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## Estate Tax - Estate of D'Ambrosio v. Commissioner: Reinterpretation of Internal Revenue Code Section 2036(A) Nets Estate \$330,000 in Tax Savings

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1997]

ESTATE TAX—*ESTATE OF D'AMBROSIO V. COMMISSIONER*:  
REINTERPRETATION OF INTERNAL REVENUE CODE  
SECTION 2036(A) NETS ESTATE \$330,000 IN  
TAX SAVINGS

I. INTRODUCTION

As between life's two certainties, death and taxes, taxes prevail because when death is no longer an option, there are still taxes to pay. Since 1916, when an individual has died, his or her estate has been subject to federal taxes.<sup>1</sup> Although the Internal Revenue Code ("Code") provides a tax credit that effectively exempts \$600,000 in assets from estate tax, taxpayers with assets in excess of \$600,000 are confronted with progressive rates—from thirty-seven percent for estates valued over \$600,000 to fifty-five percent for estates valued over \$3 million.<sup>2</sup> Thus, wealthy taxpayers

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1. See I.R.C. § 2033 (1994) (stating that estate includes all property that decedent owned at death). For estate tax purposes, the decedent's estate also includes, inter alia, certain gifts made within three years of death, property that the decedent transferred before his or her death but, in which he or she retained a life estate, transfers taking effect at death, revocable transfers, annuities, employee benefits, joint tenancy property, life insurance policies and property that the decedent transferred for partial consideration. See *id.* §§ 2035-2043 (providing estate tax rules for each property type).

The Revenue Act of 1916 established the estate tax. Revenue Act of 1916, ch. 463, Pub. L. No. 64-271, § 202(b), 39 Stat. 756, 777-78 (codified as amended in scattered sections of 26 U.S.C.). Estate tax is a tax on the transfer of property to succeeding generations and is imposed upon the property value of the decedent's estate. See Mark R. Siegel, *Retained Possession and Enjoyment: Searching Out the Reality for Residential Transfers*, 24 Sw. U. L. REV. 81, 82 n.9 (1994) (defining estate tax and contrasting it with inheritance tax); see also JESSE DUKEMINIER & STANLEY M. JOHANSON, *WILLS, TRUSTS AND ESTATES* 991 (5th ed. 1995) (stating that Congress initially enacted estate tax because of increasing military expenditures from World War I). The 1916 estate tax was not repealed after World War I because the tax had populist support as a means to level "swollen fortunes" from the "robber baron" era. See *id.* at 991-92 (noting that estate tax also was not repealed because it was source of federal revenue).

2. I.R.C. § 2010(a) (providing for tax credit). The Tax Reform Act of 1976 ("1976 Tax Act") unified estate and gift taxes. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, 1846-48 (codified as amended in scattered sections of 26 U.S.C.); see also DUKEMINIER & JOHANSON, *supra* note 1, at 995 (noting that tax credit is equivalent to exemption). In the Economic Recovery Tax Act of 1981 ("1981 Tax Act"), the unified credit increased to \$192,800, which is equivalent to an exemption of \$600,000 in estate assets from estate taxes. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 299 (current version at 26 U.S.C. § 2010(a)); see Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 501(a), 111 Stat. 778 (modifying section 2010 by gradually increasing exemption from \$625,000 in 1998 to \$1 million in 2006); DUKEMINIER & JOHANSON, *supra* note 1, at 996 (noting that tax rates begin at 37% for estates worth \$600,000 or more and that amounts over \$3 million are subject to 55% rate). Estates over \$3 million, although taxed at

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have a strong incentive to mitigate this tax through estate planning.<sup>3</sup> One technique that estate planners customarily use to reduce the estate tax burden is the sale of a remainder interest.<sup>4</sup> A remainder interest is the interest remaining in a property upon the termination of the immediately preceding estate, such as a life estate.<sup>5</sup>

For example, if a client indicates that he or she would like to give their niece \$500,000 in ABC Pharmaceuticals stock tax free, the estate planner could advise the client to sell a remainder interest in the stock to his or her niece, while retaining a life estate for himself or herself.<sup>6</sup> If the client agrees, the planner would consult the Code's actuarial tables to determine that the client's retained life estate would be worth \$341,950 and the remainder interest would be worth \$158,050.<sup>7</sup> The client's niece

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a higher rate, still receive the \$192,800 tax credit. *See id.* (stating that Code applies tax credit for all estates regardless of worth and then computes relevant estate tax). For a table showing the unified transfer tax rate graduated schedule, see *infra* note 30.

3. *See generally* DUKEMINIER & JOHANSON, *supra* note 1, at 993-94 (stating that 1976 Tax Act and Tax Reform Act of 1986, Pub. L. No. 99-517, 100 Stat. 2085 (codified in scattered sections of 26 U.S.C.), reduced several "loopholes" that helped to avoid estate tax).

4. *See generally* JESSE DUKEMINIER & JAMES E. KRIER, PROPERTY 216-17, 266-74 (3d ed. 1993) (discussing remainder interests).

5. *See* BLACK'S LAW DICTIONARY 1293 (6th ed. 1990). A life estate is a an estate with a duration limited to the life of the person holding it or the life of some other person. *See id.* at 924.

A fee simple interest is a property interest that is free of any limitations. *See id.* at 615-16. A taxpayer, owning a fee simple interest, can split this interest by selling a remainder interest in the property while retaining a life estate. *See* DUKEMINIER & KRIER, *supra* note 4, at 266-67. Thus, the property owner who sold the remainder interest is then known as a life tenant. *See* BLACK'S LAW DICTIONARY, *supra*, at 924 (defining life tenant as one whose legal right to remain in possession of property is measured by his or her or another's life). The owner of the remainder interest, known as the remainderperson, has the vested right to a fee simple interest in the property upon the death of the life tenant. *See id.* at 1293 (defining "remainderman"); *see also* DUKEMINIER & KRIER, *supra* note 4, at 267 (noting that remainder interests may be contingent). Upon the life tenant's death, the life estate terminates and is not part of the decedent's estate. *See* I.R.C. § 2033 (stating that gross estate includes all property that decedent owned at death). *But see* DUKEMINIER & JOHANSON, *supra* note 1, at 994 (discussing how Congress ended tax exemption for life estates in 1986 legislation). If the original property owner does not want to sell a remainder interest in the property, he or she may alternatively opt to retain a term interest, such as an annuity interest, or an income interest. *See* Martha W. Jordan, *Sales of Remainder Interests: Reconciling Gradow v. United States and Section 2702*, 14 VA. TAX REV. 671, 671 n.1 (1995) (discussing split property interests).

6. *See* Thomas W. Abendroth, *Sale of Remainder Interest: Will Any Court Get It Right?*, TRUSTS & EST., Sept. 1996, at 49, 50 (using similar hypothetical to illustrate sale-of-remainder-interest technique). For a discussion of the sale-of-remainder-interest technique, see *infra* notes 66-73 and accompanying text.

7. *See* Treas. Reg. § 20.2031-7(d)(6) (as amended in 1990) (providing actuarial tables to determine present value of remainder interest based on life expectancy of life tenant). The tables provide the ratios needed to compute the present value of the remainder interest based upon the transferor's actuarial life expectancy. *See id.* (setting guidelines for calculation of remainder interest). If the in-

would then pay her uncle or aunt the fair market value of \$158,050 for the remainder interest.<sup>8</sup>

Thus, under this technique, by receiving the fair market value as consideration, the client would be able to exclude the value of the stock from his or her estate.<sup>9</sup> Additionally, upon the client's death, the niece would own a fee simple interest in the stock.<sup>10</sup> Thus, if ten years after the transaction, the client dies and the ABC pharmaceuticals stock has appreciated to \$2 million, the planner would not have to include the ABC Pharmaceuticals in the client's stock because the client sold his or her

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interest to be valued is to take effect after the death of an individual, the present value of the remainder interest is computed by multiplying the value of the property by the appropriate remainder interest actuarial factor from Table S of the regulations. *See id.* § 20.2031-7(d)(2)(ii) (explaining how to compute value); *id.* § 20.2031-7(d)(6) (providing that "Table S" is used to determine present value of remainder interest); *see also* I.R.C. § 7520 (providing applicable interest rate for use in Table S); Treas. Reg. § 20.7520-3(b) (as amended in 1990) (listing certain limitations on use of actuarial tables). For example, if the planner's client is 65 years old and the § 7520 interest rate is 9.0%, the actuarial factor from Table S is .31610. *See id.* § 20.2031-7(d)(6) (giving examples of how to apply table ratios); *see also* I.R.C. § 1274(d) (adjusting federal midterm rate monthly to reflect changes in market rate); *id.* § 7520 (setting rate for Table S at 120% of federal midterm rate, which is determined under § 1274(d)). *See generally* Mitchell M. Gans, *GRIT's, GRAT's and GRUT's: Planning and Policy*, 11 VA. TAX REV. 761, 773 n.22 (1992) (discussing § 7520 and concluding that Congress set rate too high). To compute the value of the remainder interest, the actuarial factor of .31610 is multiplied by the value of the underlying property. *See* Treas. Reg. § 20.2031-7(d)(2)(ii) (providing formula). Therefore, the remainder interest in the ABC Pharmaceuticals stock is valued at \$158,050, although the life estate is worth \$341,950. *See id.* (providing actuarial factor of .31610 to help determine value of remainder interest); *see also id.* § 20.2031-7(d)(5) (illustrating, in regulation's "Example 1," valuation of remainder interest).

8. *See* Abendroth, *supra* note 6, at 49 (explaining sale-of-remainder-interest technique). Because the client's niece purchased the remainder interest for adequate and full consideration, the client's retained income interest in the ABC Pharmaceuticals stock would not cause the property to be included in his or her estate. *See id.* (noting that practitioners believed that if they valued property correctly and properly applied Internal Revenue Service (IRS) valuation tables, remainder sale would be effective to remove underlying property value from estate). Thus, when the client dies, his or her life estate terminates and the ABC Pharmaceuticals stock would pass free of the estate tax to his or her niece. *See id.* (explaining how taxpayer could transfer without incurring estate tax).

9. *See* I.R.C. § 2036(a) (stating that general rule of transfer with retained life estate is to include full value of underlying asset in decedent's estate, except when transfer is bona fide sale made for full and adequate consideration). Thus, because the client sold the remainder interest for its fair market value, the planner expects that the decedent's estate will not include the full value of the underlying property. For a further discussion of § 2036(a), *see infra* notes 13-18, 45-50 and accompanying text.

10. *See* DUKEMINIER & KRIER, *supra* note 4, at 267 (explaining that remainder interest is future interest that is capable of becoming fee simple interest at termination of life estate).

remainder interest for its fair market value.<sup>11</sup> Moreover, the niece would have fee simple ownership of stock worth \$2 million for which she had paid just \$158,050 ten years earlier.<sup>12</sup>

Although this technique would help to reduce an estate's tax burden, one concern is that the courts will not uphold its validity because of the effect of § 2036(a) of the Code, which provides that the gross estate shall include the value of property retained as a life estate "except in [the] case of a bona fide sale for . . . adequate and full consideration."<sup>13</sup> Congress enacted § 2036(a) to prevent estates from being depleted by manipulative

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11. *See id.* For a discussion of why the client does not need to include the amount that the ABC stock appreciated in his or her estate, see *supra* notes 6-9 and accompanying text.

12. *See* Abendroth, *supra* note 6, at 50 (illustrating similar example). The \$158,050 that the niece paid for the remainder interest was calculated using the IRS tables. *See* Treas. Reg. § 20.2031-7(d)(6) (listing "Table S" as chart to be used for calculating value of remainder interests). The tables assumed that the niece will receive exactly \$500,000 at her uncle's or aunt's death and that the rate of return for a current income interest was 9.0%. *See* Abendroth, *supra* note 6, at 50 (explaining reasoning behind values in actuarial tables); *see also* I.R.C. § 7520 (providing interest rate to determine actuarial factor). Because the ABC Pharmaceuticals stock significantly appreciated over 10 years, the client's niece paid a bargain price for the stock. *See* Abendroth, *supra* note 6, at 50 (explaining potential benefit of buying remainder interest). For a discussion of how estate planners used the sale-of-remainder-interest technique to take advantage of growth assets, see *infra* notes 69-73 and accompanying text.

