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The Income Tax Consequences of Sales of Present Interests and Future Interests: Distinguishing Time from Space*

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I. INTRODUCTION

The law of property defines ownership in terms of time and space. Ownership entails the possession of rights extending from the present to perpetuity over a defined area or object.[1] When these rights are sold in their entirety, the income tax consequences are generally elementary.[2]

In contrast, an owner may sell something less than all ownership rights. For example, an owner may sell rights to a physically discrete part of the entire property, thereby effectuating a "spatial division."[3] Alternatively, an owner may sell rights in the entire property for a period short of their duration, thereby effectuating a "temporal division."[4] Specifically, rights for a period from the present to some

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1. The theory of estates defines ownership of real property in terms of time. An estate in fee simple represents the greatest degree of ownership one can attain with respect to real property. Its duration is potentially infinite. *See* C. MOYNIHAN, INTRODUCTION TO THE LAW OF REAL PROPERTY 28–32 (1962); T. BERGIN & P. HASKELL, PREFACE TO ESTATES IN LAND AND FUTURE INTERESTS 20–27 (2d ed. 1984). Although the estate concept is unique to real property, full ownership of personal property is analogous to the ownership of realty in fee simple. *See* R. CUNNINGHAM, W. STOEBUCK & D. WHITMAN, THE LAW OF PROPERTY 39 (1984).

2. The seller's income is measured by the difference between the consideration he receives and his tax basis. I.R.C. § 1001(a) (1986). The consideration provided by the buyer establishes her tax basis. I.R.C. § 1012 (1986). Unless the property is of a type which deteriorates with the passage of time ("wasting property"), the buyer will not be permitted to recover her tax basis until she, in turn, sells the property. I.R.C. §§ 167, 168 (1986). Moreover, subsequent changes in the value of the property will not be reflected in the buyer's income until she sells the property. I.R.C. § 1001(a) (1986).

3. The transfer of an undivided interest in an estate in fee simple would also be within the scope of a spatial division.

4. The focus of this Article is on sales of present interests and future interests rather than gratuitous transfers of

specified future time (a "present interest")[5] or for a period from some specified future time to perpetuity (a "future interest")[6] may be transferred.

The income tax consequences of a spatial division are relatively simple because they are analogous to the income tax consequences of a sale of all ownership rights.[7] In contrast, the income tax consequences of a sale of a present interest or a future interest, which this Article terms a "temporal division,"[8] are complicated.[9] Moreover, the *tax* consequences that follow from existing law are inconsistent with the *economic* consequences of temporal divisions. Much of this inconsistency is attributable to a tendency of the courts to equate a temporal division to a spatial division, notwithstanding fundamental differences between the two transactions.[10]

Temporal divisions raise many fundamental income tax questions.[11] The most

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present interests and future interests. Consequently, unless otherwise indicated, all references to a temporal division shall contemplate a temporal division effectuated by sale. For the income tax consequences of a gratuitous transfer of present and future interests, see *infra* note 69 and text accompanying notes 273–76. "Vertical slice/horizontal slice" terminology might be applied as an alternative to the "spatial division/temporal division" nomenclature. *See* Del Cotto, *"Property" in the Capital Asset Definition: Influence of "Fruit and Tree,"* 15 BUFFALO L. REV. 1, 18 (1965–66).

5. A transfer of all rights to real property for a period measured by the life of one or more individuals, a life estate, or for a specified time period, an estate for years, might be effectuated. *See* MOYNIHAN, *supra* note 1, at 48–69; BERGIN & HASKELL, *supra* note 1, at 34–42. The owner of personal property may also transfer a life estate or an interest for a period of years in such property. *See* CUNNINGHAM, STOEBUCK & WHITMAN, *supra* note 1, at 84–85. When a present interest is transferred, the transferor retains an interest known as a "reversion" whereby all rights to the property will return to the transferor by operation of law upon expiration of the transferred life estate or term for years. *See* MOYNIHAN, *supra* note 1, at 94–95; BERGIN & HASKELL, *supra* note 1, at 56–58.

6. The owner of an estate in fee simple may retain the present interest and transfer a "remainder interest," all rights to the property upon expiration of the retained life estate or estate for years. *See* MOYNIHAN, *supra* note 1, at 110–15; BERGIN & HASKELL, *supra* note 1, at 62–66. A remainder interest in personal property can also be transferred. *See* CUNNINGHAM, STOEBUCK & WHITMAN, *supra* note 1, at 191–94. A transfer of ownership rights for a period commencing at some future time and ending at a subsequent future time (short of perpetuity) would also represent a "future interest." For purposes of the Article, however, all future interests will be assumed to be remainder interests or reversions.

7. When property is divided spatially, the seller's tax basis is allocated among the parts in the proportion to which the fair market value of each part bears to the whole. Treas. Reg. § 1.61-6(a) (1957). Otherwise, the analysis of the tax consequences to seller and buyer is identical to the analysis in the case of a sale of all ownership rights. *See supra* note 2.

8. *See supra* note 4.

9. *See* Oshins, *Grits, Splits and Tidbits,* TR. & EST., Mar. 1987, at 28, 39 ("The income tax considerations in utilizing the joint acquisition route present some very productive planning opportunities, although many questions are unsettled . . . . There are several fascinating unanswered questions in the income tax context."); Zaritsky, *Bits and Pieces: Sales of Remainder Interests and Split Purchases,* 38 U.S.C. TAX INST. ¶1600, 1601.3 (1986) ("Remainder interest sales . . . are accompanied by several notable problems and difficult, sometimes unanswerable, questions. Some of these relate to the tax consequences. . . .").

10. *See infra* Part II.

11. These questions are as follows: When a future interest is sold, is the consideration received treated as an amount realized by the seller in the year of sale? *See infra* text accompanying notes 38–41. If so, how much of the seller's tax basis may be applied against the consideration received? *See infra* text accompanying notes 42–54. Can any remaining basis be recovered by the seller through annual amortization deductions? *See infra* text accompanying notes 55–70. Is the buyer of the remainder interest taxed as the value of the remainder increases with the passage of time? *See infra* text accompanying notes 78–109. To which party is income generated by the property taxed? *See infra* text accompanying notes 71–74. When a present interest is sold, is the consideration realized by the seller in the year of sale? *See infra* text accompanying note 122. If so, how much of the seller's tax basis may be recovered at that time? *See infra* text accompanying notes 123–30. Is the seller taxed as the value of the reversion increases with the passage of time? *See infra* text accompanying notes 131–35. Is the buyer entitled to recover tax basis in the present interest through annual amortization deductions? *See infra* text accompanying notes 139–43. To which party is income generated by the property taxed? *See infra* text accompanying notes 137–38. How does the answer to each of the foregoing questions change if the underlying property is of a type that deteriorates with the passage of time? *See infra* Part IV. Characterization issues are also raised by these transactions. *See generally* Del Cotto, *supra* note 4, at 17–33. This Article does not focus on characterization issues, however, because characterization will be of less significance after 1987 due to the repeal of the capital gain deduction by the Tax Reform Act of 1986. Pub. L. No. 99-514, § 301(a), 100 Stat. 2216 (1986).

significant issues relate to the impact on both seller and buyer of the passage of time. After a temporal division is effectuated, the value of the present interest declines with the passage of time.[12] Correspondingly, the value of the future interest increases.[13] Value essentially shifts from the holder of the present interest to the holder of the future interest. Under existing law, the holder of the future interest is not taxed as this transfer of value occurs.[14] As a result, an opportunity to defer income exists.[15]

Present interests and future interests were rarely sold before 1984.[16] In late 1983, however, the Treasury Department increased the interest rate it employs for purposes of valuing present interests and future interests for gift and estate tax purposes.[17] As a result of this action, substantial estate tax savings may be derived

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Characterization remains significant in the case of the rare taxpayer with substantial capital losses. *See* I.R.C. § 1211 (1986).

12. If the value of the underlying property does not change, the value of the present interest will necessarily decline with each passing moment until it appears when the future interest vests in possession. *See infra* note 32. The Model developed in Part II is based on the assumption that the value of the underlying property does not change to make it easier to visualize the impact of the passage of time on the value of the present interest and the future interest. The assumption will be relaxed in Part III. *See infra* text accompanying notes 223–30.

13. If the value of the underlying property does not change, the value of the future interest will necessarily increase with each passing moment until the entire value of the underlying property accrues to the holder of the future interest when the future interest vests in possession. *See infra* note 35.

14. The problem relates to the general principle that "realization" must occur before a tax will be imposed. *See* Eisner v. Macomber, 252 U.S. 189 (1920). For an exception to this rule in the case of certain options and futures contracts, see I.R.C. § 1256 (1986). For a recent proposal to curtail substantially the realization requirement, see Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation,* 134 U. PA. L. REV. 1111 (1986). Related problems exist with respect to allowing an annual deduction to the holder of the present interest. *See* Blum, *Amortization of a Retained Terminable Interest After Transfer of a Remainder,* 62 TAXES 211 (1984); *infra* text accompanying notes 55–70.

15. The potential income is deferred, rather than eliminated, because the future interest holder's basis will not be increased as value shifts from the present interest to the future interest. *See infra* text accompanying notes 76–77. If, however, the value of the property falls or the holder of the future interest does not dispose of the property in a taxable transaction prior to death, the potential income will be eliminated. *See* I.R.C. § 1014 (1986). In the early 1980's, Congress aggressively attacked the ability of taxpayers to derive benefits without paying tax as the benefits accrue. As part of this attack, it expanded the scope and sophistication of the "original issue discount rules." *See infra* notes 154–69 and accompanying text. It also enacted specific legislation to deal with the problem in other contexts. *See, e.g.,* I.R.C. § 7872 (1986) (treatment of loans with below market interest rates). Congress did not address the problem in the context of temporal divisions, presumably because these transactions rarely occurred at this time. *See infra* text accompanying notes 16–18. *See generally* Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506 (1986).

16. As indicated previously, this Article focuses exclusively on sales of present interests and future interests. *See supra* note 4. Ownership is generally divided into present interest and future interest only when related parties are involved. *See, e.g.,* Oshins, *supra* note 9, at 44 ("[T]he split ownership techniques are typically employed in the context of a harmonious family situation where a senior family member is seeking to benefit his descendants. . . ."). Consequently, these transactions were generally effectuated by gratuitous transfer before 1984 because little incentive existed to structure the transfer as a sale. For the income tax consequences of a gratuitous transfer of present and future interests, see *infra* note 69 and text accompanying notes 273–76.

17. When property is transferred gratuitously, either during one's lifetime or at one's death, a federal gift or estate tax is imposed on the fair market value of the property. I.R.C. §§ 2001, 2031, 2501, 2512 (1986). *See also* I.R.C. § 2601 (1986). *But see* I.R.C. §§ 2010, 2503(b), 2505 (1986). In the case of a gratuitous transfer of a life estate, an estate for a term of years, a remainder, or a reversion, tables adopted by the U.S. Treasury Department [hereinafter Tables] are generally employed to determine what part of the value of the underlying property is attributable to the transferred interest. Treas. Reg. §§ 20.2031-7(f); 20.2512-5(f) (1984). These Tables operate by arbitrarily assuming that all assets generate a fixed annual rate of return. Based on this assumption, factors are provided for allocating the value of the underlying property between the present interest and the future interest. Prior to December 1, 1983, a 6% interest rate was employed by the Tables. Since December 1, 1983, a 10% rate has been employed. 48 Fed. Reg. 50,087 (1983) (codified at 26 C.F.R. Parts 1, 11, 20 & 25). The effect of the change in the interest rate is to increase the relative value assigned to present interests and to reduce the relative value assigned to future interests. Consequently, it has become less expensive from a gift and estate tax standpoint to transfer a future interest in property. *See generally* Lloyd, *Gift Valuation: Strategies and Developments,* 43 N.Y.U. INST. ON FED. TAX'N Ch. 49 (1985); Adams, Sweet & Bieber, *The 10 Percent Solution,* TR. & EST., Mar. 1984, at 57; Garrett, *New IRS Valuation Tables Require Different Strategies for Split Income*

when a younger family member purchases a future interest in property in which an older family member owns, or simultaneously purchases, the present interest.[18] The prospect of income deferral increases the appeal of these transactions.[19]

Income deferral is one of the few tax strategies with continuing vitality after the Tax Reform Act of 1986.[20] Consequently, temporal divisions are likely to become even more popular in future years. The time has arrived, therefore, to develop a framework that will facilitate taxing the holder of the future interest as that interest increases in value. An ideal framework will also resolve the many other income tax questions raised by temporal divisions in a manner consistent with the economic consequences of these transactions. The primary purpose of this Article is to create this framework.

In Part II, a Model will be developed to illustrate inconsistencies under existing law between the economic and income tax consequences of a temporal division. Part II will also explore the tendency of the courts to equate, erroneously, a temporal division to a spatial division. Part III will demonstrate first that, as long as a temporal division is equated to a spatial division, income deferral will result from a temporal division. Part III will then develop an alternative analytical framework to remedy the income deferral problem and to resolve, in a manner consistent with economic

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Gifts, 11 Est. Plan. 2 (1984); Teitel, *IRS Turns the Tables*, Tr. & Est., Jan. 1984, at 20; Blattmachr & Hastings, *Valuing Certain Split Interests*, Tr. & Est., June 1983, at 27.

18. The federal estate tax is imposed on the value of the decedent's estate on the date of (or, alternatively, six months after) decedent's death. I.R.C. §§ 2031, 2032 (1986). In the case of appreciating property, estate taxes may be reduced by transferring the property during the decedent's lifetime. If the decedent wishes to retain enjoyment of the property during the decedent's lifetime, however, a gratuitous transfer of a remainder interest will not result in a reduction of the taxable estate because the property will still be included in the decedent's estate at its value on the date of the decedent's death. I.R.C. § 2036 (1986). If the property is sold at its fair market value, however, the property will not be included in the decedent's estate. The proceeds of sale and any return earned on the proceeds during the decedent's lifetime, however, will be included. I.R.C. § 2036 (1986). The value of the property can be excluded from the decedent's estate if the decedent sells the remainder interest for "adequate and full consideration" while retaining a life estate. I.R.C. § 2036 (1986). The Internal Revenue Service has ruled that the Tables for valuing remainder interests transferred by gift also apply to sales of remainders. Priv. Ltr. Ruls. 80-41-098 (July 21, 1980), 81-45-012 (July 20, 1981). Because the interest rate assumption currently employed by the Tables is relatively high, the Tables will often undervalue the remainder interest in a particular asset. *See supra* note 17. Thus, the sum of the proceeds from the sale of the remainder and the return earned on the proceeds during the decedent's lifetime may very well be less than the value of the property when the decedent dies. If this occurs, estate tax savings are effectuated. It is unclear whether the sale of a remainder interest in fact removes the entire property from the decedent's estate. *See* Zaritsky, *supra* note 9, at ¶ 1601.3(A); *Practical Drafting–Sale of a Remainder Interest*, 1986 U.S. Trust 859, 864–69 [hereinafter *Practical Drafting*]. Moreover, a court recently stated in dicta that the sale of a remainder interest will only remove the property from the seller's estate if the consideration provided by the buyer is equal to the full fair market value of the property. Gradow v. United States, 11 Cl. Ct. 808, 87-1 U.S.T.C. ¶ 13,711 (Cl. Ct. 1987). A joint purchase arrangement, where an older family member purchases a present interest and a younger family member simultaneously purchases a future interest, eliminates the risk that the sale of a remainder interest by the owner of the entire property will not remove the property from the original owner's estate. In this situation, the holder of the life estate never actually owned the entire property so that it should not be included in his estate. *See* Zaritsky, *supra* note 9, at ¶1602.2(A). A joint purchase may also be effected through an older family member's purchase of a present interest in property owned by a younger family member. *See* Zaritsky, *supra* note 9, at ¶1602.1. *See generally* Oshins, *supra* note 9, at 28; *Practical Drafting*, *supra*, at 864; Leimberg & Schnepper, *The Schnepper-Leimberg Joint Purchase of a Life Estate and a Remainder Interest*, 32 Tax Notes 981 (1986) (and follow-ups 33 Tax Notes 307, 398, 1071 (1986); 34 Tax Notes 169 (1987)); Moore, *The Use of Life Estates and Remainder Interests in Estate Planning*, Miami Inst. on Est. Plan., Ch. 12 (1985).

19. *See, e.g.*, Oshins, *supra* note 9, at 39.

20. The Tax Reform Act of 1986 compressed tax rates, eliminated the capital gain deduction, curtailed many other deductions, and restricted income shifting. *See* Pub. L. No. 99-514, §§ 101, 131–35, 142, 301, 501–03, 511, 1411, 100 Stat. 2216 (1986). Thus, the new law eliminates the benefit of many former planning strategies. As a result, deferral techniques will attract the attention of taxpayers and the Internal Revenue Service in future years.

reality, the many other income tax issues raised by a temporal division. Finally, Part IV will demonstrate how the framework developed in Part III can be adapted to deal with the special problems raised when property which deteriorates with the passage of time ("wasting property") is the subject of a temporal division.[21]

II. INCONSISTENCIES UNDER EXISTING LAW

Assume that on January 1, 1988, Jay ("J") and Kaye ("K") each has $1,000,000 available for investment. Furthermore, assume that all available investments will generate a taxable return at the rate of ten percent per year during each of the succeeding three years and will neither appreciate nor depreciate in value during this period. In addition, assume that all returns will be paid at year-end and will be reinvested upon receipt.[22]

A. *No Temporal Division*

1. *Economic Consequences*

J and K each will earn returns of $100,000 in 1988, $110,000 in 1989 and $121,000 in 1990.[23] The following summarizes the economic position of J and K at the end of each year:[24]

Initial Economic Position	$1,000,000
1988—Return on Investment	100,000
Economic Position at End of 1988: $1,100,000	
1989—Return on Investment	110,000
Economic Position at End of 1989: $1,210,000	
1990—Return on Investment	121,000
Final Economic Position	$1,331,000

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21. Wasting property must be addressed in a separate section due to unique issues raised by the depreciation deduction. A buyer is allowed to recover a proportionate part of her cost annually by way of a depreciation deduction if the property purchased is a wasting asset and is used by the taxpayer in a trade or business or held for the production of income. I.R.C. § 167(a) (1986). *See, e.g.*, Griswold v. Commissioner, 400 F.2d 427 (5th Cir. 1968), *cert. denied sub nom.* Chrome Plate, Inc. v. United States, 449 U.S. 842 (1980) (wasting property); Schubert v. Commissioner, 286 F.2d 573 (4th Cir.), *cert. denied*, 366 U.S. 960 (1961)(income producing activity). The basis of the buyer of depreciable property is to be recovered over a statutorily prescribed period at a statutorily prescribed rate. I.R.C. § 168 (1986). Parts II and III of the Article will focus exclusively on nonwasting property. The special problems presented by wasting property will be considered in Part IV.

22. The income tax liability generated by the returns would be satisfied with other funds.

23. The formula for computing each annual return is as follows:

$$r = P(1+i)^t - P(1+i)^{t-1}$$

where r is the return earned t years from the time that P dollars were invested at an i interest rate (expressed as a decimal), where all prior returns have been reinvested.

24. The formula for computing the economic position at the end of a particular year is as follows:

$$E = P(1+i)^t$$

where E is the party's economic position t years from the time that P dollars were invested at an i interest rate (expressed as a decimal), where all prior returns have been reinvested.

