusal is made within a reasonable time after knowledge of the existence of the transfer. . . . Where the local law does not permit such a refusal, any disposition by the beneficiary, heir, or next-of-kin whereby ownership is transferred gratuitously to another constitutes the making of a gift.⁸

Section 37 of the Texas Probate Code⁹ provides that "when a person dies, leaving a lawful will, all of his estate devised or bequeathed by such will shall vest immediately in the devisees or legatees." The Texas courts have held that vesting does in fact occur as to the testate property at the time of death,¹⁰ and the mere failure to probate the will apparently will not prevent such immediate vesting.¹¹ No Texas case has involved the question of whether a legatee, by promptly renouncing, can prevent the vesting of title in himself. One federal district court in Texas has held, in one sentence and without discussion of section 37 of the Probate Code or its predecessor, that a legatee has a right to renounce without the imposition of a transfer tax.¹²

One taking under the statutes of descent and distribution generally cannot prevent the passage of title to himself by renunciation; hence his renunciation is treated as a gift.¹³ Inasmuch as section 37 of the Texas Probate Code vests title immediately in legatees and devisees, the same as it does in heirs, one might conclude that renunciation would be no more effective by the former than the latter. However, this is not necessarily the case. For example, California law apparently also vests title in legatees and devisees immediately as in the case of an heir. Yet the Tax Court, based upon a California decision, held that renunciation by a California legatee was effective to prevent vesting while that by an heir was not.¹⁴

Based upon the above authorities, one might reasonably hope to succeed in a gift tax case involving a Texas will renunciation. The cautious counsellor must recognize the risks involved, however, until such time as the Texas courts have further resolved the issue.

The above discussion has ignored the element of the election. While no Texas cases involving this precise question have come to the writer's

⁸ Treas. Reg. § 25.2511-1(c) (1958). *Brown v. Routzahn*, 63 F.2d 914 (6th Cir. 1933), holding no taxable gift made, illustrates the application of such rule in a state where testamentary gifts can be rejected.

⁹ TEX. PROB. CODE ANN. § 37 (1955).

¹⁰ *Roberts v. Drake*, 380 S.W.2d 657 (Tex. Civ. App. 1964) *error ref. n.r.e.*; *Brunson v. Brunson*, 372 S.W.2d 761 (Tex. Civ. App. 1963); *Buckner Orphan's Home v. Berry*, 332 S.W.2d 771 (Tex. Civ. App. 1960) *error ref. n.r.e.*

¹¹ *Buckner Orphan's Home v. Berry*, 332 S.W.2d 771 (Tex. Civ. App. 1960) *error ref. n.r.e.* See *Rodgers v. United States*, 218 F.2d 760 (5th Cir. 1955), where the taxpayer never probated his wife's will which left everything to him. The court, while citing the immediate vesting statute, reiterated that taxpayer had the right to reject or accept the devise, but that the taxpayer had not made a renunciation in this case.

¹² *Perkins v. Phinney*, 7 Am. Fed. Tax. R.2d 1753 (1961).

¹³ *Hardenbergh v. Commissioner*, 198 F.2d 63 (8th Cir.), *cert. denied*, 344 U.S. 836 (1952).

¹⁴ *William L. Maxwell*, 17 T.C. 1589 (1952).

attention, it would seem that in an election will the exercise of the widow's election is a condition precedent to the vesting of any title in her. Perhaps thereafter her title would relate back to the testator's death.¹⁵ Surely little doubt could exist, however, as to the widow's right not to elect, thereby preventing vesting within the requirements of the previously quoted regulation.¹⁶

4. *If the Widow Accepts, Is There a Gift Tax, and, if So, How Is it Calculated?* As mentioned above, in the typical widow's election situation, the value of what the widow surrenders exceeds the value of what she receives. Where such is true, the remainder passes from her to a third party, in part gratuitously. Unless the transaction is a bona fide commercial transaction, the gift tax applies.¹⁷ It is now well established that the widow's election is a non-business type of exchange susceptible to the application of the gift tax.¹⁸ Furthermore, it now appears well settled that in the typical widow's election the amount of the taxable gift is the value of the remainder interest in the widow's property which passes by election under the husband's will reduced by the life estate (or other interest) received by the widow in the husband's property.¹⁹

5. *What Are the Effects of a Provision for Invasion of Corpus or Minimum Distributions Upon the Gift Tax and Upon the Estate Tax Deduction Under Section 2043 of the Internal Revenue Code?* Sound financial planning, particularly in the smaller taxable estates, more often than not requires that limited powers of invasion, minimum distributions, remarriage provisions or similar arrangements be considered. The draftsman should consider their effect upon the gift tax liability and upon the related estate tax deduction under section 2043.²⁰

Since the widow's gift tax liability is in essence predicated upon that which she actually loses by making the election, the logical conclusion is that provisions which increase her share under the will proportionately lower her liability. Thus, where in addition to a life estate there is a provision for invasion of corpus or minimum distributions, the widow has received something of greater value than a life estate, and her taxes should be reduced accordingly. Conversely, where the life estate is to be curtailed in the event of remarriage or where the principal can be reduced by gifts to children or others, she has received something of less value than a life estate. The courts have not always applied this type of logic, however.

In *Chase National Bank*,²¹ as per the Tax Court's interpretation, the

¹⁵ Cf. *Buckner Orphan's Home v. Berry*, 332 S.W.2d 771 (Tex. Civ. App. 1960) error ref. n.r.e.

¹⁶ See text accompanying note 8 *supra*.

¹⁷ Treas. Reg. § 25.2512-8 (1958).

¹⁸ *Robinette v. Helvering*, 318 U.S. 184 (1943).

¹⁹ *Commissioner v. Siegel*, 250 F.2d 339 (9th Cir. 1957); *Estate of Emma Bressani*, 45 T.C. 373 (1966); *Zillah Mae Turman*, 35 T.C. 1123 (1961), *acquiesced in* 1964-2 CUM. BULL. 7; *Chase Nat'l Bank*, 25 T.C. 617 (1955), *rev'd on other grounds sub nom.*, *Commissioner v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958), *cert. denied*, 359 U.S. 913 (1959).

²⁰ INT. REV. CODE OF 1954, § 2043. For the provisions of § 2043 see note 105 *infra* and accompanying text.

²¹ 25 T.C. 617 (1955), *rev'd on other grounds sub nom.*, *Commissioner v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958), *cert. denied*, 359 U.S. 913 (1959).

taxpayer's husband by will purported to dispose of all community property into a testamentary trust. Taxpayer was to have a life estate therein, and the bank trustee was given broad discretionary power to distribute principal to "any beneficiary."²² In response to taxpayer's contention that her gift tax liability should be reduced by more than the value of a life estate in her husband's part, the court held that the discretionary power to distribute principal to her "is one which . . . does not represent anything given to or received by [taxpayer] that is capable of valuation."²³

Next came *Siegel*.²⁴ The taxpayer's husband by will disposed of the entire community into a trust with the taxpayer and two other individuals as co-trustees. The trustees were instructed to distribute to the taxpayer such amounts of the income or principal as, in their sole discretion, they deemed proper to maintain her in her accustomed standard of living, but in no event less than \$1,000 per month. The court found that the standard of living prescribed would have cost the taxpayer \$45,000 per year, and, in fact, actual distributions from the trust approximated that figure. The entire trust corpus was initially almost \$900,000, of which almost \$300,000 derived from her husband's part. Since the income therefrom was so large, the court found that it was unlikely principal would ever have to be invaded to make such minimum payments. The court therefore declined to reduce the taxpayer's gift tax liability by reason of the \$1,000 minimum.

More important is the question of whether the taxpayer's gift could be reduced by the value of an annuity of \$45,000. The will spelled out an ascertainable standard upon which the court in its findings put a value, and in this respect it bore little resemblance to *Chase National Bank*. Moreover, the court recognized a difference in the power of the trustees in the two cases. But, the court felt itself unable to spell out a valid distinction between them, and hence refused to allow a reduction of the gift tax for the amount in excess of the value of a life estate.

Perhaps the court was influenced by the fact that income may have approximated the \$45,000 cost of living standard. But distributions were not conditioned on income being available. Furthermore, it seems improper to use the 3½ per cent tables in valuing a life estate on the one hand and at the same time deny the possibility of principal invasion (under an ascertainable standard) because income greatly exceeds 3½ per cent.²⁵ Discretionary power does not necessarily negate the existence of an ascertainable standard.²⁶ Nevertheless, if the trustee's power had been non-discretionary, perhaps the value of the living standard distributions would have been held to reduce the amount of taxpayer's gift.