13. I.R.C. § 2036(a). Section 2036 defines the general rule for transfers with a retained life estate:

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

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

*Id.* (emphasis added); *cf.* Siegel, *supra* note 1, at 85 (noting that personal residence transferors do not retain possession if transferee voluntarily makes gift back to transferor by permitting transferor to live in residence). The § 2036(a) exception for remainder-interest transfers that are bona fide sales for "adequate and full consideration in money or money's worth" exempts property from the estate when the remainder-interest transfer did not cause depletion of the estate and evade taxation. *See* Rachel Lorey, Note, *Gradow v. United States: Death of Remainder Interest Sale as an Estate Freezing Technique?*, 8 VA. TAX REV. 183, 191 (1988) (noting that if decedent receives consideration equal to value of property transferred, estate is same size as before transaction) (citing I.R.C. § 2036(a)).

For a further discussion of the purpose of § 2036(a), see *infra* notes 14-18, 45-50 and accompanying text. For a further discussion of the bona fide sale exception of § 2036(a), see *infra* notes 47-65, 93-192 and accompanying text. For a discussion of the relationship between § 2036(a) and other Code provisions, see *infra* notes 74-92 and accompanying text.

transfers of remainder interests.<sup>14</sup> Thus, an estate planner's primary concern is what constitutes "adequate and full consideration."<sup>15</sup>

Recent case law has illustrated that, for the purposes of § 2036(a), "adequate and full consideration" for a remainder interest equals the full value of the underlying property, not the remainder interest value that the planner determined from the Code's actuarial tables.<sup>16</sup> Thus, in the earlier example, the client's transfer failed the bona fide sale exception because the remainder interest was not sold for the full value of the stock, \$500,000.<sup>17</sup> Therefore, the planner not only would have failed to give the client's niece a tax-free gift, but also would have subjected an unexpected \$1,841,950 to estate tax.<sup>18</sup>

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14. See *Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309, 312 (3d Cir. 1996) (discussing effect of § 2036(a)), *cert. denied*, 117 S. Ct. 1822 (1997). "Section 2036(a) effectively discourages manipulative transfers of remainder interests which are really testamentary in character by 'pulling back' the full, fee simple value of the transferred property into the gross estate, except where the transfer was 'a bona fide sale for adequate and full consideration.'" *Id.*; see *Estate of Wyly v. Commissioner*, 610 F.2d 1282, 1290 (5th Cir. 1980) ("The purpose of [§ 2036(a)] is to prevent circumvention of federal estate tax by use of inter vivos schemes which do not significantly alter lifetime beneficial enjoyment of property supposedly transferred by a decedent."); Henry Gottlieb, *\$330,000 Tax Appeal Victory*, N.J. L.J., Dec. 23, 1996, at 16 (noting that § 2036(a) discourages "manipulative transfers" of testamentary remainder interests).

15. For a discussion of the conflicting views about the meaning of "adequate and full consideration" in § 2036(a), see *infra* notes 49-65, 93-192 and accompanying text.

16. See *Gradow v. United States*, 11 Cl. Ct. 808, 813-14 (1987) (holding that for sale of remainder interest to meet bona fide sale exception of § 2036(a), transferors must receive adequate and fair consideration equal to fee simple value of underlying property), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990); see also *Parker v. United States*, 894 F. Supp. 445, 447 (N.D. Ga. 1995) (citing *Gradow* and concluding that value of what decedent received must be compared to entire value of underlying property); *Pittman v. United States*, 878 F. Supp. 833, 835 (E.D.N.C. 1994) (same); *Estate of Magnin v. Commissioner*, 71 T.C.M. (CCH) 1856, 1863 (1996) (stating that to determine whether consideration is adequate, court must compare value that decedent received with total value of property decedent transferred, rather than just considering remainder interest value); *Estate of D'Ambrosio v. Commissioner*, 105 T.C. 252, 259-60 (1995) (same), *rev'd*, 101 F.3d 309 (3d Cir. 1996), *and cert. denied*, 117 S. Ct. 1822 (1997). *But cf.* *Abendroth*, *supra* note 6, at 50 (noting that, prior to case law to the contrary, "virtually no one questioned the basic principle that an amount equal to the value of the remainder interest determined under the IRS tables would constitute adequate and full consideration under § 2036(a)"). For a discussion of these cases, see *infra* notes 93-192 and accompanying text.

17. See *Pittman*, 878 F. Supp. at 835 (determining for purposes of bona fide sale exception under § 2036(a), "it is the value of the *entire* property which is measured against the consideration received"). Thus, when the planner's client sold the remainder interest to his or her niece, the client should have received \$500,000, the value of the ABC Pharmaceuticals stock, as consideration, not the fair market value of the remainder interest. See *id.*

18. See I.R.C. § 2036(a) ("The value of the gross estate shall include the value of all property to the extent of any interest [including interests from transfers not meeting the bona fide sale exception] therein included."); *D'Ambrosio*, 105 T.C. at 252 (allowing amount includible in taxpayer's estate to be reduced by value of consideration received). Thus, the client's estate will include the full fee simple

Recently, the United States Court of Appeals for the Third Circuit addressed this issue in *Estate of D'Ambrosio v. Commissioner*.<sup>19</sup> The Third Circuit held that the sale of a remainder interest for its fair market value, without testamentary motivation, constituted a sale for adequate and full consideration.<sup>20</sup> Thus, in the Third Circuit, the planning technique used by the planner in the example is still a viable option.<sup>21</sup> The decision, however, created a circuit split because the Third Circuit interpreted the bona fide sale exception to be more inclusive than other federal circuit courts have in previous decisions.<sup>22</sup> Therefore, whether a tax planner can utilize

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value of the ABC Pharmaceuticals stock (\$2 million) less the consideration received from his or her niece (\$158,050) for a total of \$1,841,950. See I.R.C. § 2036(a) (requiring value of underlying property to be included in estate); see also *id.* § 2043 (providing amount included in estate is fair market value of property at time of death less consideration received).

19. 101 F.3d 309 (3d Cir. 1996), *cert. denied*, 117 S. Ct. 1822 (1997).

20. See *id.* at 318 (holding that remainder-interest transfer met bona fide sale exception of § 2036(a) and excluding underlying property from decedent's estate). The United States Court of Appeals for the Third Circuit stated that it needed to consider the issue of "whether the sale of a remainder interest for its fair market value constitutes 'adequate and full consideration' within the meaning of § 2036(a)." *Id.* at 312. The court held that the Tax Court erred as a matter of law by ruling that the consideration received by the taxpayer, which was the fair market value of the remainder interest, was not adequate and full. See *id.* For a discussion of the Third Circuit's reasoning in *D'Ambrosio*, see *infra* notes 122-92 and accompanying text.

21. See *D'Ambrosio*, 101 F.3d at 318 (holding that estate planning similar to example of client's niece meets bona fide exception of § 2036(a) and is excluded from decedent's estate for tax purposes). *But cf.* I.R.C. § 2702 (limiting Third Circuit's effect to nonfamily members and applying it only to transfers made after October 8, 1990). Section 2702 treats the sale of a remainder interest in property to a member of the seller's family as a gift, unless the purchase price paid for the remainder interest is equal to the fee simple value of the property. See *id.* (providing that "[s]olely for purposes of determining . . . whether a transfer of an interest in trust to . . . a member of the transferor's family is a gift . . . [t]he value of any retained interest which is not a qualified interest shall be treated as zero"). See generally Jordan, *supra* note 5, at 704-16 (discussing § 2702's effect on remainder-interest transfers). The amount of the § 2702 gift is the full value of the property less the consideration received from the purchaser. See Treas. Reg. § 25.2702-4(d) (as amended in 1992) (defining § 2702 gift). This limit, however, does not apply to nonfamily members. See I.R.C. § 2702(e) (stating that "member of the family" shall have meaning given such term by § 2704 (c)(2)); see also *id.* § 2704(c)(2) (defining family member). Section 2704(c)(2) states that "[t]he term 'member of the family' means, with respect to any individual—(A) such individual's spouse, (B) any ancestor or lineal descendant of such individual or such individual's spouse, (C) any brother or sister of the individual, and (D) any spouse of any individual described in subparagraph (B) or (C)." *Id.* For a further discussion of § 2702, see *infra* notes 74-92 and accompanying text.

22. Compare *D'Ambrosio*, 101 F.3d at 318 (holding that bona fide sale exception includes transfers of remainder interest for consideration equal to fair market value of remainder interest), with Gradow v. United States, 897 F.2d 516, 519 (Fed. Cir. 1990) (holding that bona fide sale exception only includes transfers of remainder interests for consideration equal to fee simple value of underlying property).

the technique of selling a remainder interest is yet to be conclusively settled.<sup>23</sup>

This Casebrief considers the Third Circuit's interpretation of § 2036(a) and compares it to contrary case law. Part II traces the history and purpose of § 2036(a), discusses the sale of remainder interests, analyzes the congressional response to taxpayer abuse of this technique and addresses recent case law.<sup>24</sup> Part III examines the Third Circuit's interpretation that the sale of a remainder interest at fair market value meets the bona fide sale exception of § 2036(a).<sup>25</sup> Part IV describes the application of the Third Circuit's ruling on remainder interests that were transferred prior to December 1987.<sup>26</sup> Finally, Part IV also reconciles the Third Circuit's decision with other provisions in the Code.<sup>27</sup>

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23. See generally *Golsen v. Commissioner*, 54 T.C. 742, 756 (1970) (stating that Tax Court will decide cases on basis of law in circuit to which appeal will lie), *aff'd*, 445 F.2d 985 (10th Cir. 1971). Because of the *Golsen* rule, the Tax Court is bound by the *D'Ambrosio* ruling for cases within the Third Circuit. See *id.* For cases in other circuits, the Tax Court is not bound by *D'Ambrosio* and, according to *Golsen*, must follow the case law decided by the circuit in which the appeal will lie. See *id.* (discussing *Golsen* rule). Thus, if the taxpayer lives in a circuit in which the court has addressed this issue, the Tax Court will follow the circuit court's decision, whether or not the Tax Court agrees. See *id.* If the circuit court in which the taxpayer lives has not addressed the issue, the Tax Court can make its own decision on the issue, even if its prior decisions addressing the issue conflict with decisions in other circuits. See *id.* Prior to 1970, because of the interests of uniform interpretation of the nation's tax laws, the Tax Court was not bound by circuit court decisions when the same issue appeared before the Tax Court for a later decision. See *Lawrence v. Commissioner*, 27 T.C. 713, 716-17 (1957) ("[A] court of national jurisdiction to avoid confusion should follow its own honest beliefs until the Supreme Court decides the point."), *rev'd on other grounds*, 258 F.2d 562 (9th Cir. 1958).

24. For a discussion of general estate tax law, see *infra* notes 28-32 and accompanying text. For a discussion of the sale of a remainder interest as an estate planning technique, see *infra* notes 33-36, 66-73 and accompanying text. For a discussion of the predecessors of § 2036(a) and § 2036(a)'s effect on estate planning, see *infra* notes 37-65 and accompanying text. For a discussion of Congress's legislative reaction to the use of the technique for tax evasion, see *infra* notes 74-92 and accompanying text. For a discussion of case law that has interpreted § 2036(a) as nullifying the use of remainder-interest transfers as estate planning devices, see *infra* notes 93-121 and accompanying text.

25. For a discussion of the scope of the § 2036(a) bona fide sale exception in the Third Circuit, see *infra* notes 122-92 and accompanying text.

26. For a discussion of how the Third Circuit's interpretation of § 2036(a) revalidates the intent of decedents who had transferred remainder interests prior to December 1987, see *infra* notes 193-96 and accompanying text.

27. For a discussion of Code provisions that effect remainder-interest transfers, see *infra* notes 74-92 and accompanying text. For a discussion of the Third Circuit's effect on transactions governed by these other Code provisions, see *infra* notes 197-202 and accompanying text.