2. *Income Tax Consequences*

In the situation outlined above, J and K each will have taxable income equal to his or her returns: $100,000 in 1988, $110,000 in 1989, and $121,000 in 1990.[25] Consequently, the income tax consequences are consistent with the economic consequences.

The Model developed above will next be applied to temporal divisions. Because income tax consequences differ depending upon the manner in which a temporal division is effectuated, the Model will, in turn, be applied to the sale of a future interest (subpart B), the sale of a present interest (subpart C), and a joint purchase (subpart D).[26]

B. *Sale of a Future Interest*

Suppose J uses his $1,000,000 to purchase nonwasting property on January 1, 1988.[27] On the same day, J sells a remainder interest to K which is anticipated to vest in possession on December 31, 1990.[28] In an arm's length transaction, K should pay $751,315 for the remainder interest.[29]

As will be demonstrated below, economically J and K will be in the same position as if no temporal division had occurred. From an income tax standpoint, however, J is taxed on an amount of income in excess of the economic benefits he derives. K, on the other hand, is taxed on an amount of income that is less than the economic benefits she derives.

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25. I.R.C. § 61 (1986).

26. A joint purchase entails the purchase of property from an owner by two other parties where one party buys the present interest and the other buys the future interest. *See supra* note 18.

27. Parts II and III of the Article will focus exclusively on temporal divisions of nonwasting property. The special problems presented by wasting property will be considered in Part IV. *See supra* note 21.

28. The parties would expect the remainder to vest in possession on December 31, 1990 if J had retained an estate for a term of three years. Alternatively, the same expectation would be present if J retained a life estate measured by J's life (or the life of some other person) if J and K believed that the measuring life would end on December 31, 1990.

29. The formula for computing the value of the remainder interest is as follows:

$$R = \frac{P}{(1+i)^t}$$

where R is the value of a remainder interest in an investment of P dollars (where the value of the investment is assumed to remain constant for the duration of the present interest) in a world in which all investments generate a return at an annual i interest rate (expressed as a decimal) where the remainder interest is anticipated to vest in possession in t years. Thus, the amount K should pay (R) for the remainder interest is computed as follows:

$$R \approx \frac{1,000,000}{(1 + .10)^3} = 751,315$$

Due to the assumptions employed in the Model, the value of the remainder interest could also be derived by applying the factor from the Tables for valuing a remainder interest subject to an estate for a term of three years. Treas. Reg. §§ 20.2031-7(f), Table B; 20.2512-5(f), Table B (1984). The value of the remainder interest can also be approximated by applying the factor from the Tables for valuing a remainder subject to a life estate where the measuring life is 93 years old when the temporal division is effectuated. Treas. Reg. §§ 20.2031-7(f), Table A; 20.2512-5(f), Table A (1984). *See supra* notes 17–18.

1. *Economic Consequences*

If J sells a remainder interest to K, J will derive returns from two separate sources during 1988, 1989, and 1990. First, J will derive returns from the property equivalent to the benefits J would have derived had no temporal division occurred.[30] In addition, J will derive annual returns from the consideration provided by K for the remainder interest.[31] Even though the value of the property remains constant, the value of J's retained present interest will decline each year. This decline in value is equivalent to the returns generated by the consideration provided by K.[32] Consequently, as illustrated in the following table, J's economic position is identical to his position when no temporal division occurred.[33]

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30. *See supra* note 23 for the formula for computing these returns.

31. *See supra* note 23 for the formula for computing these returns. When the formula is applied to an investment of $751,315 on January 1, 1988, at a 10% interest rate, the resulting returns are $75,131 in 1988, $82,645 in 1989, and $90,909 in 1990.

32. The formula for computing the value of the present interest retained by J is as follows:

$$X = \sum_{t=1}^{n} \frac{(P)(i)}{(1+i)^t}$$

where X is the value of a present interest in an investment of P dollars (where the value of the investment is assumed to remain constant for the duration of the present interest) in a world in which all investments generate a return at an annual interest rate i (expressed as a decimal), where the present interest is anticipated to expire in n years. The present value of J's present interest at January 1, 1988 is as follows:

$$1988 \text{ return: } \frac{100,000}{1.1} = 90,909$$
$$1989 \text{ return: } \frac{100,000}{1.21} = 82,645$$
$$1990 \text{ return: } \frac{100,000}{1.331} = 75,131$$
$$\overline{\$248,685}$$

At December 31, 1988, J will be entitled to the 1989 and 1990 returns but each of those two returns will be worth more on December 31, 1988 than they were worth one year earlier because they will now be received one year sooner. Thus, the present value of J's present interest at January 1, 1989 is as follows:

$$1989 \text{ return: } \frac{100,000}{1.1} = 90,909$$
$$1990 \text{ return: } \frac{100,000}{1.21} = 82,645$$
$$\overline{\$173,554}$$

Consequently, the elimination of the 1988 return is offset, in part, by the increase in the value of the 1989 and 1990 returns so that the net decline in the value of J's present interest is only $75,131. In analogous fashion, J's present interest will decline by $82,645 in 1989 and decline by $90,909 in 1990. The present interest vanishes on December 31, 1990 when the remainder vests in possession. If the present interest retained by J were a life estate, the above conditions would only be satisfied if an expectation that the measuring life would terminate on December 31, 1990 existed for the duration of the present interest and the measuring life did, in fact, terminate on December 31, 1990.

Due to the assumptions employed in the Model, the value of the present interest could also be derived by applying the factor from the Tables for valuing an estate for a term of three years. Treas. Reg. §§ 20.2031-7(f), Table B; 20.2512-5(f), Table B (1984). The value of the present interest can also be approximated by applying the factor from the Tables for valuing a life estate where the measuring life is 93 years old when the temporal division is effectuated. Treas. Reg. §§ 20.2031-7(f), Table A; 20.2512-5(f), Table A (1984). *See supra* notes 17–18.

33. *See supra* text accompanying note 24.

	Interest in Property	Cash
Initial Economic Position	$1,000,000	0
1988 — Sale of Remainder	(751,315)	$751,315
— Return from Property		100,000
— Return on Proceeds from Remainder		75,131
— Decline in Value of Present Interest	(75,131)	
Net Economic Position at End of 1988: $1,100,000		
1989 — Return from Property & Reinvested Rtn.		110,000
— Return on Proceeds from Remainder & Reinv. Rtn.		82,645
— Decline in Value of Present Interest	(82,645)	
Net Economic Position at End of 1989: $1,210,000		
1990 — Return from Property & Reinvested Rtns.		121,000
— Return on Proceeds from Remainder & Reinv. Rtns.		90,909
— Decline in Value of Present Interest	(90,909)	
Final Economic Position	0	$1,331,000

The purchase of the remainder interest by K for $751,315 leaves her with $248,685, which she will invest and earn returns on in 1988, 1989, and 1990.[34] The value of the acquired remainder will increase each year by an amount equal to the annual returns she would have earned on the rest of her original funds.[35] As the

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34. *See supra* note 23 for the formula for computing these returns. When the formula is applied to an investment of $248,685 on January 1, 1988, at a 10% interest rate, the resulting returns are $24,869 in 1988, $27,356 in 1989, and $30,090 in 1990.

35. For the formula for computing the original value of the remainder interest, see *supra* note 29. As each year passes and the remainder approaches possession, "t" declines thereby reducing the denominator of the fraction, the effect of which is to increase the value of the remainder interest. The annual increase in the value of K's remainder interest is as follows:

	Increase in Value
Initial Value: $\dfrac{1,000,000}{(1.1)^3} = 751,315$	
Value at 12/31/88: $\dfrac{1,000,000}{(1.1)^2} = 826,446$	75,131
Value at 12/31/89: $\dfrac{1,000,000}{(1.1)^1} = 909,091$	82,645
Value at 12/31/90: $\dfrac{1,000,000}{(1.1)^0} = 1,000,000$	90,909

For the formula for computing the returns K would have earned had she otherwise invested the funds used to purchase the remainder interest, see *supra* notes 23 and 31.

following illustration indicates, K will also be in an economic position identical to her position as if no temporal division had occurred:[36]

	Interest in Property	Cash
Initial Economic Position	0	$1,000,000
1988 — Purchase of Remainder	$751,315	(751,315)
— Return on Retained Funds		24,869
— Increase in Value of Remainder	75,131	
Economic Position at End of 1988: $1,100,000		
1989 — Return on Retained Funds & Reinvested Rtn.		27,356
— Increase in Value of Remainder	82,645	
Economic Position at End of 1989: $1,210,000		
1990 — Return on Retained Funds & Reinvested Rtns.		30,090
— Increase in Value of Remainder	90,909	
Final Economic Position	$1,000,000	$331,000

Thus, notwithstanding the sale of the remainder interest, both J and K are in the same economic position as if no temporal division had occurred.[37]

2. *Income Tax Consequences to Seller (J)*

a. *Income at Time of Sale*

Under present law, J will not have any income when he sells a remainder interest to K. The amount of income derived from the sale of property is determined by subtracting the seller's tax basis in the property from the consideration received.[38] When property is divided spatially and the owner sells all of his rights attributable to a discrete part of the property, the owner is required to include the consideration received in income as a potential gain from property.[39] Correspondingly, the owner

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36. *See supra* text accompanying note 24.

37. *See* Joyce & Del Cotto, *The AB (ABC) and BA Transactions: An Economic and Tax Analysis of Reserved and Carved Out Income Interests,* 31 TAX L. REV. 121, 123–30 (1976) (quantitative analysis of the issues discussed in this segment).

38. I.R.C. § 1001(a) (1986).

39. The transfer of all rights to a discrete part of the property for consideration represents an immediate parting of ownership sufficient to satisfy the "sale or other disposition" prerequisite to a realization event. I.R.C. § 1001(a) (1986). Consequently, the potential for income in the form of "gains derived from dealings in property" exists. I.R.C. § 61(a)(3).

is entitled to offset such income by that portion of his tax basis attributable to that part of the property which is sold.[40]

When J sells a remainder interest in property the fair market value of which is equal to his tax basis, J should not realize a gain because no appreciation exists in his investment at the time of sale. The consideration received by J, however, will be included in J's income in the year of sale.[41] Thus, gain will be avoided only if J can recover a proportionate part of his basis in the year of sale.[42]

By equating a temporal division to a spatial division, the instinctively correct result is achieved as to this issue.[43] J will realize the fair market value of the remainder interest in the year of sale and will offset such amount by a proportionate part of his tax basis.[44] As such, no gain is realized, and thus none is recognized, in the year of sale.[45] Both the Tax Court and the Internal Revenue Service have adopted this position.

In the consolidated cases of *Hunter v. Commissioner* and *Galey v. Commissioner*,[46] the U.S. Park Service wished to acquire ranches which the taxpayers were willing to sell provided they could retain ownership during their lifetimes. The fair market value of the Galey ranch was $315,000 and the fair market value of a remainder interest in that ranch was $165,000.[47] The Galeys sold the remainder interest and, in computing their taxable gain, offset the consideration received by their *entire* adjusted basis. The Internal Revenue Service took the position that

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40. The tax basis is allocated among the parts in the proportion to which the fair market value of each part bears to the whole. Treas. Reg. § 1.61-6(a) (1957) ("When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part.") The examples following the text of the regulation imply that the allocation is to be based on relative fair market value.

41. If the sale of the remainder interest represents a current transfer of property, the consideration would be included in J's income as a result of the realization event. *See supra* note 39. Even if the sale of a remainder interest does not represent a current transfer of property, J would be required to include the consideration received in income in the year of sale due to tax accounting conventions, irrespective of whether J is a cash method taxpayer or an accrual method taxpayer. *See infra* notes 121–22, 200, and accompanying text.

42. In contrast to the question of whether J should be permitted to recover any basis in the year of sale, he should not be permitted to recover his entire basis in the year of sale. J is not being treated from a realization standpoint as selling his entire interest in the underlying property because he is not compelled to include the full fair market value of the property in income when the remainder interest is sold. If a purported transfer of a remainder interest represents, in substance, a sale of the entire property followed by a reacquisition of a possessory interest by the seller, the seller would be required to include the full fair market value of the property in income in the year of sale. *See, e.g.*, Eller v. Commissioner, 77 T.C. 934 (1981). For a discussion of the issues involved in distinguishing transfers of future interests from transfers of the entire property followed by reacquisition of a possessory interest, see Del Cotto, *Sale and Leaseback: A Hollow Sound When Tapped?*, 37 TAX L. REV. 1 (1981).

If J were permitted to recover his entire tax basis in the year of sale, he would realize an undeserved capital loss. This is somewhat analogous to the capital loss that could be claimed by taxpayers who acquired a coupon bond, stripped the bond of its interest coupons, and then sold the bond at a discount prior to the enactment, in 1982, of a statutory provision to bar this result. I.R.C. § 1286 (1986). *See generally* McGrath, *Coupon Stripping Under Section 1286: Trees, Fruits, and Felines*, 38 TAX LAW. 267 (1985).

43. Unfortunately, analogizing a temporal division to a spatial division leads to incorrect results with regard to the many other income tax issues raised by a temporal division. *See infra* text accompanying notes 55–175.

44. The amount of tax basis that would be allocated to the remainder interest would be equal to the product of J's total basis and the ratio of the fair market value of the remainder interest to the fair market value of the entire property. *See supra* note 40.

45. Of course, if J's basis were not equal to the fair market value of the underlying property, gain or loss would be realized and recognized.

46. 44 T.C. 109 (1965).

47. *Id.* at 111. A life estate over the joint lives of the Galeys was apparently retained.

taxpayers' were entitled to apply only 165/315 of their basis against the sales proceeds and that the balance of the basis was allocable to the Galeys' retained life estate.[48] The taxpayers did not address the question of basis allocation.[49]

The Tax Court held for the Internal Revenue Service with respect to the issue of basis allocation by summarily concluding that "it is clear that there must be some apportionment of basis in a situation such as is presented by the instant case. Where part of a property is sold there must be an equitable apportionment of basis."[50] Based on the authorities cited by the court, it appears that the court was equating a temporal division to a spatial division.[51] The Internal Revenue Service ruled subsequently that the seller's basis should be allocated in a similar fashion where the retained present interest is an estate for a term of years.[52] Moreover, the Tax Court has indicated, in dictum, that it would also extend the holding in *Hunter* to a situation involving a retained term.[53]

Thus, under present law, J derives no net income when he sells a remainder interest to K because his potential income of $751,315 will be offset by $751,315 of his tax basis.[54] By equating a sale of a remainder to a spatial division, the correct result is achieved as to basis allocation. As will be demonstrated below, however, the analogy unfortunately leads to incorrect results when applied to the many other income tax issues raised by a temporal division.

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48. *Id.* at 112.

49. *Id.* at 116. Taxpayers and their counsel apparently misunderstood the substantive tax law applied to the sales in question. *Id.* at 112.

50. *Id.* at 115. The *Hunter* court accepted the Commissioner's method of allocating basis between the transferred remainder and the retained life estate based on the values that the Park Service had placed on the life estates and fee simple estates because it was "logical and reasonable" in this situation. The court emphasized, however, that its holding was confined to this case and that "the choice between methods, if one is to be made, must be left to the appropriate future occasion." *Id.* at 117.

51. The court first cited Treas. Reg. § 1.61-6(a) (1957). This regulation provides for the allocation of property in the case of a spatial division of property. *See supra* note 40 and accompanying text. Both of the examples illustrating the regulation entail a transfer of all rights to a discrete part of the property (the sale of 20 lots into which a 10 acre tract had been divided and the sale of a "filling station" that was purchased simultaneously with a used car lot).

The second authority cited by the court was Welsh Homes, Inc. v. Commissioner, 279 F.2d 391 (4th Cir.), *aff'g* 32 T.C. 239 (1960). *Welsh Homes* involved a situation where the taxpayer sold homes to individual customers and leased to each purchaser the underlying land for a term of 99 years. The court barred the seller from applying his entire basis in each home against the purchase price. Rather, the seller was required to allocate the total cost of the home and land between that which was transferred and the reversionary interest based on the relative fair market value of the respective interests. Although the transaction as analyzed by the court did involve a temporal division, it is questionable whether the case is of any relevance outside of the narrow confines of the ground rent law of Maryland. *See* Urbanek v. United States, 731 F.2d 870, 875–76 (Fed. Cir.) (dissenting opinion), *cert.¹ denied,* 469 U.S. 1034 (1984). Moreover, if *Welsh Homes* represents a temporal division, it represents a sale of a present interest rather than the sale of a future interest. *See infra* text accompanying notes 122–30.

Finally, the *Hunter* court cited Perkins v. Thomas, 86 F.2d 954 (5th Cir. 1936), *aff'd,* 301 U.S. 655 (1937). In *Perkins,* the taxpayer, in 1933, sold all his mineral interests in land he owned. He retained the surface rights which he later sold in 1936. Taxpayer claimed a loss in 1933 which he derived by applying a proportionate amount of his basis in the land against the consideration he received for the mineral rights. The courts allowed the taxpayer to achieve this result. The essence of the transaction in *Perkins* was a spatial division. In contrast to a present interest and a future interest, the mineral interests and surface rights would not merge with the passage of time.

52. Rev. Rul. 77-413, 1977-2 C.B. 298. The ruling involved the sale of a remainder interest in property in which an estate for a term of 20 years was reserved to the seller.

53. Eller v. Commissioner, 77 T.C. 934, 960 n.38 (1981). *See supra* note 42.

54. Of course, if J's basis in the property had been less than the fair market value of the property, he would have realized a gain on the sale of the remainder interest.

b. *Recovery of Remaining Basis*

Under present law, J apparently will not be allowed to recover his remaining basis after he sells the remainder interest. In the case of a spatial division of nonwasting property, that portion of the seller's tax basis that is not recovered at the time of sale is attached to the retained property.[55] The remaining basis may not be recovered prior to a subsequent sale of the retained property because the retained property is nonwasting.[56]

If a sale of a remainder interest is analogized to a spatial division, then that portion of the seller's basis not recovered at the time of sale will continue to be associated with the underlying property. Thus, the seller of a remainder interest in nonwasting property cannot recover his remaining basis by way of an annual amortization deduction reflecting the diminishing value of the retained present interest.[57] Although the issue of whether the seller of a remainder interest may amortize his remaining basis has never been adjudicated, related precedent reveals once again the tendency of the courts to equate a temporal division to a spatial division.

In *United States v. Georgia Railroad & Banking Co.*,[58] the taxpayer railroad, whose assets were subject to a ninety-nine year lease for which the taxpayer received annual rents of $600,000, distributed its reversionary interest in the stock of two subsidiaries to its shareholders approximately twenty-six years prior to the end of the lease term. The distribution was motivated by "business reasons relating to regulatory policies of the Interstate Commerce Commission."[59] Using "accepted actuarial tables," the taxpayer allocated 36.43% of its basis in the stock of the two subsidiaries to the reversionary interest it distributed.[60] After the distribution, the taxpayer attempted to recover its remaining basis in the stock of the two subsidiaries over the remaining term of the lease.

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55. Treas. Reg. § 1.61-6(a) (1957).

56. Basis may only be recovered by way of depreciation deductions where the taxpayer holds wasting property. *See supra* note 21. Issues associated with a temporal division of wasting property are discussed *infra* at Part IV.