²² If by "any beneficiary" it was meant that the trustees had broad discretion to distribute principal to persons other than the taxpayer, the question could arise whether the taxpayer's gift can be offset by a full life estate in her husband's part. Very conceivably, if principal were distributed to other beneficiaries, she would have less than a life estate. This question was apparently not raised, however, for no mention thereof is made in the court's opinion.

²³ 25 T.C. at 627.

²⁴ *Commissioner v. Siegel*, 250 F.2d 339 (9th Cir. 1957).

²⁵ See, e.g., *Schildkraut v. Commissioner*, 368 F.2d 40 (2d Cir. 1966), cert. denied, 386 U.S. 959 (1967).

²⁶ *Treas. Reg. § 25.2511-1(g)(2)* (1958).

The case of *Zillah Mae Turman*²⁷ is in some respects related to this question. There the taxpayer's husband by will disposed of all the community into trusts for his children, naming a bank trustee. The trustee was authorized to distribute so much of the income or principal as the trustee, in its sole discretion, deemed necessary for the wife's proper support and comfort. After distributions to her any remaining income or principal could be distributed to the children for their support and education.

In this case, the question of whether the wife's gift should be reduced by anything in excess of a life estate in her husband's part was moot, because, she being only forty-two years old, the value of such life estate itself wiped out any taxable gift. Nevertheless, two factors seem significant. First, as in *Siegel*, the court spoke of a life estate even though the husband's will gave only the right to support (whether more or less than income) as determined in the discretion of the trustee. Second, as in *Chase National Bank*, the court allowed the gift to be reduced by the value of a life estate in the husband's part even though the value of the life estate could apparently be reduced by distributions to other beneficiaries.

The same question is raised in cases involving estate taxes and the question of a deduction under section 2043. In the case of *Estate of Lillian B. Gregory*,²⁸ decedent's husband by will disposed of the entire community in trust with a bank as trustee, leaving decedent with a life estate and giving the trustee discretion to invade principal for the proper support and maintenance of decedent if the income was not sufficient for such purpose. In all events decedent was to receive at least \$500 per month. The total value of the testamentary trust was in excess of \$126,000, of which decedent's husband contributed over \$60,000. Based upon the government's 3½ per cent tables, the annual income of the trust would be almost \$4,500; the minimum distribution in any year was to be \$6,000. In fact, during the eight years between her husband's death and her death she received almost precisely \$6,000 per year.

The court's findings give no indication of the amount of the trust income. While the estate contended that the deduction under section 2043 should have been based upon the amount actually received by decedent, the court correctly stated that the deduction must be based upon the value of what decedent received when she exercised her election. The court, however, limited the deduction to the value of a life estate based upon valuations prescribed by the Treasury Regulations. This would appear to be an unfortunate decision. The court seems to require evidence of the probability of corpus invasion before allowing a deduction for anything greater than a life estate. It is submitted that where the widow is guaranteed a certain amount per year payable out of income or principal, she has received value at least equal to an annuity of such amount.²⁹

*Vardell's Estate v. Commissioner*³⁰ held, in effect, that a provision cur-

²⁷ *Zillah Mae Turman*, 35 T.C. 1123 (1961), *acquiesced in*, 1964-2 CUM. BULL. 7.

²⁸ 39 T.C. 1012 (1963).

²⁹ See *Estate of Sarah A. Bergan*, 1 T.C. 543, 554 (1943); *cf.* *Becklenberg's Estate v. Commissioner*, 273 F.2d 297 (7th Cir. 1959).

³⁰ 307 F.2d 688 (5th Cir. 1962).

tailing distributions to the wife from the husband's part in the event of her remarriage did not ipso facto reduce the estate tax deduction under section 2043. The wife had not remarried during her life, and no reduction was required. The court stated that hindsight could be used in the event of remarriage in determining the proper reduction "because the credit may not be claimed until after the death of the person receiving the consideration."³¹

The question arises, how will such a remarriage clause affect the gift tax question at the time of election? While the court in *Vardell* stated that hindsight could be used in calculating the deduction, the court also recognized the possibility of actuarially valuing the remarriage probability.³² While the *Gregory* approach of requiring a valuation at the time of the election seems sound,³³ much can be said also for the proposition that in making such valuation what the wife receives at such time should not be cut down by the possibility of remarriage. If a gift occurs, it would be at the time of or during the remarriage. Certainly this would pose no hardship on the Treasury since gift tax rates are cumulative. Furthermore, since the real issue is, how much gift has the wife made, until she actually remarries it would seem that her dominion and control over the income is not relinquished.³⁴ Hence, the amount of her gift should not be increased by the possibility of her remarriage.

Thus, the authorities to date have indicated that the deduction for gift tax purposes to the wife will not be increased by a discretionary power of invasion of principal in her favor and that it may not be reduced by reason of such a discretionary power in favor of other beneficiaries; that it may not be reduced by curtailment of benefits in event of remarriage; that it may not be increased by minimum distributions which may be made either out of income or principal, exceeding the 3½ per cent rate (a result the author deems erroneous); and that there has been a tendency to characterize non-life estate-remainder situations as life estate-remainder arrangements and to apply the Treasury's valuation tables thereto.

One thing stands out in all of the cases to date. In each instance where the taxpayer contended that the reduction in his taxable gift or the deduction under section 2043 should be based upon the value of an annuity equal to the annual support cost, such annuity has been larger than the value of the life estate under the Treasury Regulations. In each instance taxpayer has been unsuccessful in such contention. One wonders if the courts will be equally generous to taxpayers in the first instance where the standard of living prescribed is of less value than the life estate. The draftsman would seem well advised not to count on it.

For those who avoid gift tax in the manner next to be discussed, these problems still are highly pertinent because of their relationship to the estate tax deduction under section 2043.³⁵

³¹ *Id.* at 693.

³² *Id.* at 693 n.9.

³³ See note 28 *supra* and accompanying text.

³⁴ See Treas. Reg. §§ 25.2511-2(b), (f) (1958).

³⁵ See issue 16 in text accompanying notes 122-24 *infra*.

6. *Can the Gift Tax Be Avoided, and if So, How?* Conceivably it may be desirable, though probably generally not, to incur the gift tax on the widow's election since such tax both reduces the widow's taxable estate and serves as a credit against her estate tax.³⁶

There are at least two ways to draft the husband's will so as to avoid the imposition of a gift tax upon his wife at the time of her election. The first is to give the trustees such broad powers to distribute income or principal from her part of the property back to her that there is no assurance at the time of election that any part of her property will ever pass to anyone other than herself.³⁷ Presumably a benefit to the wife which is prescribed by an ascertainable standard would not qualify under this ruling.³⁸

The second such method is to permit, insofar as her property is concerned, the wife either by will or by lifetime distribution to vary the interests between the class of remaindermen (normally her own descendants) without reference to any fixed or ascertainable standard. For instance, she may be given the power during her lifetime to appoint, in a gratuitous manner only, any part or all of her portion of the property to any one or more of her issue as she sees fit. In such a case, the wife has not sufficiently parted with dominion and control as to mature the gift.³⁹ It is important that she be permitted to exercise any such power only gratuitously. Otherwise, she may have retained too many personal benefits from her portion of the property to be deemed put to an election.⁴⁰ In this event any estate tax deduction under section 2043 would doubtless be lost.⁴¹

7. *Does the Widow Recognize Taxable Gain or Loss Upon Exercise of Her Election?* Is the exercise of the election itself an exchange of such nature that a gain or loss is recognized by the widow? It may be fairly assumed that no deductible loss is possible. Issue 4 above resolved that where the widow gives up more than she receives she has made a taxable gift. Certainly no loss is recognizable in a gift transaction.

What about those instances where the widow receives greater value than she relinquishes? As observed in issue 3, this situation will seldom exist. When it does arise, the widow does not recognize taxable gain except in those instances where the value of her property exceeds its basis. The principal roadblock to taxation thereof is section 102(a),⁴² which excludes from income the value of property received by gift, devise, bequest, or inheritance. Section 102(a) does not require that the gift or devise be received wholly without consideration: transfers for insufficient consideration are also taxed except when made in the ordinary course of

³⁶ See *Estate of Emma Bressani*, 45 T.C. 373 (1966).