## II. BACKGROUND

### A. *Taxation of the Estate*

Estate tax is a tax levied upon the decedent's estate when the estate is transferred to succeeding generations.<sup>28</sup> Since 1981, estate taxes have not been a consideration for most lower and middle income Americans because of the unified tax credit.<sup>29</sup> The unified tax credit of \$192,800 effectively exempts \$600,000 worth of assets from estate tax.<sup>30</sup> The basic purpose of federal estate tax is to tax both the value of property owned at death and the value of property that the decedent gave away during his or

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28. See DUKEMINIER & JOHANSON, *supra* note 1, at 994 (distinguishing federal estate taxes from state inheritance taxes). Inheritance tax is a tax that states impose upon each beneficiary for the privilege of receiving a decedent's property, whereas federal estate tax is a tax that the federal government imposes upon the gross estate. *See id.* For example, under federal estate tax, if a person dies leaving \$1 million to four children, the amount of estate tax is the same whether the decedent had only one child or four children. *See id.* Under state inheritance tax, however, there are progressive rates for each child's share and the total amount of tax would be less for each child in the four-child family than the child without siblings. *See id.* (noting that inheritance tax is calculated separately for each heir and is not based on total estate).

Thus, to prevent taxpayers from circumventing estate taxes, Congress imposes a gift tax on inter vivos gifts. *See* I.R.C. § 2501 (1994) (imposing gift tax on individual's "transfer of property by gift" during each calendar year). Because of a disparity in rates, the inter vivos gift remained an advantageous transaction until the gift and estate taxes were unified by 1976. *See* Tax Reform Act of 1976, Pub. L. No. 94-955, 90 Stat. 1520, 1846-48 (codified as amended in scattered sections of 26 U.S.C.); *see also* Theodore S. Sims, *Timing Under a Unified Wealth Transfer Tax*, 51 U. CHI. L. REV. 34, 34 (1984) (discussing advantageous taxation of inter vivos gifts before 1976). Although estate and gift taxes are integrated, each method of transfer has its advantages and disadvantages. *See* Jordan, *supra* note 5, at 686-87 n.74 (outlining advantages and disadvantages of inter vivos gift). For example, the main advantage of an inter vivos gift is that "any future appreciation in the value of the transferred property is removed from the taxpayer's tax base." *Id.* at 687; *see* Gans, *supra* note 7, at 813-16 (comparing advantages of inter vivos gifts and testamentary transfers).

29. *See* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 299 (current version at 26 U.S.C. § 2010(a) (1994)) (establishing unified tax credit). The 1981 Tax Act and the current Code provide a credit against estate tax of \$192,800. *See id.* (implementing tax credit); *see also* I.R.C. § 2010(a) (providing unified tax credit).

30. *See* DUKEMINIER & JOHANSON, *supra* note 1, at 1019 (discussing unified credit against estate tax). The unified credit is equivalent to a \$600,000 exemption

her lifetime.<sup>31</sup> Thus, to incur the least possible estate tax liability, a wealthy taxpayer should structure a property transfer so that the transfer is not a gift and does not cause the underlying value of the property to be in the taxpayer's estate.<sup>32</sup>

*B. Purpose of the Remainder-Interest Transfer and the Policy to Limit Its Abusive Tendencies*

The objectives of the remainder-interest transfer are to allow the seller to retain all use and benefit from the underlying property, while removing the property from the seller's gross estate and to "permit the

from tax because an estate tax base of \$600,000 produces an estate tax of \$192,800. *See id.* The unified transfer tax rate schedule is as follows:

(A) Amount subject to tax more than	(B) Amount subject to tax equal to or less than	(C) Tax on amount in column A	(D) Rate of tax in excess over amount in column A (percent)
\$ —	\$ 10,000	\$ —	18
10,000	20,000	1,800	20
20,000	40,000	3,800	22
40,000	60,000	8,200	24
60,000	80,000	13,000	26
80,000	100,000	18,200	28
100,000	150,000	23,800	30
150,000	250,000	38,800	32
250,000	500,000	70,800	34
500,000	750,000	155,800	37
750,000	1,000,000	248,300	39
1,000,000	1,250,000	345,800	41
1,250,000	1,500,000	448,300	43
1,500,000	2,000,000	555,800	45
2,000,000	2,500,000	780,800	49
2,500,000	3,000,000	1,025,800	53
3,000,000	—	1,290,800	55

*Id.* at 996; *see* I.R.C. § 2010 (providing unified tax credit and tax rate schedule).

31. *See* DUKEMINIER & JOHANSON, *supra* note 1, at 1018 ("This is accomplished by imposing a graduated tax rate schedule on the aggregate of the decedent's taxable estate plus adjusted taxable gifts, against which various credits may be applied." The Code's definition of the gross estate encompasses (1) transfers by will or intestacy; (2) lifetime transfers that pass economic benefits upon the decedent's death; and (3) certain nonprobate transfers. *See id.* (discussing gross estate); *see also* I.R.C. §§ 2033-2044 (detailing transfers included in gross estate). For a list of assets included in the gross estate, *see supra* note 1.

The taxable estate is the gross estate less estate administration expenses, debts, funeral expenses, charities and marital deductions. *See* I.R.C. §§ 2053-2056 (detailing deductions from gross estate). To compute estate tax, add adjusted taxable gifts to the taxable estate. *See* DUKEMINIER & JOHANSON, *supra* note 1, at 1019 (defining adjustable taxable gifts as gifts made after 1976 not otherwise includible in gross estate). If the property were included in the gross estate under §§ 2033-2044, it is not includible as an adjusted taxable gift because that would result in double taxation. *See id.* (discussing reason for distinguishing adjustable taxable gifts from gross estate).

32. For a discussion of the remainder-interest transfer as a possible option to meet this objective, *see infra* notes 66-73 and accompanying text. For a discussion of the Third Circuit's approval of using the remainder-interest transfer to meet this objective, *see infra* notes 122-92 and accompanying text.

buyer to obtain valuable property at a bargain price.”<sup>33</sup> The sale of the remainder interest of a fee simple estate has three primary effects. First, the transfer splits the property into a remainder interest and a life estate to provide the seller with either a place to live or a source of income.<sup>34</sup> Second, the seller receives consideration for the remainder interest, which can be in either a lump-sum payment of cash (which the life tenant can invest) or a lifetime annuity.<sup>35</sup> Third, this transaction has potentially significant tax advantages because the seller will avoid having the property’s value added to his or her gross estate.<sup>36</sup>

33. HOWARD M. ZARITSKY, *TAX PLANNING FOR FAMILY WEALTH TRANSFERS* ¶ 11.09[3][g] (3d ed. 1997) (analyzing sales of remainder interests). “In a remainder interest sale, the buyer pays the seller an amount equal to the actuarial value of the right to the property when the seller dies [(the remainder interest)] and the seller retains the full use of the property during his or her lifetime [(the life estate)].” *Id.*

34. *See* Jordan, *supra* note 5, at 672 & n.1 (discussing split property interests). For a discussion generally defining the life estate and remainder interest, see *supra* note 5.

Property is generally comprised of two components: a “present value increment” and an “earnings increment.” Jordan, *supra* note 5, at 692 (citing Keith E. Morrison, *The Widow’s Election: The Issue of Consideration*, 44 TEX. L. REV. 223, 231 (1965)). A complete transfer of property transfers both components; thus, it transfers a fee simple interest. *See id.* (defining complete transfer of estate). A remainder-interest transfer, however, severs the two components; the seller retains the earnings increment and the buyer receives the present value increment. *See id.* (distinguishing fee simple sale from remainder-interest sale); *see also* Morrison, *supra*, at 231 (explaining split property interests).

35. *See generally* JOHN CATHERALL & DANIEL E. FELD, *ESTATE AND GIFT TAX DIGEST* § 3.01[1] (3d ed. 1996) (discussing grantor-retained annuity trusts). An annuity, acting as a long-term payoff of the remainder interest, can provide a retiree with a steady stream of income. *See, e.g.*, *Estate of D’Ambrosio v. Commissioner*, 101 F.3d at 309, 311 (3d Cir. 1996) (noting decedent transferred remainder interest in stock for lifetime annuity), *cert. denied*, 117 S. Ct. 1822 (1997).

36. *See* Lorey, *supra* note 13, at 185 (detailing estate planning techniques). The removal of an asset from the gross estate by a remainder-interest transfer has several advantages. *See id.* First, the value of the estate asset is frozen because all future appreciation has been shifted to the remainderperson. *See id.*; *see also* Jordan, *supra* note 5, at 692 (describing remainder interest as present value increment of fee simple interest, while life estate is merely earnings increment). Second, if the planner has valued the remainder interest correctly and the consideration is equal to or greater than that value, the Code excludes the property from the decedent’s gross estate. *See* Lorey, *supra* note 13, at 185; *see also* I.R.C. § 2036(a) (stating general rule that transfers with retained life estates are to include full value of underlying asset in decedent’s estate, except when transfer was bona fide sale made for full and adequate consideration); ZARITSKY, *supra* note 33, ¶ 11.09[3][g] (noting tax advantages of remainder interest sale if decedent sold remainder interest for amount equal to its actuarial value); Jordan, *supra* note 5, at 677 (noting that value of underlying property will not be subject to estate tax if decedent sold remainder interest for adequate consideration) (citing I.R.C. § 2036(a)). Third, the remainder-interest transferor enjoys increased liquidity by receiving the consideration while still retaining use of the property. *See* Lorey, *supra* note 13, at 185 (describing advantages of remainder-interest transfer to seller). Last, “the life tenant may be able to amortize the cost of the life estate.” *Id.*; *see* *Estate of Christ v. Commissioner*, 54 T.C. 490, 528-29 (1970) (holding that amortization of life estate

Even before Congress enacted federal estate tax in 1916, the remainder-interest transfer generated concern that it is a wealth transfer tailored

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is part of consideration for remainder interest), *aff'd*, 480 F.2d 1971 (9th Cir. 1973). *But see* Gordon v. Commissioner, 85 T.C. 309, 323 (1985) (determining that taxpayer, who does not invest additional money, cannot divide nondepreciable property into two parts and claim amortization deductions on term interest).

Although the remainder-interest transfer has several significant advantages, it also has potential disadvantages. *See* Lorey, *supra* note 13, at 185 (listing drawbacks to remainder-interest sale). First, if the planner improperly values the remainder interest, the consideration may be inadequate to exclude the property from the decedent's estate. *See id.* (recommending that transferor overvalue remainder interest in unclear cases); *cf.* I.R.C. § 2043 (providing that value of underlying property that § 2036(a) includes in gross estate is offset by consideration received). Second, the success of the remainder-interest transfer depends upon the remainderperson being able to finance its purchase. *See id.* (noting that if transferor attempts to finance remainderperson's purchase, property will be includible in transferor's estate). Finally, because the transferor no longer owns a fee simple interest, the property is less marketable, reducing the transferor's flexibility to sell or finance it. *See id.* (describing reduced value of transferor's property).

Two developments have caused the remainder interest sale to be a suspect estate planning device. *See* ZARITSKY, *supra* note 33, ¶ 11.09[3][g] (explaining limits of remainder-interest transfer as planning device). The first development began with the 1990 enactment of § 2702 of the Code in which Congress limited interfamily-member remainder-interest sales to sales of remainder interests in the life tenant's personal residence and of certain items of nondepreciable tangible property. *See id.* (describing § 2702's effect on remainder-interest transfers); *see also* I.R.C. § 2702 (applying to remainder-interest sales after October 8, 1990). For a further discussion of the effect of § 2702 on remainder-interest sales, *see infra* notes 74-92 and accompanying text.

The second development arose when recent case law began supporting the IRS's view that remainder-interest sales are ineffective to remove the subject property from the seller's gross estate under § 2036(a). *See* ZARITSKY, *supra* note 33, ¶ 11.09[3][g] (describing cases holding that entire property must be included in estate); *see also* Gradow v. United States, 11 Cl. Ct. 808, 813-14 (1987) (holding that for sale of remainder interest to meet bona fide sale exception of § 2036, transferor must receive adequate and fair consideration equal to fee simple value of underlying property), *aff'd*, 897 F.2d 516, 519 (Fed. Cir. 1990). Other courts followed the Gradow decision. *See* Parker v. United States, 894 F. Supp. 445, 447 (N.D. Ga. 1995) (citing Gradow and concluding that value of what decedent received must be compared to entire value of underlying property); Pittman v. United States, 878 F. Supp. 833, 835 (E.D.N.C. 1994) (same); Estate of Magnin v. Commissioner, 71 T.C.M. (CCH) 1856, 1863 (1996) (finding that, to determine whether consideration was adequate, court must compare value that decedent received with total value of property that decedent transferred, rather than just remainder-interest value). *But see* D'Ambrosio, 101 F.3d at 312, 318 (holding that sale of remainder-interest for fair market value meets bona fide sale exception of § 2036(a) and, therefore, excludes entire value of underlying property from estate).