57. Some effort should be made to distinguish between "amortization" and "depreciation." For tax purposes, depreciation is a specific type of amortization. Depreciation refers to an amortization deduction allowed under I.R.C. §§ 167 and 168 (1986). *See supra* note 21. Amortization refers to cost recovery allowances under other provisions of the Internal Revenue Code. *See* Kahn, *Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 MICH. L. REV. 1, 14 n.51 (1979).

One Tax Court judge has suggested that deductions determined by the useful life of the underlying property should be taken as depreciation deductions, whereas deductions determined by the useful life of the taxpayer's interest in the property should be taken by way of amortization. Early v. Commissioner, 52 T.C. 560, 570–71 (1969) (Tannenwald, J., dissenting), *rev'd*, 445 F.2d 166 (5th Cir.), *cert. denied*, 404 U.S. 855 (1971). As a matter of convenience, this Article will apply the terms in this fashion. Specifically, cost recovery issues relative to a purchased or retained present interest will be referred to as amortization whereas cost recovery issues relative to the underlying property will be referred to as depreciation. As previously indicated, all depreciation issues are deferred until Part IV.

Some question exists as to whether the distinction made by Judge Tannenwald is, in fact, accurate. *See* Manufacturers Hanover Trust Co. v. Commissioner, 431 F.2d 664, 667, n.4 (2d Cir. 1970). *See also* Sohosky v. Commissioner, 57 T.C. 403, 409 n.4 (1971) (acknowledging controversy associated with terms amortization and depreciation).

58. 11 A.F.T.R. 2d 1435, 63-1 U.S.T.C. ¶ 9443 (S.D. Ga. 1963), *rev'd*, 348 F.2d 278 (5th Cir. 1965), *cert. denied*, 382 U.S. 973 (1966).

59. United States v. Georgia R.R. & Banking Co., 348 F.2d 278, 280 (5th Cir. 1965), *cert. denied*, 382 U.S. 973 (1966).

60. United States v. Georgia R.R. & Banking Co., 11 A.F.T.R. 2d 1435, 1436 (S.D. Ga. 1963), *rev'd*, 348 F.2d 278 (5th Cir. 1965), *cert. denied*, 382 U.S. 973 (1966).

The district court held that the taxpayer's right to receive the income over the remaining lease term constituted property held for the production of income and was a wasting asset which the taxpayer was permitted to amortize.[61] The Fifth Circuit reversed on the ground that the retention of a fragment of the taxpayer's rights in nondepreciable property barred the taxpayer from amortizing that which was retained. Thus, the approach taken by the court was consistent with the analysis of a spatial division.[62]

In *Lomas Santa Fe v. Commissioner*,[63] the taxpayer corporation transferred a golf course to a wholly-owned subsidiary subject to an estate for forty years.[64] The taxpayer used the actuarial tables provided by the gift tax regulations to allocate 74.74% of its basis in the golf course to the retained term.[65] Subsequent to the transfer of the future interest, the taxpayer attempted to recover ratably over the forty year term that portion of its basis in the retained interest attributable to the land on which the golf course was situated.[66] After rejecting the Commissioner's argument that the transfer should be ignored, the Tax Court adopted the Fifth Circuit's position in *Georgia Railroad* and held that the taxpayer could not recover that portion of its retained interest attributable to the nondepreciable assets.[67] The Ninth Circuit affirmed.[68]

If a sale of a remainder interest is equated to a spatial division, then J will not be allowed to amortize his remaining basis as his retained present interest declines in value because his tax basis will be associated with nonwasting property.[69] Because of

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61. *Id.* at 1438.

62. "By distributing the reversion in 1954, taxpayer did nothing more than split its bundle of property rights into two parts . . . . The rights which the taxpayer retained after the distribution are merely a fragment of the total bundle of nondepreciable property rights which the taxpayer had before the distribution." United States v. Georgia R.R. & Banking Co., 348 F.2d 278, 288 (5th Cir. 1965), *cert. denied*, 382 U.S. 973 (1966).

63. 74 T.C. 662 (1980), *aff'd*, 693 F.2d 71 (9th Cir. 1982), *cert. denied*, 460 U.S. 1083 (1983).

64. The transfer enabled the taxpayer to settle all potential boundary and easement problems prior to the sale of any residential lots. It also served to insulate the taxpayer from possible direction from members of the golf course in the event such memberships were treated as equity interests under state law. Lomas Sante Fe v. Commissioner, 74 T.C. 662, 668–69 (1980).

65. *Id.* at 679. *See supra* note 17.

66. *Id.* at 669. Because the two corporations filed consolidated returns, the taxpayer continued to claim depreciation with respect to the depreciable assets transferred. *See* I.R.C. §§ 1501–04 (1986).

67. Lomas Santa Fe v. Commissioner, 74 T.C. 662, 683–84 (1980).

68. Lomas Santa Fe v. Commissioner, 693 F.2d 71 (9th Cir. 1982), *cert. denied*, 460 U.S. 1083 (1983).

69. Professor Blum has suggested that the fact patterns in these two cases might be distinguished from the sale of a remainder interest on the ground that both cases involved nonrecognition transactions which might be analogized to a gratuitous transfer by an individual to which the concept of "uniform basis" applies. Blum, *supra* note 14, at 213–15. In the case of a temporal division of ownership effectuated through a gratuitous inter vivos or testamentary transfer, the basis of the property is initially allocated between the present interest and the future interest based on relative fair market values. With the passage of time, the basis allocated to the present interest shifts to the future interest. By the time the present interest expires and all rights to the property accrue to the holder of the future interest, the entire basis is associated with the holder of the future interest. Treas. Reg. §§ 1.1014-4—8 (1957), 1.1015-1(b) (1971). *See generally* Note, *Apportionment of Date of Death Basis; Analyzing the Anomalies of Uniform Basis*, 27 TAX L. REV. 303 (1972).

Consistent with the shift in basis to the holder of the future interest under the uniform basis rules, Congress precludes the holder of the present interest from amortizing that portion of the uniform basis allocated to his interest. I.R.C. § 273 (1986). *See* I.R.C. § 1001(e) (1986) (bars holder of present interest received gratuitously from recovering basis on sale of present interest prior to expiration). The concept of uniform basis does not apply, however, to a temporal division of ownership effectuated by sale because the buyer's tax basis is governed by I.R.C. § 1012, rather than § 1014 or § 1015. Consequently, Professor Blum suggests that amortization of basis associated with the retained present interest should be permitted where the remainderperson does not take a carryover or substitute basis from the transferee. Blum, *supra* note 14, at 217. Even if the two cases discussed in the text are distinguishable from the sale of a remainder interest, amortization of basis will be barred if a sale of a remainder interest is equated with a spatial division.

the tendency of the courts to equate a temporal division to a spatial division, it appears that J cannot recover that portion of his tax basis which is not recovered at the time of sale.[70]

c. *Income After Sale*

If J sells a remainder interest to K, J will derive returns from two different sources from 1988 through 1990. First, he will receive the same returns from the property that he otherwise would have received had the temporal division not occurred.[71] In addition, he will derive returns from the consideration provided by K.

It is a well established principle of federal income taxation that the owner of property is taxed on the income therefrom.[72] If a spatial division of income-producing property were effectuated, future income generated by the property would presumably be divided between the original owner of the entire property and the party to whom a discrete part of the property was sold. Consequently, if the sale of a remainder interest by J were equated to a spatial division, one might expect that only a portion of the income generated during the period of the retained present interest would be taxed to J and that the balance would be taxed to K. Under existing law, however, when J sells a remainder interest, the income generated during the period of the retained present interest will be taxed entirely to J.[73] Thus, as when J retains all ownership rights, J will be taxed in each year on the $100,000 return he receives from the property and the income generated by those returns.

J will also be taxed on the annual returns he earns on the consideration received for the remainder interest. From an economic standpoint, these returns compensate J for the annual decline in the value of the retained present interest.[74]

Although beyond the scope of this Article, query whether the the uniform basis rules and I.R.C. §§ 273 and 1001(e) should be repealed and amortization of basis should be allowed irrespective of how the present interest is created. *See* Joyce & Del Cotto, *supra* note 37, at 162 n.145.

70. The seller should be able to recover his basis if he were to sell his retained interest before it expired. *But see* I.R.C. § 1001(e) (1986). Alternatively, he might be able to recover the remaining basis when the present interest expires in which case inconsistencies with respect to timing and characterization would be present. *See* Blum, *supra* note 14, at 215–16. Unlike the case of a spatial division, however, that which is retained will not provide an indefinite storage place for the taxpayer's remaining basis.

The commentators advocating the sale of a remainder interest generally concede that basis recovery is not allowed. *See, e.g.*, Zaritsky, *supra* note 9, at ¶1601.4(B); *Practical Drafting*, *supra* note 18, at 881–82. The concession does not come at a great cost where the owner's tax basis is relatively low. Since appreciating property held by the older generation family member for a lengthy period of time tends to be the subject of sales of remainder interests, recovery of remaining basis may not be a significant practical issue. *See, e.g.*, Zaritsky, *supra* note 9, at ¶1601.4(B).

71. *See supra* note 23 and accompanying text.

72. Helvering v. Horst, 311 U.S. 112 (1940).

73. *See, e.g.*, Thomas v. Perkins, 301 U.S. 655 (1937); McCulley Ashlock, 18 T.C. 405 (1952). A purported sale of a future interest may, in substance, represent an immediate transfer of all ownership rights. In this situation, the enjoyment that the seller derives during the period of the alleged retained present interest is, in fact, deferred consideration provided by the buyer. Where this occurs, the income generated by the property will be taxed to the buyer and, in turn, taxed to the seller as consideration for the underlying property. *See, e.g.*, Bryant v. Commissioner, 399 F.2d 800 (5th Cir. 1968); Alstores Realty Corp., 46 T.C. 363 (1966). Because a portion of the consideration received by the seller should be treated as deductible interest paid by the buyer, the indirect effect is to divide the total income between the parties. *See* Joyce & Del Cotto, *supra* note 37, at 126–29.

74. *See supra* notes 31–33 and accompanying text.

d. *Summary*

The amount of taxable income derived by J under current law when J sells a remainder interest to K is as follows:

	Income from Property	Income from Sale Proceeds	Total
1988 —	$100,000	$75,131	$175,131
1989 —	110,000	82,645	192,645
1990 —	121,000	90,909	211,909
Total	$331,000	$248,685	$579,685

Because J cannot amortize that portion of his tax basis not recovered when the remainder interest is sold, J is taxed in each year on an amount of income greater than the net economic benefit he derives.[75]

3. *Income Tax Consequences to Buyer (K)*

a. *Basis in Remainder*

When K acquires the remainder interest from J for $751,315, she will establish a cost basis in the remainder interest.[76] In contrast to the declining value of J's retained present interest, K's remainder interest will increase in value with the passage of time. Unless K is taxed on the increasing value of the remainder interest, K's tax basis should remain the same when all ownership rights in the underlying property inure to K on December 31, 1990.[77]

b. *Income After Purchase*

K will derive benefits from two different sources from 1988 through 1990. K will earn returns on that portion of her original $1,000,000 that is not invested in the remainder interest. She will obviously be taxed annually on these returns.[78]

In addition, K will derive benefits from the increasing value of the remainder interest. Specifically, her remainder interest will increase in value in each of 1988, 1989, and 1990 in an amount equal to the return K otherwise would have earned on the funds used to purchase the remainder interest.[79] Under current law, however, K

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75. *See supra* note 33 and accompanying text.

76. I.R.C. § 1012 (1986).

77. In the case of a change in the form of the taxpayer's investment with respect to which an immediate tax is not imposed, the taxpayer's basis generally remains the same. *See, e.g.*, I.R.C. § 732(b) (1986) (basis of property distributed by partnership in liquidation of partner's interest is generally equal to basis of partner's interest).

78. I.R.C. § 61 (1986). *See supra* note 34.

79. *See supra* note 35.

is not taxed each year on the increase in the value of her remainder interest.[80] In fact, K is not even taxed when the remainder vests in possession.[81]

Two cases are often cited in support of the position that a taxable event occurs when a remainder interest vests in possession.[82] In *Guthrie v. Commissioner*,[83] decedent's legatee sold her one-fifth interest in decedent's residuary estate, which consisted primarily of real estate, to an individual who, in turn, sold the interest to the taxpayer. The executor of decedent's estate sold the properties and distributed taxpayer's share of the proceeds to him. The taxpayer reported the gain as capital gain whereas the Commissioner treated the gain as ordinary income.[84] The court held for the Commissioner on the ground that the taxpayer did not "sell or exchange" his interest.[85]

In *Jones v. Commissioner*,[86] the taxpayer, in 1953, paid $3,500 to the holder of a contingent remainder interest in a trust for a $10,000 interest in the property held by the trust.[87] The holder of the present interest died in 1957. The taxpayer, in an effort to avoid the result in *Guthrie*, sold his interest in the trust for $9,400 before the corpus of the trust was distributed. The taxpayer reported the resulting gain as capital gain on his 1957 tax return.[88] The Commissioner claimed that the gain should be taxed as ordinary income because the sale constituted an anticipatory assignment of income[89] and the Tax Court agreed.[90]

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80. *See* Blum, *supra* note 14, at 217–18; Joyce & Del Cotto, *supra* note 37, at 128–29, 155–56, 183–84; Land, *Contingent Payments and the Time Value of Money*, 40 TAX LAW. 237, 280–81 (1987).

Two commentators have suggested that the courts have, at times, allowed K to be taxed on the income generated by the property during the period of the retained present interest as a proxy for the benefit derived by K with respect to the accretion in value of the remainder with the passage of time. Joyce & Del Cotto, *supra* note 37, at 155. This result occurs when K is treated as purchasing J's entire interest in the property for cash and deferred payments represented by the income generated by the property for the duration of the alleged present interest. *See, e.g.*, Bryant v. Commissioner, 399 F.2d 800 (5th Cir. 1968); Alstores Realty Corp., 46 T.C. 363 (1966); *supra* note 73. Under this scenario, K is taxed on the income when earned and is treated as paying over the income to J in satisfaction of K's debt. Since part of the payment from K to J is interest, K is entitled to a deduction so that the net effect is to tax K on an amount equal to the accretion in value of the remainder. *See* Joyce & Del Cotto, *supra* note 37, at 126–29.

81. For an antiquated, but insightful, inquiry into the issue of taxing the holder of a future interest on the accretion in value, see Maguire, *Income Taxes on the Realization of Future Interests*, 31 YALE L.J. 367 (1922).

82. *See, e.g.*, Zaritsky, *supra* note 9, at ¶1601.3(F),(G); *Practical Drafting*, *supra* note 18, at 885–87. *See generally* Note, *The Favorable Tax Treatment of Remainder Interest Investments*, 24 TAX L. REV. 527 (1969) [hereinafter Note, *Favorable Tax Treatment*].

83. 42 B.T.A. 696 (1940).

84. *Id.*

85. For income to be characterized as capital gain, it must be derived from the "sale or exchange" of a capital asset. I.R.C. § 1222 (1986). Capital gain treatment is of less significance since the repeal of the capital gain deduction by the Tax Reform Act of 1986. *See supra* note 11.

The court analogized the transaction to "the receipt of the proceeds of a bond or insurance policy at maturity or redemption." *Id.* at 697. The tax consequences of a bond redemption were uncertain at the time *Guthrie* was decided. *See* Note, *Favorable Tax Treatment*, *supra* note 82, at 530.

86. 40 T.C. 249 (1963), *vacated and remanded*, 330 F.2d 302 (3d Cir. 1964), *on remand*, 25 T.C.M. 701 (1966).

87. Jones v. Commissioner, 40 T.C. 249, 251 (1963). The remainder interest was contingent upon the remainder-person surviving the life tenant. A similar purchase in a second trust will be ignored for simplicity.

88. *Id.* at 252, 256.

89. *Id.* at 256. The "assignment of income" doctrine establishes that a taxpayer cannot shift the tax burden with respect to income generated by property owned by the taxpayer or income generated by services performed by the taxpayer merely by transferring the right to such income to another taxpayer. *See generally* M. CHIRELSTEIN, FEDERAL INCOME TAXATION 157–82 (4th ed. 1985). For a critique of the application of the assignment of income doctrine in this context, see Note, *Favorable Tax Treatment*, *supra* note 82, at 533–37.

90. Jones v. Commissioner, 40 T.C. 249, 257–59 (1963). Although the Tax Court's decision was subsequently

The difference between the parties in both *Guthrie* and *Jones* was limited to characterization. Neither case discussed the threshold question of whether a taxable event had occurred.[91] The sale in *Jones* obviously represented a taxable event.[92] Because the taxpayer in *Guthrie* received cash, it was critical to tax him at the time he received the cash even if the distribution was not, in principle, a taxable event.[93] Had the taxpayer in *Guthrie* not been taxed at the time of receipt on the difference between the cash received and the amount paid for the remainder interest, the gain never would have been taxed.[94]

A different situation exists, however, where property is received when the remainder interest vests in possession.[95] When property is received, the final opportunity to tax the purchaser of the remainder on the difference between the value of the property received and the amount paid for the remainder is not when the remainder vests in possession. Rather, the unrealized gain can be preserved by attaching the tax basis in the remainder to the property received.[96] The preserved gain will be taxed to the purchaser of the remainder when she later sells the property.[97]

To tax K at the expiration of J's present interest, K would have to be treated as constructively exchanging the remainder interest for the underlying property at that time. A constructive exchange does not comport with reality, however, because the underlying property is not sufficiently different from the remainder.[98] This conclusion is consistent with the holding of a federal appeals court in an unreported decision. The court held that no taxable event occurred when a law firm received property from a contingent remainder interest in a trust assigned to the firm by a client.[99]

Based on the foregoing analysis, it does not appear that K will be taxed on the increase in value of her remainder interest when analyzed from a "gains derived from dealings in property" perspective.[100] It may be, however, that the foregoing benefit is more akin to some other class of income. As the Model demonstrates, the

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vacated and remanded, the later decisions dealt exclusively with characterization questions. *See infra* text accompanying notes 156–61.

91. A sale or exchange is a prerequisite to taxing gains from property. I.R.C. § 1001 (1986).

92. *Id.*

93. For a discussion of whether a taxable event had, in fact, occurred, see Note, *Favorable Tax Treatment, supra* note 82, at 530–32.

94. An "exchanged basis" mechanism is not available to preserve unrealized gain when the substituted property is in the form of money. *See* I.R.C. § 7701(a)(44) (1986).

95. *Cf.* I.R.C. § 731(a)(1) (in the case of a distribution from a partnership to a partner, gain will only be recognized to the extent money is distributed).

96. *See supra* note 77 and accompanying text.

97. The gain will escape taxation, however, if the value of the property declines or the property is not disposed of in a taxable transaction before the death of the purchaser of the remainder interest. *See* I.R.C. §§ 1001(a); 1014 (1986).

98. This is consistent with language in the regulations addressing the receipt of property from a decedent which provides that gain is not to be recognized with respect to "any element of value resulting solely from the circumstance that the possession or enjoyment of the taxpayer was postponed." Treas. Reg. § 1.1014-4(a)(2) (1957).

Even if the expiration of the present interest were regarded as a taxable event to the remainderperson, from a policy standpoint, it may not be desirable to tax immediately a gain which results where the taxpayer does not make a voluntary disposition. *Cf.* I.R.C. § 1033 (1986) (provision allowing taxpayer to elect nonrecognition of gain realized when property is compulsorily or involuntarily converted).