³⁷ Rev. Rul. 62-13, 1962-1 CUM. BULL. 181.

³⁸ See Treas. Reg. §§ 25.2511-1(g)(2), 25.2511-2(b) (1958).

³⁹ Treas. Reg. §§ 25.2511-2(b), (c) (1958).

⁴⁰ See the discussion of Judge Wisdom's dissent in *Vardell* under issue 15 in text accompanying note 118 *infra*.

⁴¹ The effect of the use of these methods on the estate tax deduction under § 2043 will be discussed under issue 16 in text accompanying notes 122-24 *infra*.

⁴² INT. REV. CODE OF 1954, § 102(a).

business.⁴³ The government could hardly contend that a conditional gift in a will is a business transaction from the standpoint of the decedent.⁴⁴ In fact, the government's estate tax regulations explicitly recognize testamentary gifts requiring the surviving spouse to relinquish his or her interest in the community as a condition thereto,⁴⁵ and the net value of the transfer in such instance is a testamentary gift.⁴⁶

Nor has the government limited the transfer for inadequate consideration concept to the estate and gift tax field so as to argue that it must not be extended to income tax. The income tax regulations specifically recognize the part-sale, part-gift transaction.⁴⁷

It is believed that the draftsman can safely assume that the widow will recognize no taxable income upon making the election to the extent that the basis in her part equals the value thereof. If, however, the widow should exchange property having a value in excess of her basis therein, she undoubtedly will be faced with a taxable gain on such excess or on the amount by which the value of what she receives exceeds her basis, whichever amount is less. This is to be expected, since section 102(a) offers no shelter except to the extent that the benefit to her exceeds the *value* of what she surrenders.

Normally where all the widow relinquishes is her interest in community property, no gain will be recognized. This is because her interest in such property will have taken a basis equal to its value upon her husband's death.⁴⁸ However, certain types of community property do not take a stepped-up basis at the death of one spouse.⁴⁹ Generally, these are rights to collect income which, by reason of the method of accounting used, have not been reported as taxable income at the time of such death.⁵⁰

A problem exists where a community estate consists largely of installment notes receivable on which the election to report on the installment method has been made. Care should be exercised in the manner in which the widow in such a case is put to the election. Forcing her into an early election would probably mature her part of the unrecognized gain on such notes. Perhaps an election exercisable in installments or at a later time would be desirable.

Related to this is the question of restoration of investment credit by the widow upon election.⁵¹ Presumably to the extent the property involved is community, no recapture of depreciation would be required under sections 1245 or 1250.⁵²

8. *Can the Widow Amortize the Cost of Her "Purchased" Life Estate or*

⁴³ Treas. Reg. § 25.2512-8 (1958).

⁴⁴ *Robinette v. Helvering*, 318 U.S. 184 (1943).

⁴⁵ Treas. Reg. § 20.2056(b)-4(b) example 3 (1958).

⁴⁶ *United States v. Stapf*, 375 U.S. 118 (1963).

⁴⁷ Treas. Reg. §§ 1.1012-2, 1.1015-4 (1957).

⁴⁸ INT. REV. CODE OF 1954, § 1014(b)(6).

⁴⁹ *Id.* § 1014(c).

⁵⁰ *Id.* § 691.

⁵¹ *Id.* § 47.

⁵² *Id.* §§ 1245, 1250; see *Id.* § 1014(b)(6).

Annuity? On the basis of the logical theory that by her election the widow has purchased a life estate in her husband's property, the question arises whether she can amortize her purchase price over her life expectancy. An affirmative answer to this question could probably be readily assumed were it not for the existence of *Helvering v. Butterworth*.⁵³ In that case decedent's will left his widow the net income of his testamentary trust if she surrendered the dower rights granted to her by state law (Pennsylvania). At issue in the case was whether the trustees could deduct payments of income made to her. Apparently everyone accepted the proposition that if, by her election, she had purchased an annuity, then the estate could take no deduction for payments to her. The Court held that, by her election, the widow puts herself in the position of a beneficiary. As a beneficiary she is taxable on distributions of trust income and the trustees can deduct distributions to her.

The language which has apparently created some alarm is the Court's statement, "In no proper sense does she purchase an annuity." If, by this, the Court meant that she was not, by her election, a "purchaser," there is ample reason for concern.⁵⁴

Judge Wisdom, in his dissent in *United States v. Stapf*⁵⁵ would render *Butterworth* inapplicable to an election involving community property because of the vested right of a widow thereto as compared with the inchoate nature of the dower rights in *Butterworth*. Some cases suggest that this might not have been a proper distinction. *John Bostick*,⁵⁶ for example, applied *Butterworth* to an election involving Texas community property.⁵⁷ Subsequently, however, it has become well established that one who purchases a life estate can amortize the cost thereof.⁵⁸

Butterworth has not been cited in any case where the issue was the right of the widow to amortize the cost of her life estate. *Butterworth* expressly limited its holdings to the question of whether the widow was a "beneficiary" within the intendment of the statute involved. The only issue was, "To whom should the income be taxed?" No conflict exists between *Butterworth* and the right of the widow to amortize the cost of her life estate. Clearly the widow must include the life estate income in her taxable income.⁵⁹

Notwithstanding *Butterworth*, it has been clearly held that the electing widow is parting with consideration within the meaning of the taxing

⁵³ 290 U.S. 365 (1933).

⁵⁴ The statement in *Butterworth* that "In no proper sense does she purchase an annuity" might be explained simply on the grounds that what the widow acquired was not an annuity but a life estate. See the Court's discussion of the annuity in the *Pardee* case disposed of by the same opinion. However, compare *Helvering v. Schaupp*, 71 F.2d 736 (8th Cir. 1934), in which the court, on a fact situation and issue virtually identical to *Butterworth*, stated that the widow was not the purchaser of a life estate but took her life estate as a bequest.

⁵⁵ 309 F.2d 592, 608 n.20 (5th Cir. 1962).

⁵⁶ 31 B.T.A. 25 (1934).

⁵⁷ See also the discussion in *Commissioner v. Siegel*, 250 F.2d 339 (9th Cir. 1957), indicating that the surrender of dower rights is, by the majority view, sufficient to make her a purchaser for value.

⁵⁸ *Commissioner v. Fry*, 283 F.2d 869 (6th Cir. 1960), affirming 31 T.C. 522 (1958); *Bell v. Harrison*, 212 F.2d 253 (7th Cir. 1954); Rev. Rul. 62-132, 1962-2 CUM. BULL. 73.

⁵⁹ INT. REV. CODE OF 1954, §§ 652, 662.

statutes.⁶⁰ Furthermore, beneficiaries of life estates in testamentary trusts have been held entitled to amortize their investment in the life estate properties.⁶¹

The Fifth Circuit seems to have correctly applied *Butterworth*. In *White v. Rose*⁶² a widow was a co-tenant with her children in certain property. All joined in a conveyance to a trustee whereby the widow became entitled only to income rights in the entire property. Said the court, "She is thus a purchaser, yet not a creditor of or an incumbrancer on the trust, but a beneficiary of it for her lifetime."⁶³ This makes sense. She is the purchaser of a life interest.

Pertinent to the resolution of this issue are the provisions of section 273. "Amounts paid . . . as income to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be reduced or diminished by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time."⁶⁴ The clear import of the 1921 committee reports pertaining to the original enactment of this statutory language is that the section is to prohibit the amortization of the gift value of the life estate,⁶⁵ but it has been held that such section does not prevent the amortization of a beneficiary's own investment in such a life estate.⁶⁶ Clearly under a widow's election, only the net value of what the widow receives over what she relinquishes is a gift to her.⁶⁷ Logically then such section does not prevent her from amortizing the amount she "pays" for the life estate. This is consistent with case law permitting amortization by a purchaser.

It is submitted that the cases permitting amortization by the purchaser of a life estate are equally applicable to one who relinquishes consideration therefor in a widow's election. And it is further submitted that the same principle should apply where the interest acquired is an annuity rather than a life estate.

Assuming that amortization is permitted, the question arises as to what cost should be amortized. In many, if not most instances, the widow relinquishes a greater value than she receives. Is she entitled to amortize the full basis of what she relinquished or merely an amount equal to the value of what she received?