For a further discussion of the case law finding remainder-interest sales an ineffective way to remove the subject property from the seller's gross estate, *see infra* notes 51-65, 93-121 and accompanying text. For a further discussion of the Third Circuit decision in D'Ambrosio, *see infra* notes 122-92 and accompanying text.

to evade taxes.<sup>37</sup> In the Revenue Act of 1916,<sup>38</sup> Congress sought to impose an estate tax on lifetime transfers if the parties intended the transfer take effect "in possession or enjoyment" at the transferor's death.<sup>39</sup> Thus, the early Code utilized a substance over form principle to subject property to estate tax when the decedent enjoyed or possessed the property until death, but had previously parted with legal title.<sup>40</sup> The Supreme Court, however, in *May v. Heiner*,<sup>41</sup> refused to extend the possession and enjoyment clause of the Revenue Act of 1916 to retained life estates.<sup>42</sup> Both

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37. See Siegel, *supra* note 1, at 82-85 (discussing early congressional interest in imposing estate tax on remainder-interest transfers). Even before Congress created federal tax in 1916, state law required courts to consider the impact of inheritance taxes upon transfers with reserved life estates. See *In re Keeney's Estate*, 87 N.E. 428, 429 (N.Y. 1909) ("[A]n ingenious mind may devise other means of avoiding an inheritance tax, but the one commonly used is a transfer with reservation of a life estate."), *aff'd sub nom.* *Keeney v. Comptroller*, 222 U.S. 525 (1912). An inheritance tax is a tax imposed upon individual beneficiaries for the privilege of receiving property from a decedent. See *DUKEMINIER & JOHANSON*, *supra* note 1, at 994-95 (comparing inheritance tax with estate tax). In contrast, estate tax is a tax upon the transfer of property based on the value of property included in the decedent's estate. See Siegel, *supra* note 1, at 83 n.9 (comparing inheritance tax with estate tax).

38. Pub. L. No. 64-271, 39 Stat. 756 (codified as amended in scattered sections of 26 U.S.C.).

39. See Siegel, *supra* note 1, at 83 (noting that Revenue Act of 1916 resulted from judicial suspicion of remainder-interest transfers). The Revenue Act of 1916 provided, in pertinent part:

To the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has created a trust, in contemplation of or intended to take effect in possession or enjoyment at or after his death, except in case of a bona fide sale for a fair consideration in money or money's worth.

§ 202(b), 39 Stat. 756, 777-78.

40. See Siegel, *supra* note 1, at 83 (stating that postponed "possession or enjoyment" clause in Revenue Act of 1916 is derived from "well-entrenched substance over form principle"). It is a "well-settled" tax principle that the substance of a transaction controls over its form. See *id.* at 101 n.173 (discussing substance versus form of transaction). In 1921, the Supreme Court stated: "We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder." *United States v. Phellis*, 257 U.S. 156, 168 (1921). For example, in *Shearer v. Commissioner*, 17 T.C. 304 (1951), the Tax Court focused upon the substance rather than the form of the decedent's transaction. *Id.* at 307-08. The decedent in *Shearer* created a corporation by transferring two farms in exchange for shares of corporate stock. See *id.* at 305. Over the next few years, the decedent gave almost 80% of the stock as gifts to his children. See *id.* He then decided to dissolve the corporation. See *id.* at 306. In the dissolution, the decedent received a life estate in the farms, while his children received the remainder interests. See *id.* The court ignored the form of the transaction and included the full value of the farms in the decedent's estate. See *id.* at 307-08.

41. 281 U.S. 238 (1930), *overruled by* *Commissioner v. Estate of Church*, 335 U.S. 632 (1949). For the reasoning of the Supreme Court in *Church*, see *infra* notes 43, 165-66 and accompanying text.

42. *May*, 281 U.S. at 247. The *May* Court concluded that, because a formal legal transfer of title had taken place prior to the death of the decedent, it was not

houses of Congress reacted to the Supreme Court's decision by amending the Revenue Act in 1931 and effectively superseding *May*.<sup>43</sup> The amended statute was the predecessor to § 2036(a), which was enacted in 1954.<sup>44</sup>

Section 2036(a) and its predecessors were enacted to prevent tax evasion through the depletion of the transferor's estate.<sup>45</sup> The general rule of § 2036(a) is that the gross estate of the decedent includes all transfers

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subject to estate taxes. *Id.* at 243. In *May*, the decedent retained a contingent life estate. *Id.* (explaining that decedent's life estate was contingent upon outliving her husband). In 1931, the Supreme Court extended the *May* holding to a decedent's reservation of a primary life estate. *See, e.g., McCormick v. Commissioner*, 283 U.S. 784, 784 (1931) (per curiam) (extending *May* to primary life estate and holding that Congress has authority to impose laws with respect to remainder-interest transfers prospectively); *Morsman v. Commissioner*, 283 U.S. 783, 783-84 (1931) (per curiam) (same); *Commissioner v. Northern Trust Co.*, 283 U.S. 782, 783 (1931) (per curiam) (same).

The Revenue Act of 1916's possession and enjoyment clause apparently dates back to the Pennsylvania inheritance tax law in 1826. *See Siegel, supra* note 1, at 83 n.19 (tracing origins of "possession and enjoyment" clause). For a history of the clause, see Gertrude C. K. Leighton, Note, *Origin of the Phrase, "Intended to Take Effect in Possession or Enjoyment at or After . . . Death" (Section 811(c), Internal Revenue Code)*, 56 YALE L.J. 176, 176-79 (1946).

43. *See Siegel, supra* note 1, at 84 (discussing 1931 and 1932 amendments to the Revenue Act of 1926, Pub. L. No. 69-20, 44 Stat. 9). The joint resolution amended the statute to provide as follows:

To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, in contemplation of or intended to take effect in possession or enjoyment at or after his death, including a transfer under which the transferor has retained for his life or any period not ending before his death (1) the possession or enjoyment of, or the income from, the property or (2) the right to designate the persons who shall possess or enjoy the property or the income therefrom; except in case of bona fide sale for an adequate and full consideration in money or money's worth.

§ 302(c), 44 Stat. 9, 70. The following year, Congress amended the statute to include the phrase "the right to the income" in place of "the income." *See Siegel, supra* note 1, at 84 (noting that Congress changed statute to include transfers in which transferor retained "the right to income").

In 1949, the Supreme Court formally overruled its *May* decision. *See Estate of Church*, 335 U.S. at 637. In *Church*, the Supreme Court accepted:

the interpretation of the "possession or enjoyment" section under which an estate tax cannot be avoided by any trust transfer except by a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property.

After such a transfer has been made, the settlor must be left with no present legal title in the property, no possible reversionary interest in that title, and no right to possess or to enjoy the property then or thereafter.

*Id.* at 645. For a further discussion of *Church*, see *infra* notes 165-66 and accompanying text.

44. *See Lorey, supra* note 13, at 189 (noting also that Congress has amended § 2036(a) three times since its 1954 enactment); *see also* I.R.C. § 2036(a) (1994). For a listing of the predecessors to § 2036(a) and the changes that Congress made to these statutes, see Lorey, *supra* note 13, at 188-91 nn.33-41.

45. *See Siegel, supra* note 1, at 83-85 (discussing early legislative motivation to limit testamentary remainder-interest transfers); *see also* Gottlieb, *supra* note 14, at

in which the transferor retains a life estate.<sup>46</sup> Section 2036(a) excludes bona fide transfers made for full and adequate consideration.<sup>47</sup> If a transfer of property with a retained life estate does not meet the bona fide sale exception, the full value of the subject property is included in the decedent's gross estate.<sup>48</sup>

When reading the exception's plain language, a question of statutory interpretation arises; while a "bona fide sale for adequate and full consideration" includes a sale for the fair market value of the fee simple interest in the property, does it also include a sale for the fair market value of the remainder interest in the property?<sup>49</sup> In the 1960s, the Tax Court and two circuit courts held that the exception only includes a sale for the fair market value of the fee simple interest in the property.<sup>50</sup>

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16 (stating that § 2036(a) discourages manipulative transfers of testamentary remainder interests).

46. See I.R.C. § 2036(a); see also *DUKEMINIER & JOHANSON*, *supra* note 1, at 1027-28 (summarizing application of § 2036(a)). Section 2036(a) includes two types of lifetime transfers in the gross estate (1) retained life estates and (2) situations in which the transferor controls the enjoyment. See *id.* at 1028 (explaining scope of § 2036(a)). Although under § 2036(a)(1), the life estate terminates at death, the transfer is subject to estate taxation because the decedent retained the "right to possess and enjoy the property, or the right to its income, for life." *Id.* Section 2036(a)(2) applies to transfers in which the transferor retains the "right to control beneficial enjoyment of the property" even though the transferor cannot exercise this right to personally benefit. *Id.* For example, when the transferor designates herself as a cotrustee and the "trustees have a discretionary power to accumulate trust income or distribute it to the beneficiary," the transfer is subject to estate tax. *Id.* For the text of § 2036(a), see *supra* note 13.

47. See *Lorey*, *supra* note 13, at 188-91 (discussing legislative and judicial history of § 2036(a)).

48. See I.R.C. § 2036(a). To meet the § 2036(a) exception, the remainder-interest transfer must not only be for a full and adequate consideration, but the sale must also be bona fide. See *id.* Inherent in the meaning of a bona fide sale is an arm's length transaction. See *Jordan*, *supra* note 5, at 718-23 (discussing bona fide sales and arm's length transactions). In an arm's length transaction, both parties must receive a value equal to the property they are surrendering to avoid estate tax. See *id.* at 718 (noting that transaction must be true bargain and not merely testamentary or with donative intent). For the text of § 2036(a), including the bona fide sale exception, see *supra* note 13.

49. See *Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309, 312-18 (3d Cir. 1996) (analyzing whether bona fide sale exception includes sale of remainder interest for fair market value), *cert. denied*, 117 S. Ct. 1822 (1997). For a discussion of the Third Circuit's ruling on this issue, see *infra* notes 122-92 and accompanying text.

50. See *United States v. Past*, 347 F.2d 7, 12 (9th Cir. 1965) (holding that fair market value of transferred property is includible in decedent's gross estate for estate tax purposes); *United States v. Allen*, 293 F.2d 916, 917-18 (10th Cir. 1961) (same); *Estate of Gregory v. Commissioner*, 39 T.C. 1012, 1021-22 (1963) (same). For a discussion of *Past*, *Allen* and *Gregory*, see *infra* notes 51-65 and accompanying text. For a discussion of the Third Circuit's analysis of the *Past*, *Allen* and *Gregory* holdings and their applicability to the bona fide sale exception of § 2036(a), see *infra* notes 138-50 and accompanying text.

First, in *United States v. Allen*,<sup>51</sup> the United States Court of Appeals for the Tenth Circuit applied the adequate and full consideration test by comparing the fee simple value of the property that the decedent actually transferred to the value of the property received.<sup>52</sup> In *Allen*, the decedent created an irrevocable inter vivos trust in which she retained a partial life estate and gifted the remainder interest (and the rest of the life estate) to her children.<sup>53</sup> The decedent later sold the rest of her life estate to her son for more than the fair market value.<sup>54</sup> The decedent's executor argued that because the decedent sold her retained life estate for its fair market value, none of the trust property should be included in her es-

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51. 293 F.2d 916 (10th Cir. 1961).

52. *Id.* at 918 (stating that "[i]t seems certain" Congress intended only to exempt those transfers where consideration was equal to full value of underlying property). The *Allen* court noted that, in this case, § 2036's predecessor, § 811 of the Internal Revenue Code of 1939, applied because the decedent passed away before the 1954 enactment of § 2036. *Id.* at 917 n.1. Section 811 provided, in pertinent part:

"The value of the gross estate of the decedent shall be determined by including the value at the time of death of all property, . . . (c) Transfers in contemplation of, or taking effect at, death. (1) General Rule. To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise-(A) in contemplation of his [or her] death; or (B) under which he has retained for his life . . . (i) the possession or enjoyment of, or the right to the income from, the property . . ."