99. Sheppard Holdings, Inc. v. United States, Civ. No. 77-3066, 77-3052, 77-3170, 77-3176 (9th Cir. 1979), *reprinted in part in Practical Drafting, supra* note 18, at 885–86.

100. I.R.C.§ 61(a)(3) (1986).

remainder interest acquired by K will increase in value with the passage of time. This increase in value effectively compensates K for the consideration she surrendered while her enjoyment of the underlying property is delayed.[101] Thus, the benefit appears to be attributable to the time value of money.[102] Consequently, the class of income involved would appear to be interest, rather than gain from property.[103] In contrast to the strict realization requirement which applies to gains derived from property, the tax law in recent years has made great strides toward eliminating any impediment to the accrual of interest income in the absence of realization.[104]

Although a spatial division analogue has not been employed by the courts to tax K on the increase in value of her remainder interest, equating a temporal division to a spatial division helps to reveal the interest income element. If K is regarded as purchasing a discrete part of the entire property when the remainder interest is purchased, then the fact that she owns the entire property when the remainder vests in possession means that she subsequently received additional property. Because K became entitled to receive the balance of the property when she acquired the remainder interest, the balance of the property might be perceived as deferred consideration provided by J, at least a part of which is attributable to interest.[105] As will be discussed in detail in Part III, although mechanisms exist under current law to impute interest income, the purchase of a remainder interest probably is not within the scope of these provisions.[106] Moreover, even if the purchase of a remainder interest could be brought within the scope of these provisions by equating a sale of a remainder interest to a spatial division, income would not be imputed to the purchaser until the remainder vests in possession.[107] Consequently, application of the spatial division analogue to this issue will not preclude the purchaser of a remainder interest from deferring income. The correct result will only be achieved if the purchaser of the remainder interest is required to include in income on a yearly basis the annual increase in the value of the remainder interest.[108]

Thus, under existing law, K is not taxed on the economic benefit she derives from the increase in the value of her remainder interest.[109]

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101. *See supra* note 35 and accompanying text.

102. The time value of money is generally expressed as interest. The right to $1 in a year is worth less than the receipt of $1 now because a return can be earned by investing the latter amount. If this return is not paid as it accrues, it should increase at a compound rate consistent with the fact that if the return were paid currently, it could be reinvested. *See generally* Canellos & Kleinbard, *The Miracle of Compound Interest: Interest Deferral and Discount After 1982,* 38 TAX L. REV. 565 (1983). The foregoing description is consistent with the manner in which the acquired remainder interest increases in value. *See supra* note 35.

103. *Compare* I.R.C. § 61(a)(3) (1986) *with* I.R.C. § 61(a)(4) (1986). In the case of a taxpayer who engages in the purchase and sale of remainder interests on a continuing basis, it may be possible to bring the benefit into the tax base as business income. I.R.C. § 61(a)(2) (1986).

104. *See* Land, *supra* note 80, at 240. *See supra* note 14.

105. *See infra* text accompanying notes 170-71.

106. *See infra* text accompanying notes 163-69.

107. *See infra* text accompanying notes 172-75. Although the Model contemplates a present interest of short duration, a present interest of longer duration is possible. If taxation is deferred for a sufficiently long period of time, no economic burden is imposed on the taxpayer. *See generally* Canellos & Kleinbard, *supra* note 102, at 565.

108. *See infra* text accompanying notes 178-87.

109. The potential income is preserved, however, because K's basis in the property is limited to the cost of the remainder interest. This assumes that the property will retain its value until it is sold by K or K's successor and that K will sell the property prior to her death. *See* I.R.C. § 1014 (1986).

c. *Summary*

The amount of taxable income derived by K under current law when K buys a remainder interest from J appears to be as follows:

	Income from Accretion in Remainder	Income from Retained Funds
1988 —	0	$24,869
1989 —	0	27,356
1990 —	0	30,090
Total Income		$82,315

Because K is not taxed on the annual increase in the value of her remainder interest, the economic benefit she derives in each of the three years exceeds the income on which she is taxed.[110]

C. *Sale of a Present Interest*

Instead of J purchasing nonwasting property and selling a remainder interest to K, assume that K uses her $1,000,000 to purchase nonwasting property on January 1, 1988. On the same day, K sells a present interest to J which is anticipated to terminate on December 31, 1990.[111] In an arm's length transaction, J should pay $248,685 for the present interest.[112]

As will be demonstrated below, economically, J and K will be in the same position as if no temporal division had occurred. Moreover, the total income taxed to J and K

If the purchaser of the remainder interest were taxed on the accretion in value of that interest, her basis would presumably be increased to avoid double taxation when the property is later sold. *See, e.g.,* I.R.C. § 1272(d)(2) (1986).

110. *See supra* text accompanying note 36.

111. The parties would expect the present interest to expire on December 31, 1990 if J acquired an estate for a term of three years. Alternatively, the same expectation would be present if J acquired a life estate measured by J's life (or the life of some other person) if J and K believed that the measuring life would end on December 31, 1990.

112. The formula for computing the value of the present interest is as follows:

$$X = \sum_{t=1}^{n} \frac{(P)(i)}{(1+i)^t}$$

where X is the value of a present interest in an investment of P dollars (where the value of the investment is assumed to remain constant for the duration of the present interest) in a world in which all investments generate a return at an interest rate i (expressed as a decimal) where the present interest is anticipated to expire in n years. Thus, the amount J should pay (X) for the present interest is computed as follows:

$$X = \sum_{t=1}^{3} \frac{(1,000,000)(.1)}{(1+.1)^t} = 248,685$$

Due to the assumptions employed in the Model, the value of the present interest could also be derived by applying the factor from the Tables for valuing an estate for a term of three years. Treas. Reg. §§ 20.2031-7(f), Table B; 20.2512-5(f), Table B (1984). The value of the present interest could also be approximated by applying the factor from the Tables for valuing a life estate where the measuring life is 93 years old when the temporal division is effectuated. Treas. Reg. §§ 20.2031-7(f), Table A; 20.2512-5(f), Table A (1984). *See supra* notes 17–18.

The sale of a present interest remains a relatively uncommon transaction. An older family member might try to reduce estate taxes, however, by acquiring a present interest in property already owned by a younger family member. *See* Zaritsky, *supra* note 9, at ¶1602.1; *see also supra* note 18.

over the three-year period is equivalent to the economic benefits derived by them. J's income is deferred, however, because he derives economic benefits before he is taxed on the corresponding income. K's income, on the other hand, is accelerated because she is taxed before deriving the corresponding economic benefits.

1. *Economic Consequences*

If J purchases a present interest from K for $248,685, he will derive returns from two separate sources during 1988, 1989, and 1990. First, J will derive returns from the property. In addition, J will earn returns on his remaining $751,315.[113] J will not, however, be in a better economic position than if no temporal division occurred. The value of J's acquired present interest will decline each year by an amount equal to the annual returns generated by the original funds not used to purchase the present interest.[114] As the following table indicates, the net economic benefit derived by J in each year is equivalent to the economic benefit derived in the absence of a temporal division.[115]

	Interest in Property	Cash
Initial Economic Position	0	$1,000,000
1988 — Purchase of Present Interest	$248,685	(248,685)
— Return from Property		100,000
— Return on Retained Funds		75,131
— Decline in Value of Present Interest	(75,131)	
Net Economic Position at End of 1988: $1,100,000		
1989 — Return from Property & Reinvested Rtn.		110,000
— Return on Retained Funds & Reinvested Rtn.		82,645
— Decline in Value of Present Interest	(82,645)	
Net Economic Position at End of 1989: $1,210,000		
1990 — Return from Property & Reinvested Rtns.		121,000
— Return on Retained Funds & Reinvested Rtns.		90,909
— Decline in Value of Present Interest	(90,909)	
Final Economic Position	0	$1,331,000

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113. *See supra* notes 23 and 31.
114. *See supra* note 32.
115. *See supra* text accompanying notes 23–24.

If K sells J a present interest, she will forego the returns generated by the property from 1988 through 1990. Although K will derive annual returns from the consideration received for the present interest,[116] the resulting benefits will be substantially less than the returns she would have earned had she not sold the present interest. The value of K's retained reversion, however, will increase each year in an amount equal to the difference between the returns she otherwise would have derived from the property and the returns she actually derives from the consideration for the present interest.[117] Consequently, as the following table indicates, K will also be in an economic position at the end of each of the three years identical to the position she would have been in had no temporal division occurred.[118]

	Interest in Property	Cash
Initial Economic Position	$1,000,000	0
1988 — Sale of Present Interest	(248,685)	$248,685
— Return on Proceeds from Present Interest		24,869
— Increase in Value of Reversion	75,131	
Economic Position at End of 1988: $1,100,000		
1989 — Return on Proceeds Pres. Int. & Reinv. Rtn.		27,356
— Increase in Value of Reversion	82,645	
Economic Position at End of 1989: $1,110,000		
1990 — Return on Proceeds Pres. Int. & Reinv. Rtns.		30,090
— Increase in Value of Reversion	90,909	
Final Economic Position	$1,000,000	$331,000

2. *Income Tax Consequences to Seller (K)*

In contrast to the sale of a future interest, the total amount of income taxed to seller and buyer over the duration of a temporal division effectuated by the sale of a present interest is generally equivalent to the net economic benefits derived by the parties.[119] The tax consequences do depart from the economic consequences, however,

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116. *See supra* note 34.

117. For the derivation of the annual increase in value of K's reversion, see *supra* note 35. For the formula for computing the annual returns from the property, see *supra* note 23. For the derivation of the annual returns from the consideration provided by J, see *supra* note 34.

118. *See supra* text accompanying note 24.

119. *Compare infra* text accompanying notes 136, 144 *with supra* text accompanying notes 75, 110.

with respect to the timing of income.[120] A sale of a present interest is generally not equated to a spatial division. Rather, the income distortions that result from the sale of a present interest are attributable to established tax accounting conventions.[121]

a. *Income at Time of Sale*

As in the case of the sale of a future interest, the seller of a present interest is required to include the consideration received in income in the year of sale.[122] If a temporal division were equated to a spatial division, the seller could offset such income by a part of the seller's basis in the property.[123] In rare circumstances, courts have, in effect, equated a sale of a present interest to a spatial division by permitting the seller to apply a part of the seller's basis against the sale proceeds.[124] Generally, however, no basis recovery is permitted when a present interest is sold.[125]

If it were logical to equate a temporal division to a spatial division, basis recovery should be permitted whenever a present interest is sold because basis would be allocated in proportion to the value of the interest.[126] Were this the case, K would

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120. The time at which income is taxed is often as economically significant as the amount of income that is subject to tax. *See generally* Canellos & Kleinbard, *supra* note 102, at 565.

121. The seller's income is accelerated due to tax accounting rules that require the seller to include cash in income when received. *See infra* text accompanying notes 122, 200. The buyer's income is deferred due to the general rule that basis is to be amortized at a constant rate regardless of the actual decline in value of the asset. *See infra* text accompanying notes 141–43.

122. *See supra* text accompanying note 41. *See, e.g.,* Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958); Estate of Stranahan v. Commissioner, 472 F.2d 867 (6th Cir. 1973), *rev'g* 30 T.C.M. (CCH) 1078 (1971). *See generally* Joyce & Del Cotto, *supra* note 37, at 176–79.

123. *See supra* note 40 and accompanying text.

124. In Estate of Camden v. Commissioner, 47 B.T.A. 926 (1942), *aff'd per curiam,* 139 F.2d 697 (6th Cir. 1943), Johnson Camden purchased a life estate for $58,904 from his wife, Agnes, in a farm owned by her on which they resided. *Id.* at 928. Using actuarial tables, Agnes determined that the life estate represented 32.95% of the value of the property and, accordingly, she allocated $59,889.86 of her $181,759.82 adjusted basis in the farm to the life estate and reported a $985.86 loss with respect to the sale. *Id.* at 929. The Board of Tax Appeals concluded that Agnes was permitted to offset her income by a part of her basis. *Accord* King v. Commissioner, 31 T.C. 108 (1958).

The precedential significance of *Estate of Camden* is limited because the court reached its result by employing as a model the tax consequences of a temporal division of a gratuitous transfer which Congress subsequently modified. *See* I.R.C. § 1001(e) (1986). The case may also be undermined by the Supreme Court's decision in Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958). *See* Del Cotto, *supra* note 4, at 30.

In Connelly v. Commissioner, 34 T.C.M. (CCH) 1379 (1975), a case riddled with complaints about a confused and contradictory record, taxpayers purchased land on which they constructed apartment buildings. Thereafter, taxpayers created a cooperative arrangment, carving out a 99 year leasehold interest and selling interests in the individual apartments while retaining the reversion. Taxpayers offset the sales proceeds by their entire basis in the improvements, in response to which the Commissioner claimed that the proceeds could only be offset by a portion of the costs of the improvements and a portion of the cost of the land, based on the fair market value of transferred interest relative to that of the entire property. The court held for the Commissioner "as a result of the manner in which this case has been presented to us." *Id.* at 1385. The court emphasized, however, that it was not suggesting that the parties correctly analyzed the situation and stated, "Indeed, perplexing questions present themselves as to *whether any cost basis should be deducted from the amounts received . . . ." Id.* at 1385 n.6 (emphasis added). The court also stated that, "this case can hardly have any useful precedential value." *Id.* at 1385. *See* Welsh Homes, Inc. v. Commissioner, 279 F.2d 391 (4th Cir. 1960); *supra* note 51.

125. Taxpayers have been unable to convince a court to allow such a recovery. *See, e.g.,* Hort v. Commissioner, 313 U.S. 28 (1941)(lessor paid to cancel lease with remaining term of approximately 11 years). Recovery of basis is generally not even raised as an issue. *See, e.g.,* Commissioner v. Gillette Motor Transp., Inc., 364 U.S. 130 (1960) (payment for use of business facilities for approximately 10 months); Estate of Stranahan v. Commissioner, 472 F.2d 867 (6th Cir. 1973) (sale of right to future dividends); Rhodes' Estate v. Commissioner, 131 F.2d 50 (6th Cir. 1942) (per curiam) (sale of right to declared dividend).

126. *See supra* note 40 and accompanying text.

be able to avoid current income even if she sold J an estate for a term of one year on January 1, 1988. If K sold J a one-year term estate for $90,909, she would offset the consideration received with $90,909 of basis.[127] Although commentators have suggested that this result may, in theory, be appropriate,[128] it does not comport with existing law.[129]

Thus, under current law, K would be taxed on the entire $248,685 received from J in the year of sale. Because this amount is taxed when received rather than as earned, the effect is to accelerate taxable income relative to the time that the corresponding economic benefits are derived.[130]

b. *Income After Sale*

If K sells a present interest to J, K will derive returns from two different sources. First, K will earn returns on the proceeds provided by J and will be taxed annually on these returns.[131] In addition, K will derive benefits from the increase in value of the reversion with the passage of time.[132]

The benefits from the increasing value of the reversion are analogous to the benefits K derived when she acquired the remainder interest from J.[133] As previously indicated, K will not be taxed on these benefits under existing law.[134] This generally leads to a sensible result in the case of a sale of a present interest. In this case, K is already taxed on her entire economic benefit because she cannot recover any basis at the time of sale. Taxing K on the increase in the value of the reversion would therefore result in the imposition of a second tax on a single economic benefit.[135]

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127. For the formula for computing the value of an estate for a term of one year, see *supra* note 32.

128. The position is based on the theory that taxable income should be limited to economic gain irrespective of whether the duration of one's ownership interest is potentially infinite. *See* Joyce & Del Cotto, *supra* note 37, at 123–26, 185–88.

129. The $90,909 is essentially treated as a prepayment of income to be included in income in full when received. *See* Estate of Stranahan v. Commissioner, 472 F.2d 867 (6th Cir. 1973). Otherwise, K is able to receive cash today at the cost of surrendering some basis thereby deferring tax to the future.

Note, however, that the statutory response to the "coupon stripping" problem, *supra* note 42, permits the owner to offset the consideration received for the sale of a single interest coupon by a portion of his basis. I.R.C. § 1286(b)(3) (1986). For a criticism of this result and a suggested alternative approach, see McGrath, *supra* note 42, at 285–86.

It will be demonstrated in Part III that it may be desirable to allow basis to be applied against consideration received for the sale of a present interest in some cases, but not others. To achieve this result, income tax consequences must be based on a theory more flexible than the rigid spatial division analogue. *See infra* text accompanying notes 200–05.

130. The amount received is treated as a prepayment of income to be included in income in full when received. *See* Estate of Stranahan v. Commissioner, 472 F.2d 867 (6th Cir. 1973). Thus, tax accounting rules cause K to be taxed on the income when received rather than as earned. *See supra* notes 121–22 and accompanying text. If she were taxed on the income as earned, she would be taxed on only $75,131 in 1988, $82,645 in 1989, and $90,909 in 1990. *See supra* note 23.

131. I.R.C. § 61 (1986).

132. *See supra* text accompanying note 118.

133. *See supra* notes 35–36 and accompanying text.

134. *See supra* text accompanying notes 79–106.

135. If K were allowed to apply a proportionate amount of her basis against the proceeds of sale, then the failure to tax her on the accretion in the reversion would put her in the same position she was in when she purchased a remainder interest from J with respect to the amount and timing of taxable income. *See supra* text accompanying note 110.

c. *Summary*

The amount of taxable income derived by K under current law when she sells a present interest is as follows:

	Income from Property	Income from Sale Proceeds
1988 —	0	$248,685
		24,869
1989 —	0	27,356
1990 —	0	30,090
Total Income		$331,000

Because K must include the total consideration in income on receipt and cannot recover any basis at the time of sale, her income is accelerated relative to the economic benefits she derives.[136]

3. *Income Tax Consequences to Buyer (J)*

a. *Income After Purchase*

If J buys a present interest from K, J will derive returns from two different sources during 1988, 1989, and 1990. First, he will earn returns on that portion of his original $1,000,000 which remains after he acquires the present interest. These returns will obviously be taxed to him annually.

In addition, J will receive the returns generated by the property for the duration of the present interest. If a sale of a present interest were equated to a spatial division, only a portion of the income generated during the period of the present interest would be taxed to J and the balance would be taxed to K.[137] Under existing law, however, when K sells a present interest to J, K is regarded as transferring the rights to enjoyment encompassed in the present interest to J, and J is taxed on such enjoyment when it is derived.[138] Thus, J will be taxed on the returns he receives from the property in each year.

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136. *See supra* text accompanying note 118.

137. *See infra* text accompanying notes 199–205.

138. *See, e.g.*, Estate of Stranahan v. Commissioner, 472 F.2d 867, 868 (6th Cir. 1973).