At least two substantial hurdles must be cleared before the widow can expect to be able to amortize a basis greater than the value of what she receives. First, it seems logical and correct in principle that the widow cannot both make a taxable gift and acquire basis with the same dollar

⁶⁰ See *Commissioner v. Siegel*, 250 F.2d 339, 346 n.24 (9th Cir. 1957).

⁶¹ *Grant v. United States*, 202 F. Supp. 608 (W.D. Va. 1962); *Caroline T. Kissel*, 15 B.T.A. 705 (1929).

⁶² 73 F.2d 236 (5th Cir. 1934).

⁶³ *Id.* at 237.

⁶⁴ INT. REV. CODE OF 1954, § 273.

⁶⁵ H.R. No. 351, 67th Cong., 1st Sess. 219 (1921); 1939-2 CUM. BULL. 177.

⁶⁶ *Caroline T. Kissel*, 15 B.T.A. 705 (1929).

⁶⁷ *United States v. Stapf*, 375 U.S. 118 (1963); *cf.* the statement in *Helvering v. Butterworth*, 290 U.S. 365, 371 (1933), that the annuity in *Pardee* which was received upon relinquishment of dower rights was "in discharge of a gift or legacy."

value. The concept of the donor's basis being shifted to the donee is elemental.⁶⁸ Secondly, unless a remainder interest in fee is of "like kind" with a beneficial life estate, loss is realized by the widow at the time of the exchange, but such loss is not deductible because section 165 permits losses to be deducted only if incurred in a "transaction entered into for profit."⁶⁹ An essential requirement of a transaction entered into for profit is that the highest and best price be obtained.⁷⁰ Whether such interests are of "like kind" poses a question which would test the analogizing powers of any scholar. The author knows of no authority which as yet would supply a clear answer to this question. It would seem prudent to count on amortizing only so much of the widow's basis as does not exceed the value of what she receives.

Some question may be raised as to whether a retained special power of appointment sufficient to nullify the gift tax under Treasury Regulation section 25.2511-2⁷¹ is sufficient also to prevent the widow from having any measurable purchase price for her life estate in the husband's property.⁷² It is submitted that if the widow's special power is limited to a class composed of her issue and can only be exercised in a gratuitous way which imposes no conditions upon the recipient, the widow will have disposed of all personal benefit in favor of a limited class and will have made a measurable disposition in terms of value even though the transfer tax must await her death. It has been held that a gift is complete for income tax purposes even though exempt from gift taxes by reason of a retained, limited, special power of appointment.⁷³

Finally, the question arises whether the widow or her estate can deduct the unamortized portion of her basis if she dies prematurely. While some contention may be made to the contrary, the problem seems fairly analogous to that of whether an annuitant who dies prematurely can deduct his unrecovered cost. Deduction in such cases has been denied.⁷⁴

9. (a) *Can the Widow Sell Her Reserved Life Estate as a Capital Asset?* (b) *Can She Deduct Her Basis From the Proceeds?* (c) *Can the Purchaser Amortize His Cost Therein?* (d) *Can Such a Sale Be in the Form of a Private Annuity?* The income tax consequences pertaining to the widow's life interest in the husband's half of the property were discussed in issue 8. If amortization of her basis in such life interest is possible, income tax on income from her husband's part will be greatly minimized. Of course, the widow will remain fully taxable on income from her own reserved life estate. All four questions under this issue relate to the possibility of

⁶⁸ INT. REV. CODE OF 1954, § 1015.

⁶⁹ *Id.* § 165.

⁷⁰ *Evans v. Rothensis*, 114 F.2d 958 (3d Cir. 1940).

⁷¹ Treas. Reg. § 25.2511-2 (1958); see text accompanying notes 39-41 *supra*.

⁷² See Brown, *The Income Tax Aspects of the Widow's Election*, 1964 So. CAL. TAX INST. 519, 540.

⁷³ *Winthrop v. Meisels*, 281 F.2d 694 (2d Cir. 1960); *O'Brien v. Commissioner*, 46 T.C. 583 (1966).

⁷⁴ *Evans v. Rothensis*, 114 F.2d 958 (3d Cir. 1940); *Industrial Trust Co. v. Broderick*, 94 F.2d 927 (1st Cir.), *cert. denied*, 304 U.S. 572 (1938).

converting her reserved life interest into a different type of interest which will impose less income tax burden on the family.

These four questions are related, each dealing with some aspect of a sale (presumably intra-family) by the widow of her reserved life estate. If all four questions can be answered in the affirmative, unusually favorable income tax treatment can be achieved on her reserved life estate as well as on the purchased life estate. For instance, if she can sell her reserved life estate as a capital asset, then any gain will be subject to long term capital gain rates (assuming the requisite holding period). However, if she can deduct her basis from the proceeds, she should have little or no gain to recognize if the property was community.⁷⁵ And if the purchaser (presumably a child) can amortize his purchase price, little net income will be recognized by him. Thus, the effect is to reduce the income taxable to the family as a whole. And if the sale can be in the form of a private annuity subject to the usual rules relating thereto, the widow can effectively retain a source of support for life, of which all but the 3½ per cent interest factor is virtually tax free.⁷⁶

(a) *Can the widow sell her reserved life estate as a capital asset?* In *Estate of Johnson N. Camden*⁷⁷ it was held that a taxpayer who "carved out" a life estate from her larger fee interest had sold a capital asset. While this result may be questioned today,⁷⁸ the rule seems fairly well established that a life estate standing alone is a capital asset and that its sale is not an anticipation or recognition of ordinary income.⁷⁹ It would seem that the decision in *Lake* should not affect the validity of such cases.⁸⁰ While such cases all involved life estates created for the seller by another, no basis is apparent for treating a *reserved* life estate any differently.

(b) *Can she deduct her basis from the proceeds?* In *Estate of Johnson N. Camden*⁸¹ one who "carved out" a life estate was permitted to deduct from the proceeds a proportionate part of her total basis, such part being determined by reference to the value of the life estate as compared with the remainder. In *Eileen M. Hunter*⁸² one who sold a remainder retaining a life estate was permitted to deduct the proportion of his total basis which the value of the remainder bore to the total fee value. That the widow should be able to deduct the basis in her retained life estate seems clear both upon principle and authority.

⁷⁵ INT. REV. CODE OF 1954, § 1014(b)(6).

⁷⁶ The discussion at this point is limited to the income tax aspects. Estate tax consequences are discussed under issue 17 in the text accompanying notes 125-49 *infra*.

⁷⁷ 47 B.T.A. 926 (1942), *aff'd per curiam*, 139 F.2d 697 (6th Cir. 1943).

⁷⁸ See *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958). See also text accompanying note 85 *infra* for an explanation of *Lake*.

⁷⁹ *Allen v. First Nat'l Bank & Trust Co.*, 157 F.2d 592 (5th Cir. 1946), *cert. denied*, 330 U.S. 828 (1947); *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947); *Bell v. Commissioner*, 137 F.2d 454 (8th Cir. 1943).

⁸⁰ See *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 265 n.5 (1958) which distinguishes those instances where the right assigned constitutes the entire interest of the assignor. See text accompanying note 85 *infra* for an explanation of *Lake*.

⁸¹ 47 B.T.A. 926 (1942), *aff'd per curiam*, 139 F.2d 697 (6th Cir. 1943).

⁸² 44 T.C. 109 (1965).

(c) *Can the purchaser amortize his cost therein?* As previously discussed, it is well established that the purchaser of a life estate can amortize his cost therein.⁸³

(d) *Can such sale be in the form of a private annuity?* The private annuity cases place no limitation upon the type of property which can be sold on an annuity basis. It seems patently clear that anything of value can be used to purchase an annuity, including a life estate.⁸⁴

It is submitted that the answers to all four of the above questions should be affirmative, thus opening the way to unusual family income tax planning after the first death.

10. *Does the Husband's Estate Anticipate Income Under the Lake Doctrine Upon Exercise of the Election, and, if So, Can it Claim a Basis Offset Against the Proceeds?* The holding in *Commissioner v. P. G. Lake, Inc.*⁸⁵ was that one who "carved out" by sale an oil and gas production payment for a limited term from his larger leasehold interest had anticipated ordinary income on the sale instead of having recognized capital gain thereon. The first question posed in this issue is whether the estate anticipates ordinary income under the *Lake* doctrine on the "carve-out" of a life estate at the time of the widow's election.