*Id.* (quoting I.R.C. § 811 (1939)).

53. *Id.* at 916 (noting that decedent created irrevocable trust when she reserved 60% of income for life, with remainder to pass to her two children). Her two children were also the beneficiaries of the remaining 40% of the trust income. *See id.*

54. *See id.* at 916-17 (stating that decedent's son paid \$5,000 more than fair market value for decedent's life estate). When the decedent was 78 years old, her attorney advised that by retaining the life estate in the trust, 60% of its value would be included in her estate for estate tax purposes. *See id.* at 916. At that time, the actuarial value of the life estate was approximately \$135,000 and her 60% share of the corpus was valued at approximately \$900,000. *See id.* Ultimately, the decedent's son purchased the life estate for \$140,000. *See id.* at 916-17. The son now owned the life estate "per autre vie," that is, he owned a life estate measured by the life of his mother. *See generally* BLACK'S LAW DICTIONARY 1135 (6th ed. 1990) (defining "per autre vie"). The *Allen* court stated that the son expected that his mother's life span would be sufficient for him to return a profit on his investment. *Allen*, 293 F.2d at 917. In addition, the *Allen* court also considered the decedent's son to be a bona fide third-party purchaser because he was not in the position to benefit from any reduction in his mother's estate taxes. *Id.*

Although the decedent was in good health at the time of the transfers, she discovered shortly thereafter that she had an incurable disease, which resulted in her death. *See id.* Thus, her son suffered a considerable loss on his \$140,000 investment because his income interest terminated. *See id.* The IRS determined that the decedent's gross estate should include 60% of the corpus, less the \$140,000 paid by her son for the life estate, because "(1) the transfer was invalid because [it was] made in contemplation of death, and (2) the sale was not for an adequate and full consideration." *Id.*



tate.<sup>55</sup> The Tenth Circuit disagreed, holding that consideration is adequate only if it equals or exceeds the value of the interest that would otherwise be included in the gross estate without the transfer.<sup>56</sup>

Two years later, in *Estate of Gregory v. Commissioner*,<sup>57</sup> the Tax Court applied the adequate and full consideration test by comparing the fee simple value of the property that the decedent transferred with the value of

55. See *Allen*, 293 F.2d at 917 (noting that after paying taxes which IRS claimed decedent's estate owed, decedent's executor brought suit for refund asserting that because sale of decedent's life interest was for adequate consideration, it should not be includible in decedent's gross estate). The United States Court of Appeals for the Tenth Circuit stated that *Allen's* narrow issue was

[w]hether the corpus of a reserved life estate is removed, for federal estate tax purposes, from a decedent's gross estate by a transfer at the value of such reserved life estate. In other words, must the consideration be paid for the interest transferred, or for the interest which would otherwise be included in the gross estate?

*Id.*

56. See *id.* (rejecting estate's argument despite acknowledging that decedent only owned life estate and could not reasonably expect to sell it for fee simple value). The court reasoned:

It does not seem plausible . . . that Congress intended to allow such an easy avoidance of the taxable incidence befalling reserved life estates. This result would allow a taxpayer to reap the benefits of property for his lifetime and, in contemplation of death, sell only the interest entitling him to the income, thereby removing all of the property which he has enjoyed from his gross estate. Giving the statute a reasonable interpretation, we cannot believe this to be its [intent]. . . .

*Id.* at 918 (citations omitted). The *Allen* court also cited the view of a commentator who distinguished tax law and property law regarding the interpretation of § 2036(a). *Id.* at 918 n.2 (citing Charles L.B. Lowndes, *Cutting the "Strings" on Inter Vivos Transfers in Contemplation of Death*, 43 MINN. L. REV. 57, 70-71 (1958)). Professor Lowndes stated:

[T]he determination of what interest is transferred in contemplation of death and what is adequate consideration to prevent a transfer in contemplation of death from being taxable, should be made on the basis of the tax effect of the transfer and the effect of the consideration on the transferor's taxable estate, rather than by the comparatively irrelevant rules of property law.

Lowndes, *supra*, at 71.

Some commentators agree with the *Allen* court's result, but reject its interpretation of § 2036(a). See, e.g., Abendroth, *supra* note 6, at 53 (noting that *Allen* transaction had potential for tax avoidance that does not exist in remainder-interest transfers); Lorey, *supra* note 13, at 205 n.114 (arguing that *Allen* court cited no direct authority for its interpretation that it should weigh value of consideration against underlying property value). If *Allen* had ruled for the estate, a taxpayer could keep an income interest in gifted property for many years and at an old age, when the life estate's actuarial value is low, sell the life estate and completely avoid estate taxation. See Abendroth, *supra* note 6, at 55 (distinguishing life estates from remainder interests and stating that remainder interest transfers do not have same potential for abuse as life estates when transferred at their fair market value). For a discussion of the Third Circuit's interpretation of *Allen*, see *infra* notes 140-41 and accompanying text.

57. 39 T.C. 1012 (1963).

the consideration received.<sup>58</sup> *Gregory* involved a testamentary disposition of community property.<sup>59</sup> In *Gregory*, the consideration that the decedent received was grossly inadequate, regardless of the manner in which the court valued it.<sup>60</sup> The Tax Court concluded that § 2036(a) only excepts

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58. *Id.* at 1015. The decedent had exchanged a remainder interest worth \$65,925.08 for a life estate worth \$11,926.96. *See id.* at 1017. When the decedent died, the property that the decedent had exchanged appreciated to \$102,420.69. *See id.* at 1015. The *Gregory* court compared the \$11,926.96 that the decedent received as consideration with the value of the transferred property as of the date of the decedent's death and found the consideration inadequate. *Id.* at 1015-16. Therefore, because the transfer failed the § 2036(a) exception, the decedent's estate included the full value of the underlying property, less the \$11,926.96 consideration. *See id.* at 1022.

59. *Id.* at 1013-15 (detailing decedent's husband's will). *Gregory* was a "widow's election" case. *See id.* at 1013. In a typical "widow's election" case, the husband passed the remainder interest in all of the marital property to his children, while providing for the lifetime needs of his wife. *See Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309, 313 (3d Cir. 1996) (explaining "widow's election" wills), *cert. denied*, 117 S. Ct. 1822 (1997). In a community property state, however, half of the marital property belongs to the wife as a matter of law. *See id.* Therefore, the husband could not legally devise the property by his will. *See id.* To avoid this problem, the couple's attorney drafts the will to give the wife a choice between keeping a one-half share of the estate in fee simple and receiving nothing from her spouse or putting half of the community property in a trust, thereby exchanging her remainder interest for a life estate in the whole. *See id.*; *see also Jordan*, *supra* note 5, at 679 n.30 (describing widow's election wills). *See generally Stanley M. Johanson, Revocable Trusts, Widow's Election Wills, and Community Property: The Tax Problems*, 47 TEX. L. REV. 1247, 1253-57 (1969) (detailing tax concerns for "widow's election" wills).

In *Gregory*, by the terms of the decedent's husband's will, the decedent "was required to elect to either (a) take her share in the community property, or (b) permit her share of the community property to pass into the testamentary trust under said will." *Gregory*, 39 T.C. at 1013. At the time of the decedent's husband's death, he left community property worth \$186,104.44, in which the decedent had an equal one-half interest under California law. *See id.* Thus, the decedent's husband's gross estate was only worth \$93,052.22, while the remaining half was excluded as community property. *See id.* The decedent elected to let her interest in the community property "pass" into the testamentary trust created under her husband's will. *See id.* The decedent contributed \$65,925.08 (her remainder interest in her portion of the community property) into the testamentary trust and received her husband's life estate in return. *See id.* at 1013-15. The life estate's actuarial value was only \$11,926.96 because the decedent was 77 years old at the time of the election. *See id.* at 1013, 1017.

60. *Gregory*, 39 T.C. at 1015-16. The *Gregory* court noted that the decedent received inadequate consideration no matter how the court calculated the value of the consideration. *Id.* The court compared the value of the property transferred as of the date of the decedent's death to the consideration received at the time of transfer. *See id.* The Third Circuit has rejected the use of the date-of-death value when comparing the value of the underlying property with the consideration that the decedent received. *See D'Ambrosio*, 101 F.3d at 313 (stating that Third Circuit will compare value of remainder interest that decedent transferred with value of consideration that decedent received as of date of transfer). In *Gregory*, the actuarial value of her husband's life estate was just \$11,926.96, while the value of the property that the decedent transferred was \$65,925.08 as of the date of transfer. *Gregory*, 39 T.C. at 1013, 1017. At the time of the decedent's death, the property

those bona fide sales in which the consideration that the decedent received was of a comparable value to the value that would be included in the transferor's gross estate.<sup>61</sup>

Finally, in *United States v. Past*,<sup>62</sup> the United States Court of Appeals for the Ninth Circuit held that the decedent's transfer did not meet the bona fide sale exception because the value of the retained life estate received was inadequate in relation to the value of the underlying property exchanged.<sup>63</sup> *Past* involved a divorce settlement in which the decedent sold her remainder in one-half of the marital property in exchange for a life estate in the whole property.<sup>64</sup> The court compared one-half of the property's fee simple value with the value of the life estate received and found that the decedent did not receive full and adequate consideration.<sup>65</sup>

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value appreciated to \$102,420.69. *See id.* at 1015. For further discussion of the Third Circuit's opinion of *Gregory*, see *infra* notes 142-45 and accompanying text.

61. *See Gregory*, 39 T.C. at 1016 ("[Section 2036(a)] excepts only those bona fide sales where the consideration received was of a comparable value which would be includable in the transferor's gross estate." (citing Estate of John M. Goetchius, 17 T.C. 495 (1951))). In *Goetchius*, the Tax Court stated that "there must be the kind of consideration which in an arm's length business transaction provides the transferor of property with the full value thereof, in exchange." *Goetchius*, 17 T.C. at 503.

62. 347 F.2d 7 (9th Cir. 1965).

63. *Id.* at 13-14 (comparing value of life estate that decedent received with value of transferred property).

64. *Id.* at 13. In 1954, the decedent and her husband entered into a property settlement incident to their divorce. *See id.* at 9. Because of the decedent's alcohol addiction, her husband did not want her to own any of the couple's valuable business assets, but he did want her to have a comfortable income. *See id.* The value of the property owned by the decedent and her husband totaled \$848,746.08. *See id.* at 11. The decedent's husband received property valued at \$293,887.74, while the decedent received property valued at \$21,000 and a life estate in a trust created by the property settlement. *See id.* The trust received property valued at \$487,976.00, while a cleanup fund, set up to satisfy certain joint obligations, totaled \$45,880.34. *See id.* The decedent and her husband intended that all of the property transferred to the trust was owned by the spouses equally at the time of transfer and that the transfer was a joint transfer. *See id.* at 10-11. Under the terms of the trust, the decedent received all of the income for life with the remainder going to their children. *See id.* at 10. At the time of the settlement, the decedent was 44 years old and had a life expectancy of approximately 28 years. *See id.* at 11. Therefore, the trial court valued the life estate as "substantially greater than" \$286,691.95. *Id.* at 13 n.3. On December 25, 1956, the decedent's second husband murdered her. *See id.* at 11. The IRS, relying on § 2036(a), determined that the decedent's estate should include the entire corpus of the trust, valued at \$642,788.66 as of the date of the decedent's death. *See id.*

65. *See id.* at 13-14 (noting that decedent realized approximately 60% of actual value of trust). The value of the trust was \$487,978 from which the decedent had contributed half or \$243,989. *See id.* at 13. She received a life estate in the trust income worth \$286,691.95. *See id.* at 13-14. The court noted that the decedent contributed one-half of the life estate value and her first husband contributed the other half. *See id.* Therefore, the court reasoned that the decedent really only received her first husband's contributed portion, \$143,346. *See id.* at 14. Thus, because the decedent transferred \$243,989 and received only \$143,346, the court

### C. *Sale-of-Remainder-Interest Technique*

Despite adverse case law in the 1960s, the sale of a remainder interest was a popular estate planning device in the early and middle 1980s.<sup>66</sup> The Internal Revenue Service (IRS) triggered the growth of this technique by reversing the course of the precedent of the 1960s and accepting the notion that a remainder interest sold at fair market value meets the bona fide sale exception of § 2036(a).<sup>67</sup> As long as a remainder interest was sold for a value derived from the tables in the Estate Tax Regulations, the decedent was deemed to have received the full and adequate consideration contemplated by § 2036(a).<sup>68</sup>

In practice, estate planners recommended the sale-of-remainder-interest technique to clients who owned strong growth assets that they ultimately wanted to pass on to their heirs.<sup>69</sup> Thus, a client would sell the remainder interest to his or her children for an amount equal to the value of the remainder interest determined by the IRS actuarial tables, while retaining a life estate in the property.<sup>70</sup> If the planner valued the underly-

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concluded that she did not receive adequate and full consideration for the purposes of § 2036(a). *See id.*

Therefore, the *Past* court compared the value of the consideration that the decedent received with the full fee simple value of the property that the decedent transferred. *Id.* The decedent, however, only transferred the remainder interest of her portion of the couple's property because she retained the life estate. *See id.* Thus, the Ninth Circuit analyzed the transaction as if the decedent transferred her entire interest. *See id.* For a discussion on the Third Circuit's criticism of the Ninth Circuit's application of § 2036(a), see *infra* notes 146-48 and accompanying text.