Under unusual circumstances, a sale of a present interest has been recast as a borrowing by K of the funds J is purportedly using to purchase the present interest whereby K is treated as using the income generated by the property for the duration of the purported present interest to repay the loan to J. *See* Martin v. Commissioner, 469 F.2d 1406 (5th Cir. 1972), *aff'g without opinion* J.A. Martin, 56 T.C. 1255 (1971); Hydrometals, Inc. v. Commissioner, 485 F.2d 1236 (5th Cir. 1973), *aff'g per curiam* Hydrometals, Inc., 31 T.C.M. (CCH) 1260 (1973), *cert. denied*, 416 U.S. 938 (1974). Under this scenario, the entire income from the property is taxed to K rather than J and the only taxable income derived by J is that part of each payment from K that is deemed to be interest. Because K is allowed a deduction for the interest portion of each payment, the net effect of the approach is to allocate the income from the property between J and K. For a criticism of the manner in which this approach has been applied, see Joyce & Del Cotto, *supra* note 37, at 167–76. The government would only take this position under unusual circumstances because the effect is to defer income that would otherwise immediately be taxable to K. Because J's basis in a purchased present interest is amortizable, *infra* text accompanying notes 139–43, it might appear that it would make little difference from J's standpoint whether the transaction is treated as a purchase of a present interest or a loan to K. In the case of a loan, J would be taxed only on the interest element. In the case of a sale, J would be taxed on the entire income but J is allowed an annual offset to such income of a portion of his basis in the present interest. A difference does arise, however, because whereas in the case of

b. *Recovery of Basis*

J will establish a cost basis in the purchased present interest.[139] If a sale of a present interest were equated to a spatial division, J would not be allowed to recover his tax basis as the present interest declined in value because his basis would be associated with the underlying nonwasting property.[140] Under existing law, however, the purchaser of a present interest *is* allowed to amortize his basis over the anticipated duration of the present interest.[141] J is generally allowed to recover his basis at a constant rate[142] rather than in an amount equal to the annual decline in value of the present interest. As a result, J recovers his basis at a rate in excess of the annual decline in value of the present interest.[143]

c. *Summary*

The amount of taxable income derived by J under current law when he purchases a present interest is as follows:

	Income from Property Less Amort. Deduction	Income from Retained Funds	Total
1988 —	$100,000	$75,131	
	(82,895)		$92,236
1989 —	110,000	82,645	
	(82,895)		109,750
1990 —	121,000	90,909	
	(82,895)		129,014
Total Income			$331,000

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a loan the amount of interest would be larger in the early years and smaller in the later years, amortization of a present interest is generally allowed on a straight line basis. *See infra* note 142.

139. ..R.C. § 1012 (1986).

140. *See supra* text accompanying notes 55–56.

141. Where the present interest is a life estate, amortization is allowed over the period of the measuring life. *See, e.g.*, Sohosky v. Commissioner, 57 T.C. 403 (1972), *aff'd*, 473 F.2d 810 (8th Cir. 1973); Manufacturers Hanover Trust v. Commissioner, 28 T.C.M. (CCH) 692 (1969), *aff'd*, 431 F.2d 664 (2d Cir. 1970); Hrobon v. Commissioner, 41 T.C. 476 (1964). In the case of a purchase of a present interest, amortization is allowed over the duration of the term. *See, e.g.*, Gordon v. Commissioner, 85 T.C. 309, 322 (1985); I.R.C. § 178 (1986).

142. *See* I.R.C. § 167(c) (1986). In those instances in which the permissible method of amortization can be .certained, the straight-line method is the method employed. *See* Manufacturers Hanover Trust Co. v. Commissioner, 28 T.C.M. (CCH) 692 (1969), *aff'd*, 431 F.2d 664 (2d Cir. 1970) (life estate in trust); Bell v. Harrison, 108 F. Supp. 300 (N.D. Ill. 1952), *aff'd*, 212 F.2d 253 (7th Cir. 1954); Grant v. United States, 202 F. Supp. 608 (W.D. Va. 1962). *But see* Wolff v. Commissioner, 7 T.C. 717 (1946) (amortization deduction limited to income generated).

The straight-line method of amortization is the tax accounting convention responsible for distorting the income of the purchaser of a present interest.

143. Where the value of property remains constant, the value of a present interest in such property will decline at an accelerated rate with the passage of time. *See supra* note 32. If basis is recovered at a constant rate over the duration of the present interest, the resulting annual deduction will initially exceed, and subsequently trail, the decline in value of the present interest.

Because J is allowed to recover his basis at a rate in excess of the annual decline in value of the reversion, his income is deferred relative to the net economic benefits he derives.[144]

D. *Joint Purchase*

In examining temporal divisions, it has been assumed that either J or K acquires the property and subsequently effectuates a temporal division by selling either a remainder interest or a present interest to the other. With foresight, however, J and K could acquire their interests simultaneously from the original owner of the property in which case J would acquire the present interest for $248,685 and K would acquire the remainder interest for $751,315.[145]

When the motivation for a temporal division is estate tax savings, the joint purchase is the preferred approach.[146] Based on the foregoing discussion, it also appears that a joint purchase creates the best of both worlds for J and K from an income tax standpoint because each party is in the position of a buyer. Consequently, K is able to derive the same economic benefits she would have derived in the absence of a temporal division without being taxed on the increase in value of the remainder interest she acquires.[147] J, on the other hand, is able to derive the same economic benefits he would have derived in the absence of a temporal division while deferring some of the income corresponding to those benefits.[148]

In summary, the amount of taxable income derived by K under current law when K purchases a remainder interest in a joint purchase transaction appears to be as follows:

	Income from Accretion in Remainder	Income from Retained Funds
1988 —	0	$24,869
1989 —	0	27,356
1990 —	0	30,090
Total Income		$82,315

The amount of taxable income derived by J under current law when J purchases a present interest in a joint purchase appears to be as follows:

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144. *See supra* text accompanying note 115.

145. *See supra* notes 29, 112, and accompanying text.

146. Fewer risks exist with respect to the estate tax goals. The fair market value of the property at the time of the temporal division is established with certainty in light of the sale of the entire property by an unrelated third party. Moreover, the purchaser of the present interest is arguably outside the scope of I.R.C. § 2036 because he never owned the entire property. *See supra* notes 17–18; Zaritsky, *supra* note 9, at ¶1602.1–.2; Oshins, *supra* note 9, at 39; *Practical Drafting, supra* note 18, at 895. From an income tax standpoint, the joint purchase avoids the problem of basis recovery by the seller of a remainder interest. *See supra* text accompanying notes 55–70.

The joint purchase is also the preferred approach for income tax purposes when the underlying property is wasting. *See infra* Part IV.

147. *See supra* text accompanying notes 76–110.

148. *See supra* text accompanying notes 137–43.

	Income from Property Less Amort. Deduction	Income from Retained Funds	Total
1988 —	$100,000	$75,131	
	(82,895)		$92,236
1989 —	110,000	82,645	
	(82,895)		109,750
1990 —	121,000	90,909	
	(82,895)		129,014
Total Income			$331,000

E. *Summary*

Based on the assumptions employed in the Model, J and K are in identical economic positions regardless of whether, or how, a temporal division is effectuated. Also, income tax consequences are consistent with economic consequences in the absence of a temporal division. Inconsistencies arise, however, when a temporal division is effectuated.

When J sells K a remainder interest, J is taxed on income in excess of the economic benefits he derives because he cannot amortize his remaining tax basis. K, however, derives economic benefits in excess of the income on which she is taxed because she is not taxed on the increasing value of her remainder interest.[149] When K sells J a present interest, K is taxed on income before the corresponding economic benefits are derived because she must include the total consideration in income on receipt. J, on the other hand, derives economic benefits before he is taxed on the corresponding income because he is allowed to amortize his basis at a constant rate.[150] In Part III, a framework will be developed to reconcile these inconsistencies.

III. FRAMEWORK FOR RECONCILING INCONSISTENCIES

Distortions in the amount and timing of income to both seller and buyer result from a temporal division. Established tax accounting conventions explain the distortions that result from the sale of a present interest.[151] The problems associated with a sale of a future interest cannot be explained so easily. A trend appears to be developing whereby the income tax consequences of a sale of a future interest are established by equating the transaction to a spatial division. Any inclination to extend the spatial division analogue should be resisted because it will neither correct existing distortions nor justify these distortions. Instead, the spatial division analogue should be abandoned in its entirety and an alternative analytical framework should be developed from the guiding principle that a temporal division represents *no* division of property whatsoever.

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149. The same result occurs when K purchases a remainder in a joint purchase. *See supra* text accompanying note 147.

150. The same result occurs when J purchases a present interest in a joint purchase. *See supra* text accompanying note 148.

151. *See supra* notes 121–22, 141–43, and accompanying text. For a discussion of the extent to which these distortions are justified, see *infra* text accompanying notes 199–209.

A. *Shortcomings of Spatial Division Analogue*

The sale of a remainder interest leads to distortions in income for two reasons. First, the seller is apparently unable to amortize that part of his tax basis not recovered at the time of sale.[152] This problem will exist as long as a sale of a remainder interest is equated to a spatial division.[153] Secondly, the buyer is able to exclude from income the increase in value of the remainder interest attributable to the passage of time.[154] As introduced in Part II, the key to solving this problem is to recognize that the benefit derived by the buyer is attributable to the time value of money.[155] Even if this relationship is established, however, the buyer will continue to defer income if the sale of a remainder interest is equated to a spatial division.

Commentators have acknowledged that the benefit derived by the purchaser of a remainder interest is attributable to the time value of money.[156] Moreover, time value of money principles have been discussed in connection with the purchaser of a remainder interest in *Jones v. Commissioner*.[157] In that case, the Commissioner was attempting to characterize the gain recognized by the holder of a remainder interest as ordinary income. The holder had sold the interest in anticipation of receiving a distribution of cash.[158] On appeal, the Commissioner claimed that the taxpayer's gain was attributable to interest analogous to original issue discount.[159] The appellate court was "impressed" with the Commissioner's argument and remanded for a determination of "what part, if any, of the gain . . . was in fact the realization of interest discount . . . ."[160] On remand, the Tax Court concluded that an interest element was present because the taxpayer, at the time he purchased the remainder interest, transferred money without the expectation of a reimbursement until some future date. The court quantified the interest by applying a rate of six per cent to the taxpayer's original investment.[161]

Notwithstanding the breadth of the Tax Court's language that an interest element may be present whenever money is transferred without the expectation of a return of value until some future date, the case has not been cited for this proposition by any

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152. *See supra* text accompanying notes 57–70.

153. *See supra* text accompanying notes 55–56.

154. *See supra* text accompanying notes 79–99.

155. *See supra* text accompanying notes 100–04.

156. *See* Blum, *supra* note 14, at 217–18; Joyce & Del Cotto, *supra* note 37, at 128–29, 155–56, 161, 183–84; Land, *supra* note 80, at 280–81.

157. 40 T.C. 249 (1963), *vacated and remanded*, 330 F.2d 302 (3d Cir. 1964), *on remand*, 25 T.C.M. (CCH) 701 (1966).

158. For a more detailed discussion of the facts of *Jones* and the disposition of the lower court, see *supra* text accompanying notes 86–90.

159. Original issue discount is the difference between the "stated redemption price at maturity" and the "issue price" of a "debt instrument." I.R.C. § 1273(a) (1986). In oversimplifed, narrow terms, a newly issued bond may be purchased at a price less than the amount which the issuer promises to pay at maturity because the rate of interest which the bond pays is below that which the market demands. In effect, part of what was contemplated to be principal is converted by the marketplace to interest. *See generally* Canellos & Kleinbard, *supra* note 102, at 565–67.

Under the law which the *Jones* court was applying, the only income tax effect of original issue discount was to insure that that which represented interest was correctly characterized as ordinary income. At that time, the law did not affect the timing of income. I.R.C. § 1232 (1954).

160. Jones v. Commissioner, 330 F.2d 302 (3d Cir. 1964).

161. Jones v. Commissioner, 25 T.C.M. (CCH) 701, 707 (1966).

court in the intervening twenty-one years. Since *Jones* was decided, however, Congress has greatly expanded the scope and operation of the statutory "original issue discount rules" and a relatively small gap remains to be bridged to bring the purchase of a remainder interest within the scope of those rules.[162]

The original issue discount rules are intended to redress income tax disparities when deferred payment transactions do not provide for the payment of interest in a manner consistent with economic reality.[163] The original issue discount rules serve two functions. First, they serve a characterization function. They insure that the portion of the consideration received in a deferred payment transaction which compensates the recipient for the delay in payment is treated as interest and thereby characterized as ordinary income.[164] Second, they cause such income to be reported as it accrues economically, irrespective of when payment is actually made.[165] Thus, the absence of realization is not an impediment to establishing income when the original issue discount rules apply.[166]

Although the scope of the original issue discount rules has been expanded in recent years,[167] the presence of an "evidence of indebtedness" remains a necessary prerequisite for invoking the rules.[168] To use the original issue discount rules to tax the purchaser of a remainder interest on the increasing value of that interest, it would be necessary to find an indebtedness running from the seller to the buyer. Although no actual indebtedness exists,[169] an implied indebtedness emerges when the sale of a remainder interest is equated to a spatial division.

If a discrete part of the property is transferred to the buyer when a remainder interest is purchased, then the balance of the property must be transferred by the time that the remainder vests in possession. The balance of the property is necessarily transferred because the buyer has acquired all ownership rights in the underlying property when the present interest terminates. Because it is certain that the buyer will ultimately own the entire property at the time that the remainder is acquired,[170] it is

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162. The term "original issue discount rules" is a shorthand reference to Part V of Subchapter P of the Internal Revenue Code. I.R.C. §§ 1271–88 (1986). The scope of the provisions is broader than the term suggests in that the provisions also apply to market discount. I.R.C. §§ 1276–78 (1986).

163. For a discussion of the problem and the Congressional response through 1982, see Canellos & Kleinbard, *supra* note 102, at 565. For a discussion of the impact of subsequent changes in the law, see Lokken, *The Time Value of Money Rules*, 42 TAX L. REV. 9 (1986); D. GARLOCK, A PRACTICAL GUIDE TO THE ORIGINAL ISSUE DISCOUNT REGULATIONS (1987).

164. Prior to 1969, the exclusive function of the original issue discount rules was characterization. I.R.C. § 1232 (1954). *See generally* Canellos & Kleinbard, *supra* note 102, at 567–68.

165. In 1969, section 1232 was amended to require the accrual of interest on a straight line basis. Pub. L. No. 91-172, 83 Stat. 487 (1969). It was not until 1982, however, that economic accrual of interest was mandated. Pub. L. No. 97-248, 96 Stat. 324 (1982). Economic accrual recognizes that, economically, interest will accrue in perpetually increasing amounts when such interest is not paid as it accrues. This occurs because interest in later periods includes a return on previously unpaid interest. For a discussion of the mechanics of the original issue discount rules, see GARLOCK, *supra* note 163, at 59–90.

166. *See* Land, *supra* note 80, at 240.

167. In 1982, the scope of the provisions was expanded to apply to coupon stripping. I.R.C. § 1232B (1982) (repealed 1984, current version at I.R.C. § 1286). *See supra* note 42. In 1984, the rules were recodified and the scope was expanded to cover market discount and debt instruments issued for property. I.R.C. §§ 1271–88 (1986).

168. I.R.C. §§ 1275(a), 1286(e)(1) (1986).

169. Query whether the common law obligations of the holder of a present interest to the remainder holder with respect to waste might be equated to an "indebtedness." *See* CUNNINGHAM, STOEBUCK & WHITMAN, *supra* note 1, at 163–82.

170. The objections of the *Jones* court to finding the requisite relationship to impute interest related largely to the contingent nature of the remainder interest. *See supra* text accompanying note 87. In contrast, the purchase of a remainder

arguable that the seller becomes obligated at that time to make a deferred payment to the buyer. The deferred payment is in the form of that portion of the property not acquired by the buyer at the time the remainder is purchased. Therefore, a deferred payment transaction can be constructed to which the original issue discount rules could apply.[171] Unfortunately, however, if the purchase of a remainder interest is brought within the scope of the original issue discount rules in this fashion, the rules will not cause income to be reported as it accrues economically. Consequently, distortions in the timing of income will not be eliminated.

Deriving an indebtedness from a spatial division analogue makes it impossible to look to the value of the property at the time the remainder is purchased to quantify the benefit that will ultimately be received by the buyer. That portion of the consideration to be received by the buyer as interest is associated with the part of the property retained by the seller. The value of what the seller retains may change by the time it is transferred to the purchaser when the remainder vests in possession. Uncertainty as to the value of the deferred consideration does not bar the application of the original issue discount rules.[172] The provisions have been interpreted as not serving an economic accrual function, however, when the consideration ultimately to be received cannot be ascertained at the time the debt arises. The approach is to wait until the actual amount of consideration can be ascertained and, at that point, to characterize that part of the consideration representing interest as ordinary income.[173]

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interest from the owner of the property in the absence of contingencies eliminates the uncertainty that the purchaser of the interest will ultimately receive the property.

171. To activate the rules, the transaction would have to be brought within their scope by section 1286, which deals with "stripped bonds." To achieve this result, the seller's obligation would have to be within the scope of a "bond" which is defined to include, "any evidence of indebtedness." I.R.C. § 1286(e) (1986).

The Treasury has been granted authority to promulgate legislative regulations under the original issue discount rules. I.R.C. § 1275(d) (1986). The proposed regulations define "evidence of indebtedness" as "a bond, debenture, note, certificate or other evidence of indebtedness, including all rights to deferred payments under a contract." Prop. Reg. § 1.1275-1(b)(1) (1986). It is unclear whether "all rights to deferred payments under a contract" is intended to define that which is within the scope of an evidence of indebtedness or merely applies to items that already constitute an indebtedness. If the phrase is definitional, any agreement to make a deferred delivery of property could be subject to the original issue discount rules. *See* Walter & Strassen, *Innovative Transactions—Contingent and Adjustable Stock in a Public Context,* 65 Taxes 439, 442–43 (1987). For a summary of the various contexts in which courts have construed the term, see Jamison v. United States, 297 F. Supp. 221, 227–32 (N.D. Cal. 1968), *aff'd per curiam,* 445 F.2d 1397 (9th Cir. 1971). Although no court has taken great liberties with the term, the Tax Court has implied that the term should be interpreted broadly. *See* Wilson v. Commissioner, 51 T.C. 723 (1969).

It would not be possible to bring the transaction within the scope of the original issue discount rules under section 1274 which applies to debt instruments given in consideration of the sale or exchange of property because the only consideration provided by K is cash and cash is not within the definition of "property" for this purpose. Prop. Reg. § 1.1274-1(a)(1) (1986).

172. The original issue discount rules apply to debt instruments that provide for contingent payments. Prop. Reg. § 1.1275-4(a) (1986). Ambiguity exists as to what is contemplated by the regulations with regard to a "contingency." The term is defined by exclusion. *See* Prop. Reg. § 1.1275-4(b) (1986). It is clear, however, that the regulation does apply to the situation where the contingent payment is provided for cash. *See* Prop. Reg. § 1.1275-4(a) (1986).

The fact that contingent payment situations are now contemplated to be within the scope of the statute eliminates several of the reservations expressed by the court in *Jones* to applying the original issue discount rules to the sale of a remainder interest. *See Jones,* 25 T.C.M. (CCH) 701, 701 (1966).

173. When a contingent payment is provided for, it is includable in gross income by the holder and deductible from gross income by the issuer in their respective taxable years in which the amount of the payment becomes fixed. Prop. Reg. §§ 1.1275-4(e)(3), 1.1275-4(f)(2) (1986).

Because the purchaser of the remainder interest (the holder) is receiving value equivalent to the cash consideration she provides at the time of the purchase, the entire value of the balance of the property would be treated as interest. *See* Prop. Reg. § 1.1275-4(e)(1) (1986).