The question may be divided into two parts. First, is ordinary income recognized by the estate on the widow's gift (*i.e.*, the amount by which the value of what the widow surrenders exceeds the value of the life estate she receives)? Secondly, is ordinary income recognized by the estate on the value of the life estate transferred to the widow to the extent the widow surrenders comparable value? There would be, of course, no recognition in the first if there were none in the second, but the first has certain possible defenses not available in the second. As stated previously, a widow does not recognize taxable gain to the extent she receives greater value than she surrenders (issue 7) and a widow should not be permitted to amortize any basis in her purchased life estate greater than the value of the life estate she receives (issue 8). The same principles would seem to prevent the excess value that she conveys to her children from being taxable income to the estate. Thus the first part of the main question seems to pose little threat of income recognition to the estate.

Much more difficult is finding a defense to the application of the *Lake* doctrine and the recognition of ordinary income in the second part of the question. *Estate of Johnson N. Camden*⁸⁶ might furnish some comfort, but it probably fell in stature (on this issue) along with the oil payment carve-out cases when the Supreme Court decided *Lake*. While probably dictum, one recent case has intimated that *Lake* would apply to the consideration received for a carved-out life estate.⁸⁷ It is submitted that there

⁸³ *Commissioner v. Fry*, 283 F.2d 869 (6th Cir. 1960), *affirming* 31 T.C. 522 (1958); *Bell v. Harrison*, 212 F.2d 253 (7th Cir. 1954); Rev. Rul. 62-132, 1962-2 CUM. BULL. 73.

⁸⁴ *Gladys Chessman Evans*, 30 T.C. 798 (1958).

⁸⁵ 356 U.S. 260 (1958).

⁸⁶ 47 B.T.A. 926 (1942), *aff'd per curiam*, 139 F.2d 697 (6th Cir. 1943).

⁸⁷ *May T. Hrobon*, 41 T.C. 476, 493, 497 (1964).

is no convincing or clear basis upon which to distinguish a life estate carve-out from *Lake*. If this be so, then the only salvation from an otherwise catastrophic situation is the possibility that the estate can offset its basis against the ordinary income recognized.

The first authority for such an offset might be in the regulations themselves.⁸⁸ The regulations clearly provide that upon the sale of a life estate received from a decedent, that part of the "uniform basis" attributable to the life estate may be deducted. To illustrate, suppose A by will leaves a life estate in unimproved farm land to B with remainder to C, such land being worth \$10,000 upon A's death. The uniform basis in such land is \$10,000. If B thereafter at a time when he is sixty-five years old sells his life estate, he may deduct from the proceeds 33.42 per cent (being the portion attributable per the regulations to a sixty-five-year-old person's life estate) of such uniform basis, or \$3,342.

While the above illustration clearly applies to the sale of an inherited life estate where such life estate was all that B inherited, it is certainly not clear that such regulations would apply to the sale of a life estate carved out of an inherited fee. In fact some anomalous results would occur if they did. Treasury Regulation section 1.1014-4(a) states that "The sale, exchange, or other disposition by a life tenant or remainderman of his interest in property will, for purposes of this section, have no effect upon the uniform basis of the property in the hands of those who acquired it from the decedent. Thus, gain or loss on sale of trust assets by the trustee will be determined without regard to the prior sale of any interest in the property."⁸⁹ Thus the fee owner could sell a life estate, claiming that part of the uniform basis then attributable thereto, hold his remainder until his uniform basis therein had increased by the passage of time, and thereafter sell the remainder. He would thus be enabled to deduct in excess of 100 per cent of the original basis. Conversely, if he sold the remainder first, he would be entitled to deduct less than 100 per cent of the original basis.

While such regulations may well provide a guide to the portion of the fee owner's basis which may be allocated to the life estate,⁹⁰ it is doubted that the fee owner's basis in his reserved remainder will increase with the passage of time. The matter has apparently not been judicially resolved. However, case law does suggest that the estate should be able to deduct the same portion of its basis as the life estate value bears to the full value of the property.⁹¹

Recently the Tax Court held that a fee owner who sold a remainder interest is entitled to deduct the same portion of his basis as the value of such remainder bears to the full value of the property.⁹² Said the court,

⁸⁸ Treas. Reg. §§ 1.1014-4, -5 (1957). Cf. Treas. Reg. § 1.1015-1(b) (1957).

⁸⁹ Treas. Reg. § 1.1014-4(a) (1957).

⁹⁰ See Estate of Johnson N. Camden, 47 B.T.A. 926 (1942), *aff'd per curiam*, 139 F.2d 697 (6th Cir. 1943).

⁹¹ Columbia Oil & Gas Co. v. Commissioner, 118 F.2d 459 (5th Cir. 1941); Eileen M. Hunter, 44 T.C. 109 (1965); Estate of Johnson N. Camden, 47 B.T.A. 926 (1942), *aff'd per curiam*, 139 F.2d 697 (6th Cir. 1943).

⁹² Eileen M. Hunter, 44 T.C. 109 (1965).

"Where part of a property is sold there must be an equitable allocation of basis among the parts to determine the gain realized."⁹³ The case of *Estate of Johnson N. Camden*⁹⁴ expressly held that it was proper in determining a fee owner's gain on sale of a carved-out life estate to carve out "a basis for the life estate by applying the life expectancy of the grantee to the statutory life tables."⁹⁵

Where the owner of producing mineral leases sold them reserving a production payment therefrom, he was entitled to deduct only that portion of its basis determined by allocating the total basis between the interest sold and the interest retained.⁹⁶ The Commissioner could hardly contend that the carve-out of a production payment and a life estate are alike in applying *Lake* while at the same time denying their similarity in the allocation of basis against sales proceeds. Thus, it would seem that one might reasonably hope to succeed in offsetting basis against the ordinary income recognized under *Lake*. Because of the dire consequences of a holding to the contrary, however, one might reasonably choose the annuity route discussed below until the matter has been clearly and unquestionably resolved.

One disadvantage of the life estate route as compared with the annuity route is that in the former the application of basis against the *Lake* income will probably reduce the remaindermen's basis in the property or the estate's basis if the property is sold.

11. Will an Annuity in Lieu of a Life Estate Alleviate the Lake Problem?

The basis of the *Lake* decision is that by the transaction in question the taxpayer recognized future income. When one enters into an annuity obligation, there is a promise on the part of the obligor to make fixed periodic payments without regard to the existence of income. Prior to the enactment of section 661(a)⁹⁷ in 1954, an estate or trust which became the obligor in such a transaction continued to be taxable on all future income thereafter going to satisfy such annuity payment.⁹⁸ It necessarily follows that the estate or trust in such instance does not recognize by anticipation such future income at the time the widow elects to acquire the annuity. It seems doubtful that the enactment of section 661(a) changes this result even though the estate or trust no longer pays the tax on income used to discharge the annuity. Section 661(a) recognizes the annuity as an obligation which may be paid either from income or principal. On the assumption that the *Lake* doctrine does not apply to the annuity route, the estate's basis should remain intact. No part should be lost as an offset against anticipated income as in the case of the life estate. If such basis is subject to depreciation or depletion, it can thus reduce estate income when recognized.

⁹³ *Id.* at 115, citing Treas. Reg. § 1.61-6(a) (1957) and other authorities.

⁹⁴ 47 B.T.A. 926 (1942), *aff'd per curiam*, 139 F.2d 697 (6th Cir. 1943).

⁹⁵ *Id.* at 933.

⁹⁶ *Columbia Oil & Gas Co. v. Commissioner*, 118 F.2d 459 (5th Cir. 1941).

⁹⁷ INT. REV. CODE OF 1954, § 661(a).

⁹⁸ *Helvering v. Pardee*, 290 U.S. 365, 370 (1933); *White v. Rose*, 73 F.2d 236 (5th Cir. 1934); *cf. Helvering v. Butterworth*, 290 U.S. 365 (1933).