66. *See generally* Abendroth, *supra* note 6, at 49 (noting that sale of remainder interest technique was "hot" estate planning technique in early and middle 1980s).

67. *See* Tech. Adv. Mem. 8,145,012 (July 20, 1981) (addressing case in which decedents sold remainder interest in real property for fair market value, but not at property's fee simple value). In this private letter ruling, the IRS found that the decedents' life estate expired and was not property of the estate under § 2033 of the Code. *See id.* Thus, the IRS ruled that the decedent's transfer was for sufficient consideration. *See id.*; *see also* Lorey, *supra* note 13, at 187 (discussing IRS acceptance of remainder-interest sales). The IRS valued the transfer using the tables in the Estate Tax Regulations. *See id.* at 187 n.19 (citing Treas. Reg. § 20.2031-10(f) (as amended in 1990) (providing actuarial tables that decedent used to value remainder interest)).

68. *See* Lorey, *supra* note 13, at 187-88 (concluding that remainder-interest sale relies on statutory language and legal theories that IRS recognized); *see also* Tech. Adv. Mem. 8,145,012 (July 20, 1981) (finding that when decedents sold remainder interest for value derived from tables in Estate Tax Regulations, decedents received full and adequate consideration contemplated by § 2036(a)).

69. *See* Abendroth, *supra* note 6, at 49 (describing typical scenario employing use of sale-of-remainder-interest technique).

70. *See id.* (explaining operation of sale-of-remainder-interest technique); *see also* Treas. Reg. § 20.2031-7(d)(6) (as amended in 1990) (providing actuarial tables to determine present value of remainder interest based on life expectancy of life tenant); Lorey, *supra* note 13, at 187-88 (discussing early 1980s acceptance by IRS of actuarial value as adequate consideration for remainder interests).

The regulation's tables provide the ratios to compute the present value of the remainder interest based upon the transferor's actuarial life expectancy. *See* Treas.

ing asset correctly and used the IRS actuarial tables properly, the transfer met the bona fide sale exception of § 2036(a) and would not cause the IRS to include the property in the client's estate.<sup>71</sup> In the 1980s, the benefit of the technique derived from the IRS valuation tables, which assumed that assets yielded a ten-percent income return and did not appreciate.<sup>72</sup> The consequence of this assumption was that the tables undervalued remainder interests in growth investment assets.<sup>73</sup>

#### D. Congressional Response to the Sale-of-Remainder-Interest Technique

Congress reacted to circumvention of estate taxes through the sales of remainder interests by enacting § 2036(c) in 1987 and its successor,

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Reg. § 20.2031-7(d)(6). If the interest to be valued is to take effect after the death of an individual, the present value of the remainder interest is calculated by multiplying the value of the property by the appropriate remainder-interest actuarial factor in Table S of the regulations. *See id.* § 20.2031-7(d)(2)(ii) (providing calculation for determining present value of remainder interest); *id.* § 20.2031-7(d)(6) (providing actuarial factors); *see also* I.R.C. § 7520 (1994) (providing applicable interest rate for use in Table S); Treas. Reg. § 20.7520-3(b) (as amended in 1990) (pertaining to certain limitations on use of actuarial tables). For an example showing how to apply Table S to compute a remainder-interest actuarial value, *see supra* note 7.

71. *See* Abendroth, *supra* note 6, at 49 (concluding that upon death of client, life estate terminates and property passes unburdened by estate tax to remainderperson if follow actuarial tables); *see also* I.R.C. § 2036(a) (1994) (stating general rule of transfer with retained life estate is to include full value of underlying asset in decedent's estate unless transfer was bona fide sale made for full and adequate consideration). For the pertinent text of § 2036(a), *see supra* note 13.

72. *See* Abendroth, *supra* note 6, at 49 (stating IRS actuarial tables based on Treasury bond model). The result was that "the tables undervalued remainder interests in typical growth investment assets like stock or real estate." *Id.*; *see also* Gans, *supra* note 7, at 766-77 (detailing explanation of how taxpayers could benefit from disparities between table rates and market rates).

In 1988, Congress amended § 7520 of the Code to make the table rate more reflective of current market rates. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342, 3668 (codified as amended at I.R.C. § 7520). Section 7520 sets the rate for Table S at 120% of the federal midterm rate as determined under § 1274(d)(1). *See* I.R.C. § 7520(a)(2); Treas. Reg. § 20.2031-7(d)(6) (providing "Table S"); *see also* I.R.C. § 1274(d)(1) (adjusting federal midterm rate monthly to reflect changes in market rate). One commentator still considered § 7520's rate to be inappropriately high and noted that rates established in other code sections are lower. *See* Gans, *supra* note 7, at 773 n.22 (requiring lower rate in case of interest-free or below-market loans) (citing I.R.C. § 7872). This commentator stated: "Ironically, to the extent that § 7520 set the table rate at too high a level, it failed to completely eliminate the opportunity for rate benefit that taxpayers had enjoyed prior to its enactment." *Id.*

73. *See* Abendroth, *supra* note 6, at 49 (noting that effect of this assumption is apparent when one considers both unprecedented growth of real estate market in middle 1980s and strong bull market); *cf.* Gans, *supra* note 7, at 773 n.22 (asserting that this advantage still exists under amended Code). *See generally* Jordan, *supra* note 5, at 700-04 (discussing and providing example of how taxpayers can use actuarial assumptions to their advantage).

§ 2702, in 1990.<sup>74</sup> Section 2036(c) eliminated the bona fide sale exception of § 2036(a) for remainder-interest transfers to lineal descendants.<sup>75</sup> Congress repealed § 2036(c) in the Omnibus Budget Reconciliation Act of 1990<sup>76</sup> and replaced it with § 2702 to ensure a more accurate valuation of remainder interests.<sup>77</sup> Generally, the value of a transferred remainder interest equals its actuarial value.<sup>78</sup> For remainder interests transferred to family members after October 8, 1990, however, the remainder interest must be valued by the special valuation rules of § 2702.<sup>79</sup>

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74. See I.R.C. § 2702 (1994) (seeking to eliminate tax benefits provided by techniques like sale of remainder interest); see also I.R.C. § 2036(c) (1988) (eliminating bona fide exception of § 2036(a) for remainder interests to lineal descendants), *repealed by* Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, tit. XI, § 11601(a), 104 Stat. 1388, 1490.

75. See I.R.C. § 2036(c) (stating that "the exception . . . for a bona fide sale shall not apply to a transfer [of a remainder interest] . . . if such transfer is to a member of the transferor's family"); see also Abendroth, *supra* note 6, at 49 (noting, "in most practitioners' minds," enactment of § 2036(c) confirmed that sale of remainder interest worked).

76. Pub. L. No. 101-508, tit. XI, § 11601(a), 104 Stat. 1388, 1490.

77. See Jordan, *supra* note 5, at 705 (stating that § 2702 precludes manipulating IRS actuarial tables to understate value of remainder interests).

78. See Treas. Reg. § 25.2512-5(a)(1)(i) (as amended in 1990) (noting that fair market value of transferred remainder interest equals fair market value of underlying asset less actuarial value of interest or interests retained by transferor). For the purposes of this regulation, the fair market value of the underlying property less the actuarial value of the retained interest always equals the actuarial value of the transferred remainder interest. See Jordan, *supra* note 5, at 705 n.159.

79. See Jordan, *supra* note 5, at 705 ("Remainder interests transferred after October 8, 1990, 'to (or for the benefit of) a member of the taxpayer's . . . family' must be valued for gift tax purposes using the special valuation rules of Section 2702 of the Code."); see also I.R.C. § 2702 (providing valuation rules for family members). Section 2702 provides:

(a) Valuation rules.—

(1) In general. — Solely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), the value of any interest in such trust retained by the transferor or any applicable family member (as defined in section 2701(e)(2)) shall be determined as provided in paragraph (2).

(2) Valuation of retained interests.—

(A) In general.—*The value of any retained interest which is not a qualified interest shall be treated as being zero.*

(B) Valuation of qualified interest. — The value of any retained interest which is a qualified interest shall be determined under section 7520.

(3) Exceptions.—

(A) In general.—This subsection shall not apply to any transfer—

- (i) to the extent such transfer is an incomplete transfer, or
- (ii) if such transfer involves the transfer of an interest in trust all the property in which consists of a residence to be used as a personal residence by persons holding term interest in such trust.

Whether § 2702's special valuation rules for family-member transfers apply depends upon the nature of the retained interest and the nature of the underlying property.<sup>80</sup> The general rule of § 2702's special valuation provision is that the value of the remainder interest equals the value of the underlying property.<sup>81</sup> To accomplish this, the value of the retained interest is artificially set at zero.<sup>82</sup> Section 2702's general rule recognizes both the failure of the actuarial tables to account for appreciation and the potential this failure creates for manipulating the investment of the underlying property so that the actuarial value of the remainder interest surpasses its actual value.<sup>83</sup> Therefore, the general rule effectively treats the remainder-interest transfer as if the taxpayer transferred the property in fee simple to the remainderperson and merely delays when the remainderperson will take possession.<sup>84</sup>

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(B) Incomplete transfer. — For purposes of subparagraph (A), the term "incomplete transfer" means any transfer which would not be treated as a gift whether or not consideration was received for such a transfer. . . .

*Id.* § 2702(a) (emphasis added). Section 2704(c)(2) states that "[t]he term 'member of the family' means, with respect to any individual—(A) such individual's spouse, (B) any ancestor or lineal descendant of such individual or such individual's spouse, (C) any brother or sister of the individual, and (D) any spouse of any individual described in subparagraph (B) or (C)." *Id.* § 2704(c)(2). For a further discussion of the definition of "family members," see *supra* note 21, *infra* notes 200-02 and accompanying text. For the text of § 2702(b), applying to qualified interests, see *infra* note 86 and accompanying text.

80. See I.R.C. § 2702 (discussing various circumstances when special valuation rules for family members apply).

81. See *id.* § 2702(a)(2)(A) (setting value of retained interest at zero); see also Jordan, *supra* note 5, at 705 n.162 ("Because the value of a transferred remainder interest equals the value of the underlying asset less the value of the interest retained by the transferor, the effect of . . . [§ 2702's] general rule is to make the value of the remainder interest equal to the value of the underlying asset." (citing Treas. Reg. § 25.2512-5(a)(1)(i))). Therefore, "[t]hese rules preclude manipulating the actuarial assumptions to understate the value of a transferred remainder interest." *Id.* at 705.

82. See I.R.C. § 2702(a)(2)(A) ("The value of any retained interest which is not a qualified interest shall be treated as being zero."). For a discussion of qualified interests, see *infra* notes 86-87 and accompanying text.