No effort is made, however, to apply the economic accrual function to transactions involving contingent, deferred payments.[174]

Although the Model employed in Part II assumes that the value of the subject property remains constant for the duration of the retained present interest, this condition cannot be known with certainty at the time the remainder is purchased. Consequently, if a sale of a remainder interest is equated to a spatial division and the seller is obligated to make a deferred payment of the balance of the property to the buyer when the remainder vests in possession, then the amount of the consideration the buyer will ultimately receive is not determinable until the property vests in possession. Because the deferred consideration cannot be quantified until this time, the original issue discount rules will not cause the buyer of the remainder to be taxed each year on the increase in value of the remainder.[175]

B. *Introduction of No Division of Property Theory*

The foregoing analysis reveals that equating a temporal division to a spatial division will not eliminate the most serious income tax inconsistencies existing under current law. Although the spatial division analogue conveniently resolves the threshold income tax question raised by the sale of a remainder interest,[176] a sale of a present interest or a future interest does not, in essence, comport with a spatial division. The analogy does not facilitate a finding of the conceptually correct result when applied to other income tax issues raised by these transactions.[177] Consequently, the spatial division analogue should be abandoned in its entirety.

When a remainder interest is sold, the entire property should be regarded as remaining with the seller until the retained present interest expires. At that point, the entire property is transferred to the purchaser of the remainder. As will be demonstrated, this "no division of property" theory leads to results that are conceptually correct with respect to all income tax issues raised by the sale of a remainder interest. Moreover, in contrast to the spatial division analogue, the no division of property theory can also be applied in a logical fashion to ameliorate the income tax inconsistencies associated with the sale of a present interest. Finally, the theory serves to correct existing inconsistencies in the case of a joint purchase.

The spatial division analogue also presents the practical problem of determining the value of the property when the remainder vests in possession. Unless the property is publicly traded, an appraisal would be necessary.

174. The economic accrual function does apply to contingent payment transactions that are contingent only as to time or that call for fixed or minimum payments within a specified time period. *See* Prop. Reg. §§ 1.1275-4(b)(2), 1.1275-4(d) (1986). For alternative approaches to dealing with the contingent payment problem, see Land, *supra* note 80, at 283–305.

175. If the original issue discount rules were to apply to this situation, the seller of the remainder interest would recover that portion of his tax basis that he was not able to recover at the time of sale because the original issue discount rules treat the deferred consideration provided by the seller as interest paid to the buyer. *See* I.R.C. § 163 (1986). When the contingent payment rules apply, however, the seller's deduction, like the buyer's income, is deferred until the contingency is resolved. Prop. Reg. §§ 1.1275-4(e)(3), 1.1275-4(f)(2) (1986).

176. As previously indicated, treating a sale of a remainder interest as a spatial division does lead to the correct result with respect to the amount of the seller's gain or loss. *See supra* text accompanying notes 38–54.

177. *See supra* Part II.

1. *Sale of a Future Interest*

a. *Income Tax Consequences to Buyer (K)*

Returning to the Model developed in Part II, when K buys a remainder interest from J, J and K should be bargaining over their expectations as to the value of the property at the time the remainder interest is expected to vest in possession. If J can earn an annual return of ten percent on his money, he would be foolish to accept only $751,315 for the remainder interest if he felt the property would be worth more than $1,000,000 on December 31, 1990.[178] Similarly, if K can earn an annual return of ten percent on her money, she would be foolish to pay as much as $751,315 if she felt the property would be worth less than $1,000,000 on December 31, 1990.[179] Thus, in an arm's length transaction, the remainder interest should be sold at a price equal to the anticipated value of the property on December 31, 1990, discounted at a rate of ten percent per annum. In the Model, the anticipated value of the property on December 31, 1990 is $1,000,000.

It is of course possible that the property will be worth more than $1,000,000 on December 31, 1990. To the extent that the value of the property exceeds $1,000,000, however, it represents value over which the parties did not bargain. The excess is asset appreciation that should not be taxed until the property is sold or exchanged.[180] The receipt of the property by K when the remainder vests in possession does *not* constitute such a sale or exchange. Rather, it simply represents delivery of property for which K previously paid. Hence, consistent with current law, K does not derive a gain from property when the remainder vests in possession.[181]

At the same time, however, the difference between the anticipated future value of the property and the $751,315 paid by K represents bargained for compensation which the parties contemplated K would receive for surrendering her money in advance of receiving the property.[182] For income tax purposes, the parties generally should be bound by their original arrangement irrespective of the value of the property when the remainder vests in possession.[183] Specifically, K should be treated

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178. When $751,315 is invested on January 1, 1988, to return 10% per year and all returns are reinvested, the $751,315 will have grown to $1,000,000 by December 31, 1990. *See supra* note 24. Because it is assumed that all investments generate an annual return of 10%, the value of the property will increase only if it generates more than $100,000 of income per year. If the amount of income generated by the property increases during the period of the retained present interest, J will derive an additional benefit from the higher returns he receives for the duration of the retained present interest, but it is unlikely that this will compensate J fully for the additional value in the underlying property.

179. *See supra* note 178.

180. I.R.C. § 1001(a) (1986).

181. If K bought an option on January 1, 1988 to acquire property for $1,000,000 on December 31, 1990 and the property was worth more than $1,000,000 on that date, K would not have income when the option was exercised. *Cf.* Alley v. United States, 12 A.F.T.R. 2d 5436 (D. Ind. 1963). In the case of a purchase of a remainder interest, K need not commit an act as affirmative as exercising an option for all rights to the property to inure to her. *See supra* note 4.

182. The purchase of a remainder interest essentially involves a prepayment for the future delivery of property. *See* Land, *supra* note 80, at 280–81.

183. Based on the assumptions in the Model, this creates no great hardship to K because the value of the property when ultimately received by K is equal to the value over which the parties bargained. No hardship would be created if the property were to increase in value, but a hardship would be created where the property declines in value. For consideration of whether it is justifiable to hold the parties to their original bargain when such a hardship might be suffered, see *infra* text accompanying notes 223–30.

as transferring $751,315 to J on January 1, 1988 in exchange for the anticipated future receipt of property worth $1,000,000 on December 31, 1990. The difference, quite clearly attributable to the time value of money, should be regarded as accruing to K with the passage of time. The increase in the value of K's interest should be taxed to K annually, based on statutory principles which establish a precedent for relaxing realization under these circumstances.[184]

Assuming that interest is imputed to K at a rate of ten percent per year, the income tax consequences to K of the purchase of the remainder interest would mirror the economic consequences of the transaction.[185] K would report interest income of $75,131 in 1988, $82,645 in 1989, and $90,909 in 1990.[186] In addition, K would continue to be taxed on the annual returns from that portion of her original funds that were not used to purchase the remainder.[187] Thus, the income tax consequences to K would be as follows:

	Income from Accretion in Remainder	Income from Retained Funds	Total
1988 —	$75,131	$24,869	$100,000
1989 —	82,645	27,356	110,000
1990 —	90,909	30,090	121,000
Total Income			$331,000

b. *Income Tax Consequences to Seller (J)*

Turning to J, it is necessary to ascertain the impact of the no division of property theory on the threshold question of whether J realizes a gain or a loss when he sells the remainder interest. As previously indicated, the application of the spatial division analogue to this issue led to the instinctively correct result that J should derive neither gain nor loss when he sold the remainder interest to K.[188] Query whether the same result can be derived when analyzing the sale of a remainder interest under the no division of property theory.

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184. When the transaction is analyzed in these terms, the complexity associated with uncertainty surrounding the value of the consideration to be received in the future is avoided. *See* Land, *supra* note 80, at 237 ("intractable nature of the problem"). As previously discussed, the Treasury has essentially conceded that it is generally too difficult to apply economic accrual principles to contingent payment transactions to which the existing original issue discount rules apply. *See supra* notes 172–74 and accompanying text. If the parties are bound to the agreed anticipated future value of the property, no contingency exists as to the value of the deferred consideration. Consequently, it would not be difficult to apply economic accrual principles.

For a discussion of a legislative approach to implement this result, see *infra* text accompanying notes 234–40.

185. If the original issue discount rules under existing law were applied, K will be taxed on the correct amount of income at the correct time (with correct characterization) if the "applicable Federal rate" were equivalent to 10% per year simple interest. I.R.C. § 1274(d) (1986). Based on the interest rate assumptions employed in the Model, it is appropriate conceptually to impute interest at the 10% rate. As will be demonstrated, this approach is appropriate whenever the Tables are utilized to value the remainder interest. *See infra* text accompanying notes 216–30.

186. *See supra* note 23. In the case of a retained life estate, if the life tenant died prematurely, K's income would be accelerated. If the life tenant outlived his life expectancy, K would not be taxed on any amount once the life expectancy was reached.

187. I.R.C. § 61 (1986). *See supra* note 34.

188. *See supra* text accompanying notes 38–54.

Whether J realizes gain or loss in the year of sale depends upon whether J is required to include the consideration he receives in income in the year of sale and the extent to which J is permitted to recover his basis in the year of sale. If J is regarded as retaining the entire property when he sells a remainder interest to K, then the $751,315 he receives in the year of sale represents a prepayment for the future delivery of the property. No contingencies exist as to J's right to these funds since ownership of the property will shift to K by operation of law.[189] Consequently, J will be required to include the $751,315 in income in the year of sale irrespective of J's accounting method.[190]

Because J is required to include in income the consideration he receives in the year of sale, he will avoid gain or loss only if he can recover a proportionate part of his basis in the year of sale. Technically, J would not be entitled to recover his basis until the property is delivered to K on December 31, 1990, regardless of J's accounting method.[191] From a conceptual standpoint, however, this result leads to an undesirable mismatching of income and expense.

Admittedly, the tax law is quite willing to sacrifice transactional consistency to preserve the goal of imposing a tax when cash is received.[192] The two goals tend to be mutually exclusive because prepayments typically involve the receipt of revenues before expenses are incurred.[193] A prepayment for property in which a taxpayer already has a tax basis, however, provides a unique opportunity for preserving the dual goals of insuring that cash is included in income when received and allowing a matching of income and expense.

Because J already has a basis in the subject property when the remainder interest is purchased by K, it is generally sensible to allow J to apply a proportionate part of his basis against the prepayment. The justification for basis recovery is not because a discrete part of the property is transferred when the remainder is purchased. Rather, J would be permitted to recover part of his basis as a matter of convenience in response to the tax accounting convention that ·taxes a prepayment at the time of

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189. Thus, the consideration could not be regarded as a downpayment which might justify excluding the consideration from income until the property was transferred. *See* Rev. Rul. 69–93, 1969-1 C.B. 139 (nominal amount); Jefferson Auto Parking, 22 T.C.M. (CCH) 1341 (1963) (forfeiture in event of subsequent breach by purchaser). Nor could the consideration be excluded in the current year on the theory that K had simply acquired an option. *See* Koch v. Commissioner, 67 T.C. 71 (1976).

190. If J were a cash method taxpayer, he would be required to include the amount in income because it represents cash in hand. I.R.C. § 446(c)(1) (1986). Even if J were an accrual method taxpayer, he would be required to include the payment in income under the claim of right doctrine. North Am. Consol. Oil v. Burnet, 286 U.S. 417 (1932); *see also* Schlude v. Commissioner, 372 U.S. 128 (1963); American Auto. Ass'n v. United States, 367 U.S. 687 (1961). None of the limited statutory exceptions to current reporting of income would apply in this situation. *See* I.R.C. §§ 455 (prepaid subscription income), 456 (prepaid membership dues) (1986). *See also* Rev. Proc. 71-21, 1971-2 C.B. 549 (deferral of advance payments for services); Treas. Reg. § 1.451-5 (1986) (deferral of advance payments on sale of goods).

191. As a cash method taxpayer, J is not entitled to a deduction until payment is made (i.e., the property is delivered). I.R.C. § 446(c)(1) (1986). If J were an accrual method taxpayer, J would not be entitled to a deduction until economic performance occurs (i.e., the time the property is provided to K). I.R.C. § 461(h) (1986).

192. *See* RCA Corp. v. United States, 664 F.2d 881 (2d Cir. 1981), *cert. denied*, 457 U.S. 1133 (1982); Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1969). *See generally* Note, *Protecting the Public Fisc: Fighting Accrual Abuse with Section 446 Discretion*, 83 Colum. L. Rev. 378 (1983).

193. Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1969).

receipt.[194] In other words, perhaps this is a situation where two conceptual wrongs make a practical right.[195]

If J is allowed to recover a proportionate part of his basis at the time of sale, the no division of property theory facilitates the recovery of J's remaining basis as the retained present interest expires. J's obligation to transfer the entire property to K in the future creates the potential for J to accrue an annual interest expense which corresponds to the annual interest income imputed to K.[196] The effect is to allow J to recover his remaining basis in a tax deductible manner consistent with the annual decline in the value of the retained present interest.[197] Consistent with existing law, J would be taxed on the income from the property for the duration of the retained present interest because the entire property remains with him during this period.[198] Thus, the income tax consequences to J would be as follows:

	Income from Property Less Interest Deduction	Income from Sale Proceeds	Total
1988 —	$100,000	$75,131	
	(75,131)		$100,000
1989 —	110,000	82,645	
	(82,645)		110,000
1990 —	121,000	90,909	
	(90,909)		121,000
Total Income			$331,000

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194. For a recent illustration of a liberal approach to cost recovery where corresponding income is prematurely accelerated in a different context, see Rotolo v. Commissioner, 88 T.C. 1500 (1987) (corporate taxpayer using the completed contract method of accounting that was required to include in income at the time of liquidation advance payments received under certain incomplete contracts was allowed to offset such income by the cost of certain inventory on hand at the time of liquidation).

195. Because recovery of basis would be allowed as a rule of convenience, it would not be necessary to allow basis recovery in all cases. For example, it might be desirable to allow basis recovery only where the anticipated duration of the retained present interest is not so long as to result in the allocation of nominal value to the transferred remainder. *See infra* text accompanying notes 248–52.

An alternative to this rule of convenience is to retain the spatial division analogue for the limited purpose of quantifying the income of the seller when a temporal division occurs. This approach is preferable to any approach that would not allow the seller of a remainder to recover basis at the time of sale. From a conceptual standpoint, however, it is not as satisfying as a uniform framework that can be applied in a consistent fashion to all tax issues raised by the sale of a temporal interest.

196. This is consistent with the existing original issue discount rules which apply to both lender and borrower. *See supra* note 173.

197. This would presumably be treated as "investment interest." The limitation on the deductibility of investment interest should not have an adverse impact on J, however, because the interest expense would not exceed the investment income generated by the consideration provided by K. I.R.C. § 163(d) (1986).

J's net deduction should be limited to his basis. To the extent that J's basis was less than the fair market value of the property at the time that the remainder interest was sold, J would essentially be treated as using appreciated property to pay interest which would trigger a gain thereby resulting in a net deduction limited to J's basis. *See, e.g.*, International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943) (payment of compensation with appreciated property generating taxable gain which offsets deduction for compensation). Whereas the interest deduction will be ordinary, the gain from the property may be capital. *See supra* note 11. As a practical matter, it might be preferable to allow the seller to recover his remaining basis at a constant rate. *See infra* text accompanying notes 241–47.

In the case of a retained life estate, if J died prematurely, the deduction would be accelerated. Alternatively, if J outlived his life expectancy, no further deduction would be allowed. *See supra* note 186.

198. *See supra* text accompanying notes 71–73.

2. *Sale of a Present Interest*

If the no division of property theory represents a conceptually correct view of a sale of a future interest then it should also lead to sensible results when applied to the sale of a present interest. As will be demonstrated, the no division of property theory can be used to ameliorate the timing of income problems that arise when a present interest is sold.

a. *Income Tax Consequences to Seller (K)*

When K sells a present interest to J, the underlying property should be regarded as remaining with K. It is true that the value of K's interest in the property declines when the present interest is sold.[199] This is not because some discrete part of the underlying property has been transferred, however, but rather because rights to enjoyment which may be regarded as different and distinct from the physical property have been transferred.

Because tax accounting rules dictate that the taxpayer is to include cash in income when received, the consideration K receives for the present interest must be reported by her in the year of receipt.[200] This causes K to be taxed on income before she derives a corresponding economic benefit.[201] Under certain circumstances, K should be afforded relief from reporting the entire consideration in income. A rule of convenience comparable to that which would allow the seller of a remainder interest to recover basis in the year of sale should apply to the sale of certain present interests.[202] Specifically, where the present interest is of sufficient duration to capture a very substantial portion of the value of the underlying property, K should be allowed to apply a proportionate amount of her basis in the underlying property against the consideration provided by J to measure her income in the year of sale.[203]

The no division of property theory is sufficiently flexible to accommodate such a rule of convenience. The flexibility of the theory is in marked contrast to the spatial division analogue which, if applied to the sale of a present interest, would dictate basis recovery in all instances, irrespective of the magnitude of the present interest.[204]

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199. *See supra* text accompanying note 118.

200. *See supra* notes 121–22 and accompanying text. It would be incorrect to suggest that the assignment of income doctrine enables K to refrain from including the prepayment in income until the rights to enjoyment which K transferred to J ripen in J's hands. *See* Joyce & Del Cotto, *supra* note 37, at 176–79.

201. *See supra* text accompanying notes 119–36.

202. *See supra* text accompanying notes 191–95.

203. This also helps to explain the apparent inconsistency under current law created by the few courts which have sanctioned basis recovery in the case of a sale of a present interest. *See supra* note 124.

In any situation in which K is permitted to recover basis at the time of sale, K should be taxed on the accretion in the value of the reversion in a fashion similar to which K is taxed on the accretion in the value of the remainder when a remainder interest is purchased. *See supra* text accompanying notes 182–86. This would have the secondary effect of re-establishing in K that part of the basis that was recovered at the time of sale by the time that the reversion vests in possession.

204. *See supra* text accompanying notes 126–29. For the sake of uniformity, however, it is important that the rule of convenience which is developed to allow basis recovery in the case of a sale of a present interest be applied consistently to the sale of a remainder interest. For example, if a sale of a present interest which represents at least 85% of the value of the underlying property justifies basis recovery, then basis recovery should only be justifed in the case of a sale of a remainder interest which represents more than 15% of the value of the underlying property. In the case of a particular

The no division of property theory would not impact on the returns generated by the consideration provided by J which would continue to be taxed to K in accordance with existing law.[205]

b. *Income Tax Consequences to Buyer (J)*

Under the no division of property theory, the buyer of a present interest can be regarded as acquiring rights to future enjoyment at the time the present interest is purchased.[206] Thus, it remains appropriate to tax J on the income derived from the property as those rights ripen.[207] Moreover, in accord with existing law, J should be allowed to recover the cost he incurs in acquiring the rights to future income as such income is generated.[208] Finally, the returns generated by the part of J's original funds not used to purchase the present interest would continue to be taxed to J.[209]

3. *Joint Purchase*

The no division of property theory also solves the most significant income tax problem associated with a joint purchase. The problem involves the ability of the purchaser of the remainder interest to exclude from current income the annual increase in value of the remainder interest.[210] The no division of property theory solves this problem similarly to the manner in which it solves the analogous problem which arises when K buys a remainder interest directly from J.[211]

When K purchases a remainder interest from J, interest income can be imputed to K with respect to J's obligation to transfer the entire property to K at the expiration of the present interest.[212] It is possible to construct an analogous obligation to K in a joint purchase arrangement, although the obligation runs from the third party owner, rather than from J.

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temporal division, basis recovery should only be allowed with respect to either the resulting present interest or the resulting future interest in any particular case. *See infra* text accompanying notes 248–52.