The widow should be able to amortize the cost of her "purchased" annuity just as effectively as she could the cost of a "purchased" life estate (as discussed in issue 8). Such amortization is effected by treating the "purchase" price as "investment in the contract" and following the annuity taxation rules set out in section 72.⁹⁹ Generally the widow would doubtless recognize less taxable income by thus amortizing the cost of her purchased annuity than she would as a beneficiary under the rules of section 662 alone.¹⁰⁰

12. *During Administration of the Husband's Estate, Is Income From the Widow's Property, Which Passes by Election Under Husband's Will, Taxed to the Estate?* It has generally been held that income from community property, received by the executor during administration of one spouse's estate, is nevertheless taxed half to the estate and half to the survivor.¹⁰¹ In one case the same rule has been applied where the widow elected to let her part of the community pass under the husband's will.¹⁰² However, the court, in a split decision, placed some reliance upon a provision in the husband's will giving the wife the power to withdraw her half of the corpus. There has been no uniformity of opinion as to whether the electing surviving spouse should report the income from her half during administration.¹⁰³

It would seem that as to this issue the draftsman can rely upon proper post-mortem planning and leave the final resolution up to those with less foresight. Since all income will either be paid or set aside to the widow in a life estate situation, it would require little effort on the part of the executor to credit the widow for that part not paid to her within the estate's taxable year. Assuming proper authority under the will and state law to make such credit, then all income attributable to the widow's portion will be taxed to her rather than the estate during administration.¹⁰⁴

13. *Does the Widow's Estate Receive a Deduction Under Section 2043, and, if So, How Is it Calculated?* Basically, section 2043¹⁰⁵ provides an

⁹⁹ INT. REV. CODE OF 1954, § 72.

¹⁰⁰ *Id.* at § 662.

¹⁰¹ *Sneed v. Commissioner*, 220 F.2d 313 (5th Cir. 1955); *Bishop v. Commissioner*, 152 F.2d 389 (9th Cir. 1945); *cf.* *Barbour v. Commissioner*, 89 F.2d 474 (5th Cir. 1937); Rev. Rul. 55-726, 1955-2 CUM. BULL. 24. See Jackson, *Community Property and Federal Taxes*, 12 SW. L.J. 1, 34-37 (1958).

¹⁰² *Wells-Fargo Bank & Union Trust Co. v. United States*, 245 F.2d 524 (9th Cir. 1957).

¹⁰³ Compare Brown, *The Income Tax Aspects of the Widow's Election*, 1964 SO. CAL. TAX INST. 519, 522-24 with Wren, *Estate Planning and the Widow's Election*, 34 ROCKY MT. L. REV. 281, 289 (1962) and Wren, *Widow's Election*, 7 ARIZ. L. REV. 1, 24-25 (1965).

¹⁰⁴ INT. REV. CODE OF 1954, §§ 661(a)(2), 662(a)(2).

¹⁰⁵ *Id.* § 2043.

Section 2043. Transfers for Insufficient Consideration.

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

(b) Marital Rights Not Treated as Consideration.—For purposes of this chapter,

estate tax deduction to partially offset certain lifetime transfers, made for an inadequate consideration, which are included in the transferor's estate. Such deduction applies where the transfer is not a bona fide sale but value is nevertheless given by the transferee, though in an amount less than that he receives. The deduction is equal to the value so given by such transferee.

The question is whether the typical widow's election (involving community property or separate property of the electing widow) presents a case for a deduction under section 2043. In other words, may the widow's estate deduct from the value of her half of the property an amount equal to the value of the life estate she receives in her husband's property?¹⁰⁶

The initial case on the point was *Vardell's Estate v. Commissioner*¹⁰⁷ which, by a split decision, reversed the Tax Court and held that such a deduction was available. The decision has since been uniformly followed on this point.¹⁰⁸ The cases indicate that the consideration received by the decedent is to be valued at the time of the transfer in question. The cases also indicate that, absent short life expectancy on the part of the life tenant, the life estate should be valued under Treasury Regulation section 20.2031-7.¹⁰⁹

Under issue 5 above, the *Gregory* case was discussed relative to the question of whether the deduction under section 2043 could be equal to the value of an annuity received by the widow. The court there limited the deduction to the value of a life estate. It would seem that under the facts of the *Gregory* case, the larger annuity value should have been allowed as a deduction. Aside from the unfortunate decision in *Gregory*, no case has specifically involved this question. Notwithstanding *Gregory*, it is believed that in a proper case, where the husband's will spells out an annuity as such (rather than mandatory invasion of principal as in *Gregory*), the deduction under section 2043 should be taken from the annuity column of Treasury Regulation section 20.2031-7.¹¹⁰

In planning a widow's election will following the life estate route, one

a relinquishment or promised relinquishment of dower or curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the decedent's property or estate, shall not be considered to any extent a consideration "in money or money's worth."

¹⁰⁶ The recent case of *Estate of Morrison T. O'Nan*, 47 T.C. 648 (1967) presents interesting possibilities of an even larger deduction. Pursuant to a divorce in which decedent's wife gave up her rights to future support, decedent conveyed to her the remainder interest after his life in specific property. The court deemed the support rights and the remainder interest to be of equal value and held that no part of the specific property was includable in decedent's estate. The exchange was for full and adequate consideration. INT. REV. CODE OF 1954, § 2036(a).

Suppose the widow's election provision is drafted so that the widow need elect to give up a remainder in only an amount of property such that the remainder is exactly equal in value to the life estate the wife receives at the time of election. This would seem to qualify as "a bona fide sale for an adequate and full consideration." See Treas. Reg. §§ 20.2036-1(a), 20.2043-1(a) (1958).

The net result of this approach would be to give a larger deduction to the widow's estate. The difference in the amount of such deduction and that provided by § 2043 would, however, appear to decrease as the widow's age at election date increases.

¹⁰⁷ 307 F.2d 688 (5th Cir. 1962).

¹⁰⁸ *United States v. Past*, 347 F.2d 7 (9th Cir. 1965); *Whitely v. United States*, 214 F. Supp. 489 (W.D. Wash. 1963); *Estate of Lillian B. Gregory*, 39 T.C. 1012 (1963).

¹⁰⁹ Treas. Reg. § 20.2031-7 (1958).

¹¹⁰ *Id.* See *Estate of Sarah A. Bergan*, 1 T.C. 543, 554 (1943).

must consider whether the income from the life estate will likely vary significantly from the 3½ per cent rate assumed by the government tables. If the income will likely exceed 3½ per cent, the widow's estate over her life expectancy may accumulate enough earnings to more than offset the deduction under section 2043 which is based on a 3½ per cent yield. Particularly should this be weighed when it is considered that life expectancies in use by commercial underwriters today exceed those used by the government tables in valuing life estates. Fortunately, the annual gift tax exclusions give the widow a way to soften the blow of these archaic valuation tables, and the use of annual gifts will in many cases be advisable taxwise.

In those instances where the income will likely exceed a 3½ per cent rate of return, the draftsman cannot safely count on being able to sustain a larger life estate valuation for deduction under section 2043.¹¹¹ In such instances, use of an annuity based on a higher percentage (than 3½ per cent) of the principal should be considered.

14. *Will a Remarriage Clause Reduce the Section 2043 Deduction?* The effect of a remarriage clause on the widow's gift tax liability at the time of election was noted with some uncertainty in issue 5. No such uncertainty exists with regard to the widow's estate tax liability if one is willing to rely upon the clear holding of *Vardell*.¹¹² Under that case, no reduction in the section 2043 deduction would be required if the widow in fact did not remarry. If she did remarry, her section 2043 deduction would have to be appropriately reduced. It is submitted that such a rule is worthy of reliance.

15. *What Is the Effect of a Provision for Invasion of Corpus Upon the Section 2043 Deduction?* This is a critical question because a big percentage of the taxable estates are not large enough to safely cut the widow off from any power of invasion for support. In fact, in most medium-sized estates, the power of invasion for the support of the widow is probably greater than the tax saving at issue.

Logically it would seem that to the extent the power of invasion pertains to the husband's part of the property, there should be no reduction of the section 2043 deduction, for the power, if anything, increases what the widow receives for electing.¹¹³

Of perhaps greater interest is the question of whether a retained power of invasion in the widow's half may be so broad as to prevent her from having been put to an election.¹¹⁴ It is submitted that where the power

¹¹¹ See *Hipp v. United States*, 215 F. Supp. 222 (W.D.S.C. 1962); *Carl E. Weller*, 38 T.C. 790 (1962); *Estate of Irma E. Green*, 22 T.C. 728 (1954); *Huntington Nat'l Bank v. Commissioner*, 13 T.C. 760 (1949). Other factors which might affect the valuation of the deduction under § 2043 are considered under issues 14, 15 and 16 in text accompanying notes 112-24 *infra*.

¹¹² *Vardell's Estate v. Commissioner*, 307 F.2d 688 (5th Cir. 1962).