83. See Jordan, *supra* note 5, at 706 (noting that general rule assumes exact opposite of actuarial tables).

84. See *id.* at 706-07 (stating that taxpayers will seek to shift wealth to remainderperson to fullest extent possible and invest property so that entire return is realized as appreciation). Thus, if the transferor structures the remainder-interest transfer so that he or she may manipulate the investment of the underlying property yield so that it is less than the expected income, the transferor is taxed as if he or she transferred the property outright. See *id.* at 707 (discussing effect of § 2702's general rule). One commentator stated: "To the extent that the transferor receives income payments [ ] made to the taxpayer as holder of the income interest, there is double taxation." *Id.* at 707 n.168. This effect would occur because the Code includes the income payments in the transferor's gross estate "even though the present value of the income payments is subject to the gift tax at the time of the transfer of the remainder interest." *Id.*

The Code has two primary exceptions to these special valuation rules.<sup>85</sup> First, the remainder interest is excluded from the general rule if the taxpayer retains a qualified interest.<sup>86</sup> If the taxpayer retains either a qualified annuity interest or a qualified unitrust interest, the value of the remainder interest is its actuarial value.<sup>87</sup> The second exception to § 2702's general rule applies when the taxpayer transfers a remainder interest in his or her personal residence.<sup>88</sup>

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85. See I.R.C. § 2702 (providing qualified interest exception and personal residence exception).

86. See *id.* § 2702(a)(2)(B), (b) (exempting any retained interest that is qualified interest from general rule). For the purposes of § 2702, a qualified interest means:

- (1) any interest which consists of the right to receive fixed amounts payable not less frequently than annually,
- (2) any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually), and
- (3) any noncontingent remainder interest if all of the other interests in the trust consist of interests described in paragraph (1) or (2).

*Id.* § 2702(b). Section 2702(b)(1) is known as a qualified annuity interest and § 2702(b)(2) is known as a qualified unitrust interest. See Jordan, *supra* note 5, at 707-11 (explaining qualified interests).

87. See I.R.C. § 2702(a)(2)(B); see also *id.* § 2702(b)(1) (defining "qualified annuity interest"); *id.* § 2702(b)(2) (defining "qualified unitrust interest"). As one commentator notes, "the value of a remainder interest that follows a retained qualified interest equals the value of the underlying [property] less the actuarial value of the retained interest, or the actuarial value of the remainder interest." Jordan, *supra* note 5, at 707 n.172 (citing I.R.C. §§ 2702(a)(2)(B), 7520(a); Treas. Reg. § 25.2512-5 (as amended in 1990)). For a detailed discussion of qualified annuity interests and qualified unitrust interests, see Jordan, *supra* note 5, at 707-11.

88. See I.R.C. § 2702(a)(3)(ii) (stating that special valuation rules of § 2702 will not apply "if [transfer with retained interest] involves the transfer of an interest in trust all the property in which consists of a residence to be used as a personal residence by persons holding term interests in such trust"). The Treasury Regulations limit the taxpayer to two residences that may qualify for this exemption: a principal residence and one other residence. See Treas. Reg. § 25.2702-5(b)(2), (c)(2) (as amended in 1992). The regulations also place severe restrictions on such transfers to prevent a transferor from using the personal residence exception to circumvent the general rule. See *id.* § 25.2702-5(b)(3), (c)(2).

To qualify for this exception, the remainder interest transfer must be accomplished by a personal residence trust or a qualified personal residence trust. See *id.* § 25.2702-5(a) (limiting exception); see also Jordan, *supra* note 5, at 712 n.199 (explaining that primary distinctions between personal residence trust and qualified personal residence trust involve amount of cash each trust may hold and whether trust may sell personal residence that it holds). If the transferor uses a personal residence trust to transfer a remainder interest in his or her personal residence, the value of the retained interest is its actuarial value. See *id.* at 712 (discussing use of personal residence trust) (citing I.R.C. § 2702(a)(3)(ii); Treas. Reg. § 25.2512.5). For a detailed discussion of the personal residence exception, see *id.* at 711-15.



Section 2702 effectively terminated the sale-of-remainder-interest technique with regard to interfamily transfers.<sup>89</sup> For transfers to non-family members, the proper value of the remainder interest is its actuarial value.<sup>90</sup> Congress intended this Code section to apply to transfers after October 8, 1990 and did not intend it to be retroactive.<sup>91</sup> Subsequent case law, however, narrowed the bona fide sale exception of § 2036(a) by effectively applying the policy of § 2702 retroactively to the 1980s transactions and prospectively to non-family-member transfers.<sup>92</sup>

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89. See I.R.C. § 2702(a) (stating that remainder interest transferred after October 8, 1990, "to (or for the benefit of) a member of the transferor's family" must be valued for gift tax purposes using section's special valuation rules). Generally, if the retained interest does not qualify under one of § 2702's narrow exceptions, the value of any retained interest is zero. See *id.* § 2702(a)(2)(A) (listing specific exceptions). Thus, the IRS values the remainder interest at the value of the underlying property. See Jordan, *supra* note 5, at 723 (stating that when remainder interest is sold to family member, § 2702 prevents seller from shifting wealth to remainderpersons tax free by "redefining adequate consideration for purposes of the gift tax to equal the value of the underlying property"); see also Treas. Reg. 25.2512-5(a)(1)(i) (stating general rule for remainder-interest valuation). Therefore, a transferor selling a remainder interest to a family member can avoid having § 2036(a) include the full value of the underlying property in his or her estate, if the transferor sells the interest for the value of the underlying property. See I.R.C. § 2036(a) (1994) (providing that if holder of retained life estate transfers such estate, value of gross estate will include value of all property, including value of transferred estate).

These rules preclude using the IRS actuarial tables to understate the value of a transferred remainder interest when the transferor is selling the remainder interest to a family member. See Jordan, *supra* note 5, at 705 (discussing § 2702's policy to prevent manipulation). The members of a transferor's family include the transferor's spouse; any ancestor, lineal descent or spouse of an ancestor or lineal descendant of the transferor or the transferor's spouses; and the transferor's brothers and sisters and their spouses. See I.R.C. §§ 2702(e), 2704(c)(2) (defining term "member of the family"). For further discussion of who is a "member of the family," see *supra* notes 21, 79 and 200-02.

90. See Treas. Reg. § 25.2512-5(a)(1)(i) (explaining that fair market value of transferred remainder interest equals fair market value of underlying asset less actuarial value of interest or interests retained by transferor). For the purposes of this regulation, the value of the underlying property less the actuarial value of the retained interest always equals the actuarial value of the remainder interest. See Jordan, *supra* note 5, at 705 n.159 (discussing how to determine worth of transfer for nonfamily members).

91. See I.R.C. § 2702 (applying to transfers after October 8, 1990); see also Abendroth, *supra* note 6, at 50 (noting that § 2702 did not affect pre-1990 remainder-interest transfers). See generally I.R.C. § 2036(c) (1988) (applying similar rules for family-member transfers from December 17, 1987 until October 8, 1990), repealed by Omnibus Budget Reconciliation Act of 1990, tit. XI, § 11601(a), Pub. L. No. 101-508, 104 Stat. 1388, 1490.

92. See, e.g., *Gradow v. United States*, 11 Cl. Ct. 808, 815 (1987) (concluding that, to meet exception of § 2036(a), decedent must receive consideration equal to value of underlying property that decedent transferred), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990). For a further discussion of *Gradow* and its progeny, see *infra* notes 93-121 and accompanying text.

E. *Apparent Invalidation of the Sale-of-Remainder-Interest Technique*

While Congress was attempting to reduce the use of the sale-of-remainder-interest technique, the Court of Claims's interpretation of the § 2036(a) bona fide sale exception in *Gradow v. United States*<sup>93</sup> effectively invalidated the technique.<sup>94</sup> The *Gradow* court held that the price paid for a remainder interest must equal the value of the entire property at the time of the transfer.<sup>95</sup> *Gradow* was a widow's election case in which the surviving spouse elected to transfer her interest in community property to a designated trust and retained a life estate.<sup>96</sup> Following the surviving spouse's death, her executor claimed that her transfer to the trust was for adequate and full consideration because the life estate she received in her husband's property exceeded the value of the remainder interest in the property she relinquished.<sup>97</sup>

The Court of Claims accepted the IRS's argument that, for the purposes of § 2036(a), the decedent did not transfer a remainder interest, but rather she transferred her entire interest in the community property.<sup>98</sup>

93. 11 Cl. Ct. 808 (1987), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990).

94. *Id.* at 813, 815 (holding that sale of remainder interest for its fair market value is insufficient consideration for purposes of § 2036(a) bona fide sale exception).

95. *Id.* at 812-13 (discussing reasoning for limiting scope of bona fide sale exception).

96. *Id.* at 809 (noting that decedent sought to control both shares of community property by creating trust). For a discussion of "widow's election" cases, see *supra* note 59.

Decedent and her husband were residents of California, a community property state. See *Gradow*, 11 Cl. Ct. at 809. The decedent's husband's will gave his wife an election. See *id.* If she opted to reject the will, she would only receive her one-half share of the community property. See *id.* If she chose to take under the will, however, she could transfer her part of the community property into a trust consisting of her and her husband's community property, from which she would receive all the income for life and which would entitle her to own the couple's residence outright. See *id.* Upon her death, the corpus of the trust was to go to her son. See *id.*

In 1979, the decedent elected the latter option under her husband's will. See *id.* Therefore, the decedent's half of the community property, exclusive of the residence, was worth \$461,610, while the life estate interest in the trust income was \$192,039. See *id.* Thus, the decedent received total consideration, including the residence and other personal effects, of \$300,695. See *id.* The value of the remainder interest in the community property was \$211,367. See *id.* The decedent died in 1980. See *id.*

97. See *Gradow*, 11 Cl. Ct. at 809 (discussing executor's claim that decedent's transfer to trust was for adequate consideration). The executor valued the consideration that the decedent received at \$300,695 and valued the remainder interest at \$211,367. See *id.* Because the value of the retained life estate exceeded the value of the transferred remainder interest, the executor asserted that the transfer was for full and adequate consideration under § 2036(a). See *id.* In 1983, however, the IRS asserted a deficiency in estate taxes of \$162,271. See *id.* The executor initially paid the deficiency and also \$78,662 in interest, but in 1985 the executor filed a claim for a refund. See *id.*

98. See *id.* at 813 ("The only way to preserve the integrity of [§ 2036(a)] . . . is to view the consideration moving from the surviving spouse as that property which

Accordingly, the court reasoned that the adequacy of consideration required to meet the bona fide sale exception of § 2036(a) must be measured against the value of the property that would be included in the decedent's estate, not against the value of the property transferred.<sup>99</sup> From this interpretation, the court found that the transfer failed to meet the bona fide sale exception of § 2036(a) because the life estate that the spouse received was not sufficient consideration for the full value of the property she transferred to the trust.<sup>100</sup>

The *Gradow* court based its reasoning on statutory interpretation and the need to "preserve" the purpose of § 2036(a).<sup>101</sup> The court initially stated that the most natural reading of § 2036(a) leads to the result that a remainder interest must equal the value of the entire property to meet the bona fide sale exception.<sup>102</sup> The court interpreted the term "property" in the phrase "the gross estate shall include . . . all property . . . of which decedent has at any time made a transfer" as referring to the fee simple interest of the property.<sup>103</sup> The court then opined that "[f]undamental principles of grammar dictate that" the bona fide sale exception relates to

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is taken out of the gross estate."). For a further discussion of the court's interpretation of § 2036(a), see *infra* notes 101-07 and accompanying text.

99. *Gradow*, 11 Cl. Ct. at 816. For a discussion of the court's reasoning for this conclusion, see *infra* notes 101-07 and accompanying text.

100. See *Gradow*, 11 Cl. Ct. at 813 (discussing why consideration that decedent received was inadequate). The court of appeals noted that the decedent received \$234,767 pursuant to her election. See *Gradow v. United States*, 897 F.2d 516, 518 n.6 (Fed. Cir. 1990). This consideration was inadequate because the half of the property that the decedent contributed to the trust was worth \$444,641. See *id.* at 518 n.7.

101. *Gradow*, 11 Cl. Ct. at 813 (reasoning that requirement for property transfer to be bona fide sale "for adequate and full consideration" preserves the purposes of the rest of § 2036(a), because it is based on the expectation that what is being added to the surviving spouse's assets will be subject to inclusion in the gross estate").