The same approach would apply where the present interest is a life estate of uncertain duration because the value of the life estate would be based on anticipated life expectancy. Note that this approach represents a departure from the allocation of basis rules under the stripped bond provision where basis is allocated between corpus and interest coupons in a purely mechanical fashion based on relative fair market values. I.R.C. § 1286(b)(3) (1986). *See supra* note 42. For a criticism of this aspect of the original issue discount rules and a suggestion that basis recovery should only be permitted where interest coupons representing a threshold value are transferred, see McGrath, *supra* note 42, at 285–86.

205. *See supra* text accompanying note 131.

206. *See supra* text accompanying notes 138, 199.

207. *See supra* text accompanying note 138.

208. Existing law could be improved upon, however, by developing a method of amortization which would allow for basis recovery consistent with the annual decline in value of the present interest in contrast to the straight-line method of amortization which tends to accelerate the deductions. *See supra* notes 141–43 and accompanying text. As a practical matter, however, it is more convenient to continue to allow straight-line amortization. *See infra* text accompanying notes 246–47.

209. I.R.C. § 61 (1986).

210. *See supra* text accompanying note 147. For a discussion of the problems associated with a joint purchase of wasting property, see *infra* Part IV.

211. *See supra* text accompanying notes 178–86.

212. *See supra* text accompanying notes 182–84.

In the case of a joint purchase, the allocation of the total purchase price between J and K stems from a bargain based on expectations identical to those which determined the purchase price of K's remainder when J purchased the entire property.[213] In the case of a joint purchase, however, neither J nor K initially owns the entire property. Rather, each of J and K provides his or her share of the consideration to a third party owner who is only interested in the total purchase price. The owner may, in fact, have expectations different from those that influenced the allocation of value between J and K. Nevertheless, J and K each deals directly with the third party owner.

Consequently, the purchase of the remainder interest by K for $751,315 should be viewed as creating a momentary obligation on the part of the third party owner to transfer property anticipated to be worth $1,000,000 on December 31, 1990 to K.[214] This provides an adequate obligation from which interest can be imputed for the duration of the retained present interest notwithstanding that the third party owner's obligation is immediately extinguished by virtue of the sale of the present interest to J.[215]

C. *Departure from the Fictional World of the Model*

The foregoing analysis reveals that the no division of property theory will serve to establish income tax consequences consistent with the economic consequences of a temporal division in the world of the Model. It is now necessary to consider the extent to which the real world differs from the Model.

The world of the Model entails two unrealistic assumptions. First, it was assumed that all investments will generate a taxable return of ten percent per year during the three year period considered. Obviously, investment choices will always be available which generate different rates of return because return is a function of the risk associated with the investment.[216] Moreover, interest rates associated with a given level of risk may fluctuate over time as a result of changes in market conditions.

Prior to considering the impact of the above considerations on the no division of property theory, it is critical to recognize that an identical interest rate assumption is employed in the world in which most temporal divisions are deemed to occur.

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213. *See supra* text accompanying notes 178–79.

214. Some may object to this on the ground that the third party owner might have been unwilling to sell a remainder interest to K for the amount of consideration K provided but for the fact that J was simultaneously purchasing the present interest. Notwithstanding this possibility, in both form and substance it is the third party owner who is selling to J and K. The income tax consequences should not be affected by whether the third party owner would have chosen to deal separately with either one or the other.

215. *See supra* text accompanying notes 182–84. This is analogous to the situation where J buys the property, sells K a remainder interest on January 1, 1988, and then sells the retained present interest to some other party on January 2, 1988. The subsequent sale of the retained present interest by J would not impact on the income tax consequences of the purchase of the remainder interest by K.

Because the tax consequences to J do not depend on establishing a debtor/creditor-like relationship with the seller, the joint purchase arrangement does not create any additional complexity with respect to J.

The foregoing discussion assumes that neither J nor K, in substance, purchases the entire property. *See* Gordon v. Commissioner, 85 T.C. 309 (1985) (alleged joint purchase held to be in substance purchase of entire property by alleged purchaser of present interest).

216. J. WESTON & E. BRIGHAM, MANAGERIAL FINANCE 653–59 (7th ed. 1981).

Temporal divisions have become popular estate planning devices in recent years.[217] The key to achieving the estate tax savings is the ability to use tables promulgated by the Treasury Department for purposes of establishing the allocation of value between present interests and future interests. These tables currently assume that all assets generate an annual return of ten percent.[218] Consequently, the assumption employed in the Model is not unrealistic in those instances in which the Treasury tables are used to value the respective interests.

It is possible that a temporal division may be effectuated where seller and buyer do not use the Treasury tables to value the respective interests.[219] As previously indicated, in the case of a sale of a remainder interest, the parties should be bargaining over the anticipated value of the property when the remainder vests in possession.[220] This value should be discounted by the parties to present value, based on their assumptions regarding prevailing rates of return for the duration of the retained present interest, to establish a price for the remainder interest. By comparing the future value of the property over which the parties were bargaining to the purchase price of the remainder interest, an appropriate rate can be derived for imputing interest to the buyer. The appropriate rate would be the rate that causes the buyer to be taxed each year on the economic benefit that the parties anticipated the buyer would derive.[221] Because this approach is likely to present insurmountable practical problems, it would probably be more sensible to impute interest at the prevailing market rate.[222]

The second unrealistic assumption employed in the Model is that the value of the property will neither appreciate nor depreciate during the period over which the present interest extends. Appreciation or depreciation during the period of the temporal division would impact on the economic consequences of the transaction. Appreciation or depreciation would not impact on the appropriate income tax consequences because of the requirement that realization must occur before gain or loss from property is reflected in income.[223] Nevertheless, the application of the no division of property theory may create an inappropriately adverse income tax effect in certain instances where the expectations of the parties as to value do not materialize.

As previously indicated, in the case of a purchase of a remainder interest, price should be a function of the anticipated value of the property when the remainder vests in possession.[224] It is the difference between the anticipated value of the property and

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217. *See supra* notes 17–18.

218. Treas. Reg. §§ 20.2031-7(f), 20.2512-5(f) (1983).

219. *See, e.g.*, Hunter v. Commissioner, 44 T.C. 109 (1965).

220. *See supra* text accompanying notes 178–79.

221. As a practical matter, it may be difficult to discern the value of the property over which the parties are bargaining in the case of a sale of a remainder interest in property that is not publicly traded. Even if value can be discerned, other practical difficulties are likely to be confronted where a given interest rate is not assumed.

222. The most logical proxy would be the "applicable Federal rate" which is employed by the original issue discount rules. I.R.C. § 1274(d) (1986).

223. I.R.C. § 1001(a) (1986).

224. *See supra* text accompanying notes 178–79.

the price of the remainder interest which is imputed as interest to the buyer.[225] If the value of the property when the remainder vests in possession is less than the value anticipated by the parties in arriving at their bargain, then the buyer will have included in taxable income an amount in excess of the economic benefit actually derived.[226]

When taxpayers choose to structure transactions in the world created by the Treasury tables, the parties should be bound by all tax consequences which logically result in that world, irrespective of whether the ultimate economic results mirror the assumptions employed by the Treasury tables.[227] Thus, the no division of property theory leads to justifiable income tax consequences where purchase price is determined under the Treasury tables.[228]

It is more difficult, however, to justify the application of economic accrual principles to create periodic income to the buyer of a remainder interest when the Treasury tables are not employed to arrive at the purchase price. Whether the buyer will, in fact, reap the anticipated benefit depends on whether the value of the property when the remainder vests in possession is at least equal to the value that was anticipated by the parties.[229] Consequently, where the purchase price of the remainder interest is not determined under the Treasury tables, it may be appropriate to wait until the property vests in possession and tax the buyer at that time only to the extent that the anticipated economic benefit actually materializes.[230] Thus, although the no division of property theory is helpful in establishing appropriate income tax consequences when the Treasury tables are not employed, the theory should be applied under these circumstances with the flexibility that it facilitates.

D. *Implementation*

The no division of property theory entails a departure from existing law in three principle areas. First, income is imputed to the purchaser of a remainder interest.[231] Second, the seller of a remainder interest is allowed to recover basis associated with the retained present interest.[232] Finally, recovery of basis at the time of a temporal division depends on both the nature and the magnitude of the interest transferred.[233]

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225. *See supra* text accompanying notes 182–86.

226. The buyer would, however, have additional basis in the property to reflect amounts previously taken into income and, therefore, should ultimately derive an offsetting tax loss. Nevertheless, it is unlikely that the loss will offset the tax burden imposed on the interest income due to differences in timing and characterization. Moreover, other loss limitation rules may apply. *See, e.g.,* I.R.C. § 469 (1986).

227. Another alternative is to abandon or refine the Tables. In terms of abandoning the Tables, it is unlikely that an ad hoc approach to valuation is administratively feasible. In terms of refining the Tables, any assumed interest rate will either be too high or too low in particular cases thereby resulting in an inevitable whipsaw problem. *See supra* note 17.

228. The same result should be reached regardless of whether the present interest is an estate for a term of years or a life estate. In the latter case, the Tables essentially make an assumption as to life expectancy and that assumption should bind the parties irrespective of whether the measuring life is, in fact, longer or shorter than what was anticipated. *See supra* note 17.

229. *See supra* note 183.

230. Admittedly, this raises the practical problem of valuing the property at the time that the remainder vests in possession.

231. *See supra* text accompanying notes 178–86.

232. *See supra* text accompanying notes 196–98.

233. *See supra* text accompanying notes 188–95, 199–204.

Congressional action should be taken to cause income to be imputed to the purchaser of a remainder interest.[234] Rather than expanding the scope of the existing original issue discount rules, however, a simpler, more direct statutory approach is preferable. An original issue discount analysis is helpful in understanding why and how the purchaser of a remainder interest should be taxed on the annual increase in the value of the interest. The original issue discount rules, however, are enormously complex.[235] Consequently, they should generally be confined to business transactions involving financial intermediaries with the sophistication and technology to deal with this level of complexity. Congress has recognized this problem in the past and should continue to do so in the future.[236]

The new statutory mechanism should be triggered whenever a remainder interest is purchased.[237] If the Treasury tables are used to value the remainder, interest should be imputed annually to the purchaser of the remainder at the rate specified in the Treasury tables.[238] In the rare instance in which the Treasury tables are not used, interest should be imputed at an estimated market rate.[239] When the Treasury tables are not used, the purchaser generally should not be taxed until the remainder vests in possession.[240]

Congressional action is not needed to enable the seller of a remainder interest to amortize basis not recovered at the time of sale. The seller is barred from amortizing the remaining basis only if a sale of a remainder interest is equated to a spatial division.[241] Congress has not sanctioned this analogy.[242] Moreover, the analogy is conceptually incorrect.[243] Consequently, a court could allow the seller of a remainder interest to recover the remaining basis in the same manner as the purchaser of a present interest is permitted to recover his basis in the present interest.[244] Specifi-

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234. A tenuous argument might be made that a sale of a remainder interest is already within the scope of the original issue discount rules. *See supra* note 171.

235. *See, e.g.*, Lokken, *supra* note 163, at 9.

236. Congress enacted a separate statutory provision to impute interest in the case of below market loans. I.R.C. § 7872 (1986). Under that provision, an original issue discount analysis is generally required in the case of term loans but not in the case of demand loans. Certain intra-family term loans are treated as demand loans. *See* I.R.C. § 7872(a), (b) (1986). The legislative history provides as follows: "[A]n original issue discount analysis is required to determine the income tax consequences of a term loan. By treating gift loans as demand loans for income tax purposes, such analysis is avoided." H.R. CONF. REP. No. 861, 98th Cong., 2d Sess. 1020 n.11 (1984).

An effort to limit the scope of the original issue discount rules to sophisticated transactions can also be inferred from the statutory exceptions to the original issue discount rules. *See* I.R.C. § 1274(c)(3) (1986). The exceptions include sales for $1,000,000 or less of farms by individuals or small businesses, sales of principal residences, and sales involving payments of $250,000 or less. *See generally* Lokken, *supra* note 163, at 81–85.

237. It should not matter whether the seller retains the present interest or sells it as part of a joint purchase. The provision should also be activated whenever the seller of a present interest is allowed to recover basis at the time of sale. *See infra* text accompanying notes 248–52.

238. *See supra* note 17.

239. The applicable federal rate might be used. *See* I.R.C. § 1274(d).

240. *See supra* text accompanying notes 223–30. This liberal rule should not apply, however, to any transaction designed to circumvent the statute.

241. *See supra* text accompanying notes 55–56.

242. *Cf.* I.R.C. §§ 273, 1001(e) (1986) (in case of a gratutitous transfer, basis associated with the present interest may neither be amortized nor recovered on a sale prior to expiration of the present interest). *See supra* note 69.

243. *See supra* Part II.

244. United States v. Georgia R.R. & Banking Co., 11 A.F.T.R.2d 1435, 63-1 U.S.T.C. ¶ 9443 (S.D. Ga. 1963), *rev'd*, 348 F.2d 278 (5th Cir. 1965), *cert. denied*, 382 U.S. 973 (1966); Lomas Santa Fe v. Commissioner, 74

cally, the seller would be allowed to recover his remaining basis at a constant rate over the duration of the present interest.[245] Admittedly, a more perfect conceptual result would be achieved if the seller were required to recover his remaining basis in a manner consistent with the rate at which income is imputed to the buyer.[246] For the sake of simplicity, however, a limited departure from economic reality should be tolerated.[247]

Congressional action is desirable to clarify the circumstances in which a seller is allowed to recover a proportionate part of his basis when a temporal division occurs. Historically, the courts have allowed the seller of a remainder interest, but have generally not allowed the seller of a present interest, to recover basis at the time of sale.[248] The uncertainty created by this ad hoc approach is undesirable. Instead, a simple statutory provision should be enacted. It should be based on the premise that basis recovery should generally be allowed when a remainder interest is sold and should generally not be allowed when a present interest is sold.[249] It should provide for a departure from this general rule in two instances. When the value of the transferred remainder is extremely small relative to the value of the underlying property, no basis recovery should be permitted.[250] Conversely, when the value of the transferred present interest is extremely large relative to the value of the underlying property, the seller should be allowed to recover a proportionate part of his basis.[251] For example, the exception to the general rule might apply to remainders representing less than fifteen percent of the value of the property and present interests representing at least eighty-five percent of the value of the underlying property.[252]

IV. A Special Case: Wasting Property

To this point, it has been assumed that only property of a type which does not deteriorate with the passage of time will be the subject of a temporal division.[253] It is not unusual, however, for a temporal division to be effectuated with respect to wasting property.[254] In contrast to nonwasting property, a temporal division of

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T.C. 662 (1980), *aff'd*, 693 F.2d 71 (9th Cir. 1982), *cert. denied*, 460 U.S. 1093 (1983). *See supra* text accompanying notes 58–68.

245. *See supra* notes 141–42 and accompanying text.

246. *See supra* note 143.

247. In the unlikely event that this were to lead to an abusive situation, corrective legislation could be enacted at a later time.

248. *See supra* text accompanying notes 46–53, 124–25.

249. *See supra* notes 194–95, 202 and accompanying text.

250. *See supra* note 195.

251. *See supra* note 203 and accompanying text. When a seller of a present interest is permitted to recover basis at the time of sale, the statutory mechanism which taxes the buyer of a remainder on the increasing value of the remainder should apply to tax the seller of the present interest on the increasing value of the reversion. *See supra* text accompanying notes 182–86.

252. Under the existing Tables, this rule roughly would allow a seller of a remainder interest to recover basis at the time of sale only if the retained present interest were for a term no longer than 20 years or were measured by the life of an individual who is no younger than 50 years old. Conversely, the rule roughly would allow the seller of a present interest to recover basis at the time of sale only if the transferred present interest were for a term longer than 20 years or were measured by the life of an individual who is under age 50. *See* Treas. Reg. §§ 20.2031-7(f); 20.2512-5(f); *supra* note 17.

253. *See supra* note 21.

254. Wasting property is often the subject of joint purchase arrangements. *See, e.g.*, Zaritsky, *supra* note 9, at ¶¶1601.3(E), 1602.2(C); Oshins, *supra* note 9, at 36–38.

wasting property is analogous to a spatial division to the extent that the property deteriorates during the period over which the present interest extends. If the property deteriorates, the part of the property which deteriorates is enjoyed exclusively by the holder of the present interest. Something less than the entire original property will be enjoyed by the holder of the future interest when the future interest vests in possession.

A temporal division of wasting property raises the same income tax issues as a temporal division of nonwasting property. In addition, a temporal division of wasting property raises the question of how the temporal division impacts upon depreciation deductions that would otherwise be allowed with respect to the property.[255] Much confusion exists about this issue.[256] It is necessary to return to the Model developed in Part II to delineate the parameters of the problem. In Part II, the subject property had a value of $1,000,000 on January 1, 1988 and was nonwasting. Because all investments were assumed to generate a ten percent annual return, the subject property generated an annual income stream in perpetuity of $100,000.[257] For purposes of Part IV, it will still be assumed that the subject property is worth $1,000,000 on January 1, 1988, and that all investments will generate a ten percent annual return during the period from January 1, 1988 through December 31, 1990. It will be assumed further, however, that the subject property will generate a level income stream for only twelve years at which point the property will be worthless.[258] As a result of these assumptions, the annual return generated by the property would be $146,763.[259]

A. *No Temporal Division*

1. *Economic Consequences*

It was demonstrated in Part II that irrespective of the investment selected, each of J and K would derive a return of $100,000 in 1988, $110,000 in 1989, and $121,000 in 1990.[260] Because it was assumed that the property would neither appreciate nor depreciate in value, J and K each had his or her original $1,000,000 in addition to the $331,000 of returns, for a total of $1,331,000, on December 31, 1990. In the case of wasting property, the party who purchases the property should

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255. I.R.C. §§ 167, 168 (1986). *See supra* note 21.

256. *See* Zaritsky, *supra* note 9, at ¶ 1601.3(E); Oshins, *supra* note 9, at 36–38; Leimburg & Schnepper, *supra* note 18, at 982.

257. *See supra* note 178.

258. The assumption is unrealistic but its unrealistic nature does not affect the analysis developed in this Article. Generally, the income generated by wasting property will decline before it disappears.

259. The formula for computing the annual return is as follows:

$$r = \frac{P}{\sum\limits_{t=1}^{n} \frac{1}{(1+i)^t}}$$

where r is the annual level return on an investment of P dollars in property absorbed in n years at the prevailing interest rate i (expressed as a decimal).

260. *See supra* text accompanying notes 23–24.

earn a larger annual return from the property to compensate the purchaser for the annual decline in value resulting from the limited period over which the property will generate its returns.[261] Consequently, the party who purchases the property should still be in an economic position identical to the position of the party who selects an alternative investment. The following illustrates the economic position of the party who purchases the wasting property:

	Property	Cash	Total
Initial Economic Position	$1,000,000		
1988 — Return from Property		$146,763	
— Decline in Value of Property	(46,763)		
Net Economic Position at End of 1988: $1,100,000			
1989 — Return from Property & Reinvested Rtn.		161,439	
— Decline in Value of Property	(51,439)		
Net Economic Position at End of 1989: $1,210,000			
1990 — Return from Property & Reinv. Rtns.		177,583	
— Decline in Value of Property	(56,583)		
Final Economic Position	$845,215	$485,785	$1,331,000

Thus, the larger annual returns compensate the property owner for the annual decline in value of the property resulting in a net return of $100,000 in 1988, $110,000 in 1989, and $121,000 in 1990. Although the owner's final economic position is identical to that of the owner of nonwasting property in Part II,[262] an additional $154,785 in cash compensates for the $154,785 decline in the value of the property.