¹¹³ Compare the taxpayers' contentions in the gift tax cases of *Chase Nat'l Bank*, 25 T.C. 617 (1955), *rev'd on other grounds sub nom.*, *Commissioner v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958), *cert. denied*, 359 U.S. 913 (1959) and *Commissioner v. Siegel*, 250 F.2d 339 (9th Cir. 1957). See issue 5 in text accompanying notes 21-25 *supra*.

¹¹⁴ This is discussed briefly in issue 16 in text accompanying note 122 *infra*.

of invasion is limited by an ascertainable standard relating to the costs of her customary support, she has made a measurable disposition and has thus been clearly put to an election.¹¹⁵

Two estate tax cases to date involving section 2043 have also involved powers of invasion with respect to both halves of the community. One involved an ascertainable standard;¹¹⁶ the other did not.¹¹⁷ Both allowed the section 2043 deduction. It is noteworthy, however, that Judge Wisdom dissented in one of the cases on the ground that, because of the widow's retained benefits, "any appearance of a transfer at the time of the widow's exercise of her election was illusory."¹¹⁸ Caution would thus indicate the use of only a measurable standard of invasion.¹¹⁹

It is suggested that any power of invasion of the husband's half for the benefit of beneficiaries other than the widow be only with the widow's consent. Otherwise, the life estate received by the widow may be reduced in value, hence a reduction in the section 2043 deduction. *Chase National Bank*,¹²⁰ a gift tax case, involved such a power exercisable in favor of "any beneficiary." The court gave no discussion to its effect, however.¹²¹ Of course, if the wife's benefit is an annuity rather than a life estate, such a provision would probably not cause any reduction if the distributions to other beneficiaries were not permitted to jeopardize the annuity.

16. *What Is the Effect Upon the Section 2043 Deduction of Avoiding Gift Taxes Upon the Election?* Two methods for avoiding gift tax were discussed under issue 6. The first method, as described in Revenue Ruling 62-13,¹²² involves the retention of possible benefits so extensive that there is no assurance that anything will pass to the remaindermen. The use of this method invites disallowance before any court which agrees with Judge Wisdom's dissent in *Vardell*. It would seem prudent to avoid this method unless compelling reasons dictate the use thereof. The second method involves the retention of a special power of appointment to vary the interests within a prescribed class (such as issue). The power must be exercised in a gratuitous manner only.¹²³ It has been previously pointed out that such a provision does not destroy the completion of a gift for income tax purposes.¹²⁴ Certainly the widow has truly made a disposition or transfer of value. There is nothing illusory about it, and Judge Wisdom's

¹¹⁵ See Treas. Reg. § 25.2511-2(b) (1958).

¹¹⁶ *Vardell's Estate v. Commissioner*, 307 F.2d 688 (5th Cir. 1962).

¹¹⁷ *Estate of Lillian B. Gregory*, 39 T.C. 1012 (1963).

¹¹⁸ *Vardell's Estate v. Commissioner*, 307 F.2d 688, 699 (5th Cir. 1962).

¹¹⁹ In *Vardell* the widow had a general power of appointment over her husband's half as well. The power was of a pre-1942 vintage so that, being unexercised, it was not includable in her estate. A similar power today would cause the husband's half to be included in the widow's estate. An offsetting deduction under § 2043 would be available, unless Judge Wisdom's position prevailed, but the net effect would be to leave the widow's half fully taxed.

¹²⁰ 25 T.C. 617 (1955), *rev'd on other grounds sub nom.*, *Commissioner v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958), *cert. denied*, 359 U.S. 913 (1959).

¹²¹ See also *Zillah Mae Turman*, 35 T.C. 1123 (1961), *acquiesced in*, 1964-2 CUM. BULL. 7.

¹²² Rev. Rul. 62-13, 1962-1 CUM. BULL. 181.

¹²³ Treas. Reg. §§ 25.2511-2(b), (c) (1958); see note 39 *supra* and accompanying text.

¹²⁴ *William D. O'Brien*, 46 T.C. 583 (1966); *Winthrop v. Meisels*, 281 F.2d 694 (2d Cir. 1960); see text accompanying note 73 *supra* (issue 8).

dissent would not appear to be aimed at this type of arrangement. No reason is apparent why the use of such method to avoid gift taxes will expose the widow to any great danger of loss of the section 2043 deduction.

17. *What Are the Estate Tax Consequences of a Sale by the Widow of Her Retained Life Estate?* Section 2036¹²⁵ provides that where one transfers property for less than a full and adequate consideration, retaining the income therefrom, such property shall be included in his gross estate for estate tax purposes. Applying this section to the electing widow who retains a life estate in her own part of the property means that her taxable estate will include all of the property so transferred by her, although reduced by the section 2043 deduction. By its own terms, however, section 2036 applies only where the income has been "retained for [the transferor's] life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death."¹²⁶

If an electing widow subsequently sells her retained life estate for an amount equal to its then value, thus retaining at her death no interest in the trust, does she effectively avoid the application of section 2036? By the express language of such section it would seem so. If by selling her retained life estate for a fair price (presumably valued under the Treasury's regulations) the widow can thus remove such property, her estate comes out ahead; but what about her support? (Of course, a limited power of invasion with respect to the husband's part gives protection here.) It would seem that a sale by the private annuity route would be equally effective.¹²⁷

Thus, a widow can relieve her heirs from the payment of estate taxes on her part while she retains an annuity to provide a continuing source of support. Her annuity payments receive favorable income tax treatment (a subject beyond the scope of this article) and, as previously discussed, the purchasers can amortize their cost of the life estate.¹²⁸

The widow would have to give up any right to have the corpus of her part invaded for her benefit in order to avoid the application of section 2036.¹²⁹ The spendthrift clause should thus permit the wife to relinquish or dispose of any benefit she might have in the trust created from her property.

But what about the basic question—Will the sale of her retained life estate remove the property from the widow's taxable estate? The question was first presented in the California case of *In re Thurston's Estate*,¹³⁰ under a state statute subjecting to inheritance tax property transferred for an inadequate consideration where the "transferor expressly or im-

¹²⁵ INT. REV. CODE OF 1954, § 2036.

¹²⁶ *Id.* (emphasis added).

¹²⁷ Gladys Cheesman Evans, 30 T.C. 798 (1958); Estate of Robert J. Cuddihy, 32 T.C. 1171, 1177 (1959).

¹²⁸ Presumably the entire annuity payment as it is made can be amortized. Associated Patentees, Inc., 4 T.C. 979 (1945).

¹²⁹ Section 2036 also applies where the transferor has retained "the enjoyment of" the property.

¹³⁰ *In re Thurston's Estate*, 223 P.2d 12 (Cal. 1950) (sitting en banc).

pliedly reserves for his life an income or interest in the property transferred."¹³¹ The decedent gratuitously conveyed property to his children, reserving a life estate therein. Subsequently, decedent relinquished his life estate to his children for an adequate consideration. Since the conveyance took place four years prior to death, it was admittedly not in contemplation of death. In holding that the property was not taxable in the decedent's estate the court said: "Even though a tax attaches to a transfer when the transferor has reserved a life estate in the property, however, it can be avoided by the subsequent relinquishment of the life estate before the death of the transferor, if such relinquishment is not made in contemplation of death."¹³²

The court distinguished an earlier California case, *Estate of Madison*¹³³ which had held the property includable. In *Madison* the property had been conveyed in trust with a retained life estate. Later the life tenant relinquished his life estate. The court in *Madison* emphasized that the gift was in trust.

[S]o that, for the rest of his lifetime, the principal would be kept intact and the income would be paid to the family of which he was the head. . . . The respondents' interests were contingent upon their surviving the trustor. Each trust contained spendthrift provisions so that the beneficiaries could neither dispose of their interest in the corpus . . . nor request that the trusts be terminated before the trustor's death. . . . Moreover, irrespective of spendthrift provisions, the trusts could not be so terminated, since other persons, some person not yet born, had possible interests in the trust property.¹³⁴

Distinguishing *Madison*, the court in *Thurston* stated: "In contrast to the *Madison* case, the gifts here were not in trust and the trustor placed no shackles on the property that could not be and were not removed before his death. His children were the absolute owners of the realty for more than three years before his death and could do with it what they wished."¹³⁵

It is submitted that this distinction would not be valid under federal law. Nothing in sections 2033 through 2041¹³⁶ taxes a gift in trust similar to the above-mentioned features of the *Madison* trust where the grantor has no revisionary interest.¹³⁷ Even if *Madison* were followed, it would seem possible to avoid its effect by having the widow exercise the special power of appointment that she retained to avoid gift taxes,¹³⁸ thus passing the property out of the trust. Such exercise should not, however, be a part of the same transaction whereby she sold her life estate, unless the beneficiary of such power and the purchaser of the life estate were differ-

¹³¹ *Id.* at 13.

¹³² *Id.* at 14 (emphasis added).

¹³³ *In re Madison's Estate*, 159 P.2d 630 (Cal. 1945).

¹³⁴ *Id.* at 636-37 (citations omitted).

¹³⁵ *In re Thurston's Estate*, 223 P.2d 12, 16 (Cal. 1950).

¹³⁶ INT. REV. CODE OF 1954, §§ 2033-41.

¹³⁷ *Cf.* *Estate of Robert J. Cuddihy*, 32 T.C. 1171 (1959) discussed in text accompanying notes 146-47 *infra*.

¹³⁸ See Treas. Reg. §§ 25.2511-2(b), (c) (1958). See note 33 *supra*, and issue 6 in text accompanying notes 39-41 *supra*.

ent persons. Otherwise, the purchaser would doubtless be deemed to have purchased a fee and thereby be deprived of amortization.

By way of dicta, and apparently to allay fears of the California taxing authority, the court in *Thurston* excepted from its holding the transfer of a life estate relinquished for a consideration *in contemplation of death*. It said, "A tax measured by the entire corpus cannot be avoided by the payment of a consideration equal to the value of the interest relinquished."¹³⁹

The Commissioner adopted, and quoted extensively from, this dicta in Revenue Ruling 56-324.¹⁴⁰ The ruling limited its application to transfers in contemplation of death.

Subsequently, *United States v. Allen*¹⁴¹ was decided. There the facts amply supported the trial court's conclusion that the sale by a dying woman of her life estate for its actuarial value was in fact in contemplation of death. Although it was made in contemplation of death, the trial court found that the sale was for an adequate and full consideration, *i.e.*, the actuarial value of the income interest she then retained. Accordingly, it excluded the trust property from her gross estate.

The court of appeals reversed, stating, "Our narrow question is thus whether the corpus of a reserved life estate is removed, for federal estate tax purposes, from a decedent's gross estate by a transfer at the value of such reserved life estate."¹⁴² However, the court relied upon the fact that the trial court had found the transaction to be in contemplation of death. It recognized the logic of the taxpayer estate's position, but stated:

It does not seem plausible, however, that Congress intended to allow such an easy avoidance of the taxable incidence befalling reserved life estates. This result would allow a taxpayer to reap the benefits of property for his lifetime, and, *in contemplation of death*, sell only the interest entitling him to the income, thereby removing all of the property which he has enjoyed from his gross estate.¹⁴³

The Tenth Circuit, in *United States v. Heasty*,¹⁴⁴ has recently had occasion to discuss its holding in *Allen*. In *Heasty*, decedent in 1946 conveyed land to himself and his wife as joint tenants with right of survivorship. In 1948 decedent and wife conveyed such land to their issue, reserving joint life estates. Decedent's wife died in 1952 and decedent died in 1960. Basing its attack upon sections 2036 and 2040¹⁴⁵ and *United*

¹³⁹ *In re Thurston's Estate*, 223 P.2d 12, 17 (Cal. 1950) (sitting en banc).

¹⁴⁰ 1956-2 CUM. BULL. 999.

¹⁴¹ 293 F.2d 916 (10th Cir. 1961), *cert. denied*, 368 U.S. 944 (1961).

¹⁴² *Id.* at 917.

¹⁴³ *Id.* at 918 (emphasis added).

¹⁴⁴ 370 F.2d 525 (10th Cir. 1966).

¹⁴⁵ INT. REV. CODE OF 1954, §§ 2036, 2040. For a summary of § 2036's provisions see text accompanying notes 125-26 *supra*. Section 2040 provides:

The value of the gross estate shall include the value of all property to the extent of the interest therein held as joint tenants by the decedent and any other person, or as tenants by the entirety by the decedent and spouse, or deposited, with any person carrying on the banking business, in their joint names and payable to either or the survivor, except such part thereof as may be shown to have originally belonged to such other person and never to have been received or acquired by the latter from the decedent for less than an adequate and full consideration in money or mon-

States v. Allen, the government contended that decedent's estate should include the value of the entire property. In holding for the taxpayer, the court distinguished *Allen* on two grounds. The first such ground was that in *Allen* the decedent was the sole transferor, whereas in *Heasty* the wife was a necessary party to the second transfer. The second such ground was that in *Allen* the second transfer (*i.e.*, the retained life estate) was made within three years of death in contemplation of death.

Finally, in *Estate of Robert J. Cuddiby*,¹⁴⁶ decedent created a trust in 1926 from which he retained income for life. On April 8, 1949, he released his reserved income right for \$49,000 cash from his children. He died on December 22, 1952. The Commissioner included the trust in his estate under what is now section 2036. The court held that the trust was not includable since decedent had not retained the income from the property for a "period which does not in fact end before his death."¹⁴⁷

It thus appears that where the widow lives three years after her conveyance, there is respectable case law to the effect that no part of the property is includable in her estate. Furthermore, it is submitted that it should not be includable if the widow made a sale of her life estate at a time when death was not imminent, even though she happened to die within three years. The argument would run thus:

(a) The earlier "transfer" (election) was not in contemplation of death since it occurred more than three years before death.¹⁴⁸

(b) The earlier "transfer" did not bring the transfer in under section 2036 since the retention in fact ended before the widow's death.

(c) The "transfer" of the life estate was for a full and adequate consideration, thus out from under section 2035.

(d) Where a widow in the light of imminent death conveys her life estate, this is a subterfuge which the law cannot condone. Such was the fact in *Allen*.¹⁴⁹ In such a case, the contemplation of death language should be limited to imminent death (as in the case of *causa mortis* gifts) and should not be extended to an arbitrary three-year period set out in a statute which by its words does not apply. The real section under which the tax is levied is 2036 with a judicial limitation that when death is imminent a person cannot step out from under the

ey's worth: *Provided*, That where such property or any part thereof, or part or the consideration with which such property was acquired, is shown to have been at any time acquired by such other person from the decedent for less than an adequate and full consideration in money or money's worth, there shall be excepted only such part of the value of such property as is proportionate to the consideration furnished by such other person: *Provided further*, That where any property has been acquired by gift, bequest, devise or inheritance, as a tenancy by the entirety by the decedent and spouse, then to the extent of one-half of the value thereof, or, where so acquired by the decedent and any other person as joint tenants and their interests are not otherwise specified or fixed by law, then to the extent of the value of a fractional part to be determined by dividing the value of the property by the number of joint tenants.

¹⁴⁶ 32 T.C. 1171 (1959).

¹⁴⁷ *Id.* at 1177. Since the earlier transfer was made before March 4, 1931, the court based its holding first upon Int. Rev. Code of 1939, § 811(c)(1)(B) (now INT. REV. CODE OF 1954, § 2036(b)).

¹⁴⁸ INT. REV. CODE OF 1954, § 2035.

¹⁴⁹ *United States v. Allen*, 293 F.2d 916 (10th Cir.), *cert. denied*, 368 U.S. 944 (1961). See note 141 *supra* and accompanying text.

application of such section. This is the holding of *Allen* and anything to the contrary in *Thurston's Estate* is dicta.

III. CONCLUSION

Tax considerations should complement rather than control the manner of testamentary disposition. Informed testators have tended to realize, however, that where taxable estates are involved, trust arrangements almost inevitably accomplish the desired end result more effectively than non-trust dispositions. Advantages inherent in the trust route include avoidance of successive estate and gift taxes and unusual flexibility in the splitting of family income into lower brackets. Substantial non-tax advantages also inhere in the trust tailored to the family's needs. Limited powers of invasion, special powers of appointment, remarriage clauses and similar provisions have made the testamentary trust truly the foundation of estate planning.

An analysis of the above issues and their probable solutions indicates that without jeopardizing the customary advantages, both tax and non-tax, of the testamentary trust, the widow's election opens opportunities for additional tax savings in the medium-sized or large estate.