2. *Income Tax Consequences*

It was demonstrated in Part II that irrespective of which investment alternative was selected, the parties would be taxed on their annual returns.[263] If the owner of wasting property were taxed on the entire annual return derived from the property,

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261. The extent to which the property will decline in value in a particular year can be computed by applying the following formula:

$$d = r \left[\sum_{t=1}^{x} \frac{1}{(1+i)^t} - \sum_{t=1}^{x-1} \frac{1}{(1+i)^t} \right]$$

where d is the decline in value of an investment generating a level return r (*supra* note 259) that will continue to generate its return for x years in a world in which all investments generate an annual return at an interest rate i (expressed as a decimal).

262. *See supra* text accompanying note 24.

263. *See supra* text accompanying note 25.

more of his income would be subject to tax than the owner of nonwasting property, notwithstanding that the economic position of the parties would be identical. To put the owner of wasting property in the same income tax position as the owner of nonwasting property, an offsetting deduction to reflect the annual decline in the owner's investment in wasting property must be allowed.

The income tax law does allow an owner of income-producing wasting property to recover his tax basis prior to disposition of the property at specified rates over specified periods.[264] The cost recovery mechanisms are more a matter of economic policy, however, than an effort to compensate the taxpayer for an actual decline in economic value.[265] For purposes of this analysis, it will be assumed that the wasting property is not designated specifically within any statutory property class and, by default, the taxpayer's basis will be recovered over a period of seven years.[266] For the sake of computational simplicity, it is assumed that the straight line method is employed to calculate the annual deduction to which the taxpayer is entitled.[267] Thus, the owner would be entitled to an annual deduction of $142,857 for seven consecutive years beginning in 1988.[268]

The income tax consequences to the owner of the wasting property would be as follows:

	Income from Property Less Depreciation Deduction	Total
1988 —	$146,763	
	(142,857)	$3,906
1989 —	161,439	
	(142,857)	18,582
1990 —	177,583	
	(142,857)	34,726
Total Income		$57,214

B. *Temporal Division*

1. *Economic Consequences*

As previously indicated, in the case of a temporal division, J and K should be bargaining over the anticipated value of the property at the time the future interest is

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264. I.R.C. §§ 167, 168 (1986). *See supra* note 21. *See generally* Kahn, *supra* note 57, at 1.

265. *See, e.g.,* CHIRELSTEIN, *supra* note 89, ¶ 6.07, at 131; Fribourg Navigation Co. v. Commissioner, 383 U.S. 272, 277 (1966) ("[T]ax law has long recognized the accounting concept that depreciation is a process of estimated allocation . . .").

266. I.R.C. § 168(e)(3)(C) (1986).

267. Under the straight line method, the taxpayer's annual deduction is computed by dividing his tax basis by the number of years over which the basis is to be recovered. As a general rule, the statute permits cost to be recovered with respect to personal property at an accelerated rate unless the taxpayer elects to use the straight line method. I.R.C. § 168(b).

268. $1,000,000/7 = 142,857. His tax basis would be reduced by the annual deduction. I.R.C. § 1016 (1986). Of course, if the taxpayer were to sell or exchange the property prior to the end of the seven years, he would recover his remaining basis at the time of the sale or exchange. I.R.C. § 1001 (1986).

expected to vest in possession.[269] Based on the Model used in this Part IV, the anticipated value of the property at December 31, 1990 is $845,215.[270] Thus, this is the value which should be allocated between the present interest and the future interest. Based on the assumption that all investments will generate a ten percent annual return during the period from 1988 through 1990, the $845,215 should be allocated between J and K in the same proportion that the $1,000,000 was allocated between them in Part II. Specifically, $210,192 should be allocated to J's present interest and $635,023 should be allocated to K's future interest.[271] The balance of the value of the property on January 1, 1988, $154,785, should be allocated entirely to the present interest. This represents the part of the underlying property that will be consumed during the period in which J enjoys the property.

Irrespective of how the temporal division is effectuated, the economic consequences to J over the three year period are summarized as follows:

	Property	Present Interest	Cash
Initial Economic Position	$154,785	$210,192	$635,023
1988 — Return from Property			146,763
— Decline in Value of Property	(46,763)		
— Return on Initial Cash			63,502
— Decline in Value of Present Interest		(63,502)	
Net Economic Position at End of 1988: $1,100,000			
1989 — Return from Property & Reinvested Rtn.			161,439
— Decline in Value of Property	(51,439)		
— Return on Initial Cash & Reinvested Rtn.			69,852
— Decline in Value of Present Interest		(69,852)	
Net Economic Position at End of 1989: $1,210,000			
1990 — Return from Property & Reinvested Rtns.			177,583
— Decline in Value of Property	(56,583)		

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269. *See supra* text accompanying notes 178–79.

Based on the assumptions made in Part II, the value of the property at the time of the temporal division could be used as a proxy for the value over which the parties should be bargaining. In the case of wasting property which is anticipated to decline in value, the use of current value as a proxy for the value of the property when the future interest is anticipated to vest in possession will result in an allocation of too much value to the future interest and too little value to the present interest. Nevertheless, when a temporal division is effectuated to achieve estate tax savings, it is unlikely that the value which the parties choose to allocate will ever be less than the value of the property at the time of the temporal division. This is because estate tax savings will not be achieved if the future interest is undervalued or the present interest is overvalued. *See supra* notes 17–18.

270. *See supra* text accompanying notes 261–62.

271. *See supra* notes 29, 32. (P=$845,215).

— Return on Initial Cash & Reinvested Rtns.			76,838
— Decline in Value of Present Interest		(76,838)	
Final Economic Position	0	0	$1,331,000

The economic consequences to K are summarized as follows:

	Future Interest	Cash
Initial Economic Position	$635,023	$364,977
1988 — Return on Initial Cash		36,498
— Increase in Value of Future Interest	63,502	
Net Economic Position at End of 1988: $1,100,000		
1989 — Return on Initial Cash & Reinv. Rtn.		40,148
— Increase in Value of Future Interest	69,852	
Net Economic Position at End of 1989: $1,210,000		
1990 — Return on Initial Cash & Reinv. Rtns.		44,162
— Increase in Value of Future Interest	76,838	
Final Economic Position	$845,215	$485,785
Final Net Economic Position: $1,331,000		

Thus, J and K are in the same economic position at the end of each year and at the end of the entire period as they were when no temporal division occurred.[272]

2. *Income Tax Consequences*

The foregoing economic analysis demonstrates that a temporal division of wasting property represents, in part, a spatial division if the parties anticipate that the property will decline in value during the period over which the present interest extends. Aside from the income tax issues raised by the spatial division component, a sale of a present interest or a future interest in wasting property raises the same income tax issues as a sale of a present interest or a future interest in nonwasting property. Thus, the framework developed in Part III also applies when the underlying property is wasting. To the extent that a temporal division of wasting property represents a spatial division, however, the additional issues of whether

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272. *See supra* text accompanying note 262.

depreciation deductions should be allowed and, if allowed, to whom such deductions should be allowed, must be resolved.

Commentators have frequently suggested that depreciation deductions should be computed as if no temporal division had occurred and allocated entirely to the holder of the present interest pursuant to Internal Revenue Code section 167(h).[273] Section 167(h) provides in relevant part as follows:

> In the case of property held by one person for life with remainder to another person, the [depreciation] deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee . . . on the basis of the trust income allocable to each.

Section 167(h) makes perfect sense in the case of a temporal division created in a gratuitous fashion.[274] In that situation, a single historical basis is associated with the underlying property and the only question is how depreciation deductions otherwise allowable to the original owner of the undivided property should be allocated between the present interest holder and the future interest holder during the period in which ownership is divided.[275] The original owner's historical basis is reduced to the extent of these deductions and the future interest holder receives the remaining basis, if any, when the future interest vests in possession.[276]

Applying section 167(h) to a sale of a present interest or a future interest, however, essentially puts the cart before the horse. When a present interest or a future interest is sold, no single uniform historical tax basis exists from which to perpetuate future depreciation deductions. Rather, the holder of the present interest and the holder of the future interest each has a separate tax basis attibutable to independent investments. Consequently, each taxpayer's separate investment must be analyzed to determine whether a depreciation deduction is allowed to the taxpayer. In other words, a sale of a present interest or a future interest in wasting property does not simply raise the question of how an allowed depreciation deduction is to be allocated between two taxpayers, but rather raises the threshold question of whether any depreciation deduction is allowed to either taxpayer.

For a taxpayer to be allowed a depreciation deduction with respect to a particular asset the taxpayer must have a capital investment in that asset.[277] Based on the

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273. *See* Zaritsky, *supra* note 9, at ¶ 1601.3(E); Leimberg & Schnepper, *supra* note 18, at 982; Oshins, *supra* note 9, at 36. Although the commentary focuses on present interests which are life estates, the same analysis presumably would be applied to a term interest on the theory that it is analogous to a trust arrangement. *See* I.R.C. § 167(h) (1986).

274. Query whether temporal divisions effectuated by sale should be analyzed in their entirety as gratuitous transfers when related parties are involved. The mere fact that related parties are involved should not cause that which is potentially a sale to be analyzed as a gift. *See* Kwall, *The Income Tax Consequences of a Gratuitous Transfer of Appreciated Property Contingent Upon the Donee's Promise to Pay the Gift Tax*, 31 DE PAUL L. REV. 45, 61 n.89 (1981); Diedrich v. Commissioner, 457 U.S. 191 (1983).

275. *See supra* note 69.

276. *See supra* note 69.

277. See Tolwinsky v. Commissioner, 86 T.C. 1009 (1986), where the court denied the taxpayer any depreciation deductions with respect to a motion picture because taxpayer had no capital investment in the motion picture, but allowed taxpayer amortization deductions with respect to the income interest to which taxpayer's investment was attributed. *See also* Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Helvering v. Lazarus, 308 U.S. 252 (1939); Gladding Dry Goods Co. v. Commissioner, 2 B.T.A. 336 (1925).

assumptions made in the Model, it can be demonstrated that J does, in fact, have a capital investment in the underlying property and should be allowed depreciation deductions to recover that investment, regardless of whether J is the seller of the remainder interest or the purchaser of the present interest.

If J purchases the property for $1,000,000 on January 1, 1988 and sells K a remainder interest for $635,023 on the same day, then $154,785 of J's original investment continues to represent a capital investment in the underlying property.[278] The $154,785 represents an investment in income-producing wasting property which J should be allowed to recover through depreciation deductions.[279] The remaining $210,192 is attributable to J's retained present interest and should be recovered by J in the manner described in Part III.[280]

If K purchases the property for $1,000,000 on January 1, 1988 and sells J an estate for a term of three years for $364,977 on that date, then $154,785 of the amount paid by J represents a capital investment in the underlying property and the remaining $210,192 represents a capital investment in the present interest. In contrast to the discussion in Part III, K is actually transferring property to J to the extent of $154,785 of the consideration J is providing.[281] J should be entitled to recover his capital investment in the property through depreciation deductions. These depreciation deductions are separate and distinct from the amortization deductions which should be allowed with respect to that portion of J's investment attributable to the present interest ($210,192).[282]

If J and K simultaneously purchased, respectively, an estate for a term of three years for $364,977 and a remainder interest for $635,023, J is again making a capital investment of $154,785 in the underlying property which he should be allowed to recover through depreciation. The remaining $210,192 represents an investment in the present interest which J should recover through amortization deductions.[283]

It is possible, of course, that a present interest or a future interest in wasting property might be sold where the parties do not expect the value of the underlying property to decline between the time that the temporal division is effectuated and the time that the future interest vests in possession.[284] In this situation, the parties should be expected to reach a bargain identical to the bargain that would be reached if the

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278. *See supra* text accompanying note 271.

279. Notwithstanding that the no division of property theory treats J as continuing to own the entire property until the remainder vests in possession, J's capital investment in the property is limited to $154,785 once the remainder interest is sold.

J should be allowed to recover the $154,785 through depreciation deductions irrespective of whether the anticipated decline in value actually occurs. *See supra* note 21.

280. *See supra* text accompanying notes 244–45.

281. *See supra* text accompanying note 271. K should be permitted to recover a part of her basis at the time of transfer in this situation. Treas. Reg. § 1.61-6(a) (1957); *supra* note 40.

282. *See supra* text accompanying notes 139–43.

283. *See supra* text accompanying notes 139–43.

In all of the foregoing situations, K would not be entitled to depreciation deductions until the remainder vests in possession. Although one might argue that K has a capital investment in the underlying property prior to this time, the part of the property to which K's capital investment might be traced is nonwasting. *See supra* note 35.

284. If this perception was shared by the market, the property would not be expected to generate a greater return for the duration of the present interest than nonwasting property with the same present value.

underlying property were nonwasting.[285] As a result, the capital investment by the holder of the present interest would be allocable exclusively to the present interest.

Because the holder of the present interest has no capital investment in the underlying property in this situation, the holder of the present interest should not be allowed any depreciation deductions.[286] If depreciation deductions were allowed to the holder of the present interest, the holder would be in the anomolous position of claiming two deductions for the same capital investment.[287] Although depreciation deductions are generally allowed irrespective of whether wasting property will in fact decline in value, such deductions can only be claimed by a taxpayer who has a capital investment in the underlying property.[288] Based on the deal negotiated between the parties, neither the holder of the present interest nor the holder of the future interest satisfies this requirement during the period over which the present interest extends.

It might be suggested that, as a practical matter, it will be difficult to discern the extent to which the parties anticipate the property will deteriorate between the time that the temporal division is effectuated and the time that the future interest vests in possession. The problem is not as great as it first appears. Transactions of this type will typically be effectuated between related parties who employ the Treasury's tables.[289] These tables allocate value between the present interest and the future interest assuming all property generates a ten percent annual return.[290] When the tables are

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285. When estate tax savings is the motivation for the sale of a remainder interest or a joint purchase, the value over which the parties will bargain is unlikely to entail any reduction from present value to reflect anticipated deterioration. This is because the estate tax goals will not be achieved if the purchaser of the future interest does not provide adequate consideration. Consequently, to avoid undervaluation of the future interest, it is unlikely that any dollar of present value would be allocated entirely to the present interest. *See supra* note 269.

286. Nor would the holder of the future interest be entitled to any depreciation deductions until the future interest vested in possession. This is because based on the deal struck by the parties, any capital investment in the underlying property by the holder of the future interest would be nonwasting for the duration of the present interest.

287. Quite logically, depreciation deductions have not been allowed historically with respect to a capital investment which the taxpayer is allowed to recover through an amortization deduction. *See* I.R.C. § 168 (repealed by § 1951(b)(4)(A) of the Tax Reform Act of 1976) (taxpayer entitled to amortization or depreciation with respect to investment in certain emergency facilities, but not both); I.R.C. § 169 (repealed by § 704(a) of the Tax Reform Act of 1969) (taxpayer allowed depreciation only with respect to that portion of investment in certain grain storage facilities with respect to which no amortization deduction was allowed).

Those commentators who have suggested that section 167(h) serves as authority for depreciation deductions to the holder of the present interest have acknowledged the potential for deductions in excess of the investment of the present interest holder. *See* Zaritsky, *supra* note 9, at ¶1601.03(E) ("'[S]ection 167(h) . . . suggests that the life tenant should be able to deduct depreciation based on the entire combined basis of the underlying property. If the life tenant claims deductions in excess of his or her own allocated share of the total basis, the Service should be able to recapture the excess deductions under a tax benefit theory, though it is uncertain whether it could recapture them immediately or only at any later sale of the underlying property."); Oshins, *supra* note 9, at 48 n.28 ("This seems to indicate that the life tenant can take deductions in excess of [his] basis."); Leimberg & Schnepper, *supra* note 18, at 982 ("The Code *requires* [the purchaser of the remainder interest in a joint purchase] to take all available depreciation deductions [using the *combined* basis of both joint owners] so long as he lives.").

This absurd result will not occur when section 167(h) is applied only to the gratuitous transactions to which it logically should apply because depreciation deductions are limited to the transferor's "uniform basis" in that situation. *Supra* note 69. Unfortunately, neither the Treasury Regulations nor the legislative history clarifies that Section 167(h) should be confined to gratuitous transfers. *See* Treas. Reg. § 1.167(h)-1 (1964); S. Rep. No. 960, 70th Cong., 1st Sess., 1939-1 C.B.(Pt. 2) 409, 423; H.R. Conf. Rep. No. 1882, 70th Cong., 1st Sess., 1939-1 C.B.(Pt. 2) 444, 445.

288. *See supra* note 277.

289. *See supra* notes 17–18.

290. *See supra* note 17.

employed, the amount allocated between the parties under the tables can be calcu-
lated.[291] Anticipated deterioration would represent the difference between the present
value of the property at the time of the temporal division and the amount allocated
between the parties under the tables.[292]

It may be difficult to discern the extent to which the parties anticipate the
property to deteriorate in the unusual case in which the Treasury's tables are not used
to value the temporal interests. In this situation, it will be difficult to determine the
value over which the parties are bargaining because the anticipated returns over which
the parties are bargaining will not be known.

The foregoing analysis remains useful, however, even when the Treasury tables
are not employed by eliminating any possibility that a taxpayer will be entitled to
deductions in excess of such taxpayer's total capital investment. Although it will be
difficult to control the allocation of the present interest holder's total investment
between the present interest and the underlying property in this situation, the
taxpayer's capital investment will serve to limit the total recovery to which the
taxpayer is entitled. A potential timing difference does remain.

V. CONCLUSION

Sales of present interests and future interests raise many fundamental income tax
questions. As demonstrated above, when these transactions are analyzed by equating
a temporal division to a spatial division, a reasoned response to a particular problem
leads to inappropriate results in other cases. Temporal divisions need to be analyzed
within a framework that will lead to answers that are conceptually correct to all of the
income tax questions raised by these transactions. This Article has attempted to
develop that framework.

The correct conceptual view of a temporal division emerges by confronting the
most significant problem under existing law in this area. This problem is the failure
to tax the purchaser of a remainder interest on the benefit derived as the remainder
increases in value. Although the benefit is analogous to interest income, it is not
taxed because the purchaser receives nothing tangible on which a tax can be
imposed.

Recently, the tax law has made great strides in taxing benefits analogous to
interest in the absence of technical realization. The purchaser of a remainder interest
can be taxed in a similar fashion. This result can be accomplished by treating the
transaction as a deferred transfer of the entire property, rather than a division of
property. Moreover, the view that a temporal division represents no division of
property is sufficiently flexible to deal with the many other income tax issues raised
by these transactions in a logical fashion.

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291. *See supra* notes 29, 32. The variable in this situation is P, rather than R or X.

292. The parties will probably need to establish the present value of the property to demonstrate the absence of a
gift element. *See supra* note 18. As previously indicated, it is unlikely that the parties will allocate any part of the present
value to deterioration to avoid the risk of overvaluing the present interest or undervaluing the future interest in which event
the desired estate tax savings would not be achieved. *See supra* note 269.

In light of the current congressional search for sources of tax revenue and the popularity of temporal divisions, a legislative response to these transactions is likely. The framework developed in this Article provides a foundation on which appropriate legislation can be based. In developing a solution to the problems of existing law, it is urged that the complex original issue discount rules not be extended. Rather, a simpler, more direct statutory response is desirable.