102. See *id.* at 813 & n.6 (stating that "there is no doubt" that "property" refers to that part of trust corpus attributable to decedent). The court was persuaded by three cases from the 1960s that interpreted the bona fide sale exception of § 2036(a) to require consideration equal to the underlying value of the property. See *id.* at 810-13 (citing *United States v. Past*, 347 F.2d 7 (9th Cir. 1965); *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961); *Estate of Gregory v. Commissioner*, 39 T.C. 1012 (1963)). The *Gradow* court asserted that the "most natural reading of 2036(a) leads to the same result." *Id.* at 813.

For a discussion of the facts, holding and reasoning of *Past*, see *supra* notes 62-65 and accompanying text. For a discussion of the facts, holding and reasoning of *Allen*, see *supra* notes 51-56 and accompanying text. For a discussion of the facts, holding and reasoning of *Gregory*, see *supra* notes 57-61 and accompanying text.

103. *Gradow*, 11 Cl. Ct. at 813 (alterations in original) (quoting I.R.C. § 2036(a) (1994)). The court stated:

In the context of this case, there is no question that the term "property" in the phrase "The gross estate shall include . . . all property . . . of which decedent has at any time made a transfer" means that part of the trust corpus attributable to plaintiff. If § 2036(a) applies, all of [decedent's] former community property is brought into her gross estate.

*Id.* (quoting I.R.C. § 2036(a)).

the same "property, i.e., the one-half of the community property [that the decedent] placed into trust."<sup>104</sup> The *Gradow* court considered this interpretation to be the most consistent with the purposes of § 2036(a).<sup>105</sup>

Under the alternative reading of § 2036(a), the *Gradow* court reasoned that as long as the surviving spouse was not elderly at the time of an election, a couple could easily avoid taxes on one-half of the property.<sup>106</sup> The court concluded that this result was contrary to the intent of Congress and "that testamentary transfers for less than full consideration would be brought back into the estate for tax purposes."<sup>107</sup> In 1990, the United States Court of Appeals for the Federal Circuit affirmed the judgment and the interpretation of § 2036(a) by the Court of Claims.<sup>108</sup>

The *Gradow* decision has spawned a mixed reaction to the proper meaning of adequate and full consideration required by the bona fide sale exception of § 2036(a).<sup>109</sup> Although the ruling has generated negative commentary, two district courts and the Tax Court have followed *Gradow*

104. *Id.*

105. *See id.* (concluding that plain language of § 2036(a) supports interpretation that "property" refers to decedent's portion of trust corpus). The court then reasoned that treating the portion of the trust corpus attributable to the decedent as the consideration she contributed is consistent within the purposes of § 2036(a). *See id.* The court noted that the net result of the decedent's election was to ensure her lifetime needs and then to move the property to the next generation. *See id.* If she had not made the election, the decedent would have had to include the property she received from the will in her gross estate. *See id.* By electing under the will, the decedent received the same benefit from the property as if she had kept it and also ensured its transfer to her son. *See id.*

106. *See id.* The *Gradow* court reasoned:

If the measurement of consideration flowing from the surviving spouse in these circumstances was limited to the remainder interest, then, as long as the surviving spouse is not very elderly at the time of the election, it would be a simple matter for a couple to avoid estate tax on half of their property.

*Id.*

107. *See id.* (concluding this simple tax avoidance scheme "is plainly not how Congress contemplated 2036(a) would operate").

108. *See Gradow v. United States*, 897 F.2d 516, 519 (Fed. Cir. 1990). In the United States Court of Appeals for the Federal Circuit, the decedent's executor argued that the Court of Claims's interpretation violated "commercial common sense, normal rules of statutory interpretation, the legislative history of section 2036(a) and the long-term understanding of what constitutes 'adequate consideration.'" *Id.* The Federal Circuit, however, was unpersuaded and stated that the executor's arguments were not well-grounded in law. *See id.* The court concluded, without independent analysis:

The . . . [Court of Claims's] well reasoned opinion indicates a complete consideration of the arguments raised here on appeal and we are unpersuaded of any legal error in the court's interpretation or application of section 2036(a). Accordingly, the judgment of the . . . [Court of Claims] is affirmed, and we adopt that court's more extensive analysis.

*Id.*

109. For a discussion of this mixed reaction from both the courts and legal commentary, see *infra* notes 110-21 and accompanying text.

in their holdings.<sup>110</sup> The United States District Court for the Eastern District of North Carolina, in *Pittman v. United States*,<sup>111</sup> was the first court to support *Gradow*.<sup>112</sup> In *Pittman*, the court held that the decedents' three remainder-interest transfers were not for full and adequate consideration.<sup>113</sup> Therefore, the decedents' estates included the fair market values of the three properties in the estate.<sup>114</sup> The *Pittman* court stated that "it is

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110. See, e.g., *Parker v. United States*, 894 F. Supp. 445, 447 (N.D. Ga. 1995) (citing *Gradow* and concluding that value of what decedent received must be compared to entire value of underlying property); *Pittman v. United States*, 878 F. Supp. 833, 835 (E.D.N.C. 1994) (same); *Estate of Magnin v. Commissioner*, 71 T.C.M. (CCH) 1856, 1862-63 (1996) (stating that to determine whether consideration is adequate, court must compare value that decedent received with total value of property decedent transferred, rather than just remainder interest value); *Estate of D'Ambrosio v. Commissioner*, 105 T.C. 252, 259-60 (1995) (same), *rev'd*, 101 F.3d 309 (3d Cir. 1996), *and cert. denied*, 117 S. Ct. 1822 (1997).

For a discussion of *Pittman*, see *infra* notes 111-15, 154 and accompanying text. For a discussion of the Tax Court's decision in *D'Ambrosio*, see *infra* notes 116-18, 123 and accompanying text. For a discussion of the negative legal commentary regarding the *Gradow* decision, see *infra* notes 119-21, 157-60 and accompanying text.

111. 878 F. Supp. 833 (E.D.N.C. 1994).

112. *Id.* at 835 (citing *Gradow* in reference to measurement and meaning of consideration in context of § 2036(a)). In *Pittman*, the plaintiff is the daughter of the decedents, Marjorie and Howard Arnold, as well as Howard's executrix. See *id.* at 834. In 1985, Howard and Marjorie conveyed remainder interests in three properties to their daughter. See *id.* First, Marjorie conveyed a remainder interest in real property ("Property A") for \$124,995, consisting of \$6,250 cash and a \$118,745 promissory note. See *id.* Property A's fair market value was \$543,338. See *id.* Next, Marjorie conveyed a remainder interest in a second property ("Property B") to her daughter for \$62,574, consisting of \$3,129 cash and a \$59,445 promissory note. See *id.* Property B had a fair market value of \$272,000. See *id.* Finally, Howard conveyed a remainder interest in a third property ("Property C") for \$7,463, consisting of \$373 cash and a \$7,090 promissory note. See *id.* The fair market value of Property C was \$130,200. See *id.* The plaintiffs argued that with each conveyance, both parents retained a life estate. See *id.*

When Marjorie died in 1988, Property A was worth \$711,199 and the fair market value of Property B was \$355,750. See *id.* In 1989, when Howard died, Property C had a fair market value of \$207,203. See *id.* The decedents' estate tax returns did not include the properties in their estate, but the estates did include the balances due on the promissory notes. See *id.* The IRS assessed Marjorie's and Howard's estate for \$294,569 and \$90,170 respectively. See *id.* The plaintiff paid these assessments, but filed a claim for a refund in federal district court. See *id.*

113. See *id.* at 835-36 (stating that on decedent's three transfers to have met bona fide sale exception of § 2036(a), decedents must have received at least fair market values for properties).

114. See *id.* at 836 (noting that "the fair market values of the properties are included in [Marjorie's and Howard's] estates, reduced by any consideration received"). The court reduced these fair market values by the cash payments and the principal reductions on the promissory notes that their daughter had made. See *id.* Because of the court's ruling, the value of both Marjorie's and Howard's estates increased significantly. See *id.* Upon Marjorie's death, Property A was worth \$711,199 and Marjorie had received only \$15,270 for the remainder interest. See *id.* The court held that the \$695,929 difference should be included in Marjorie's estate. See *id.* Property B was worth \$355,750 on the day that Marjorie died, but she had only received \$7,645 for the remainder interest. See *id.* The court con-

the value of the *entire* property which is measured against the consideration received."<sup>115</sup> Furthermore, in *Estate of D'Ambrosio v. Commissioner*,<sup>116</sup> the Tax Court, despite recognizing the considerable adverse legal commentary, held that the decedent designed the remainder-interest transfer for consideration equal to its actuarial value to avoid the payment of estate

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cluded that the \$348,105 disparity should also be included in Marjorie's estate. *See id.* Upon Howard's death, Property C's value was \$207,203 and Howard had received only \$1770 for the remainder interest. *See id.* Consequently, Howard's estate increased by \$205,433. *See id.*

115. *Id.* at 835. The court also stated: "Such valuation is necessary in order to establish an equilibrium for estate tax purposes." *Id.* (citing *Gradow v. United States*, 11 Cl. Ct. 808, 813-14 (1987), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990)); *cf. Parker*, 894 F. Supp. at 447 (concluding that, although it had reservations about *Gradow* decision, estate did not meet burden of proving IRS wrong).

In *Parker v. United States*, the decedent died at the age of 78 after having full-time nursing care for several years prior to her death. *Id.* at 445. A year before she died, the decedent transferred \$350,000 to Trust Company Bank to be included in an investment fund. *See id.* at 445-46. In exchange, the decedent received the right for income for life from the fund, which totaled \$897,666. *See id.* at 446. Three trusts, the remainderpersons in the fund, contributed the additional \$547,666. *See id.* The life estate that the decedent received was worth \$257,671. *See id.* at 447. The decedent received only \$6000 from the fund, however, prior to her death. *See id.* at 446. Her gross estate did not include the \$350,000 that she had invested in the fund. *See id.* The IRS assessed additional taxes on the basis that the decedent's estate should have included the \$350,000. *See id.*

The IRS argued that the \$350,000 should be included in the decedent's gross estate because (1) the decedent did not receive adequate and full consideration; (2) the life estate was not capable of being valued; and (3) "the decedent retained a beneficial interest in the property transferred." *Id.* at 446-47. The IRS used *Gradow* as its primary support. *See id.* at 447. The district court stated that, although it has some reservations about the *Gradow* holding, the executor did not meet the burden of proving the IRS's interpretation of *Gradow* to be wrong. *See id.* Therefore, the decedent's transfer did not meet the bona fide sale exception of § 2036(a). *See id.* at 448.

116. 105 T.C. 252 (1995), *rev'd*, 101 F.3d 309 (3d Cir. 1996), *and cert. denied*, 117 S. Ct. 1822 (1997).

tax that otherwise would have been due.<sup>117</sup> Thus, the Tax Court included the full value of the property in the decedent's estate.<sup>118</sup>

Legal commentators have emphasized that the *Gradow* rationale is incorrect because the sale of a remainder interest for its actuarial value does not deplete the gross estate.<sup>119</sup> In addition, commentators have discussed

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117. *Id.* at 254 & n.4, 260 (characterizing case as one with estate planning technique aimed at removing value of property from gross estate). In *D'Ambrosio*, the decedent owned one-half of the preferred stock of Vaparo, Inc., a family-owned corporation. *See id.* at 253. In 1987, the decedent, then 80 years-old, transferred the remainder interest in her shares to Vaparo in exchange for an annuity that was to pay her \$296,039 per year. *See Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309, 311 (3d Cir. 1996), *cert. denied*, 117 S. Ct. 1822 (1997). In addition, the decedent retained her income interest in the shares. *See D'Ambrosio*, 105 T.C. at 253. The fair market value of the stock was \$2,350,000. *See id.* at 253-54. According to the IRS actuarial tables, the annuity had a fair market value of \$1,324,014. *See id.* at 254 & n.4. This was also the fair market value of the remainder interest. *See id.* at 253.

In 1990, the decedent died after receiving only \$592,078 in annuity payments and \$23,500 in dividends. *See id.* at 253-54 & n.3. Her executrix did not include any interest in the Vaparo stock when she computed the decedent's estate. *See id.* at 254. The IRS, however, issued a notice of deficiency, asserting that the gross estate included the full fee simple value of the Vaparo shares at the date of death (estimated fair market value of \$2,350,000) less the amount of annuity payments that the decedent received during her life. *See id.*

The Tax Court, relying on *Gradow*, reasoned that the decedent's remainder-interest transfer of her stock was an abusive tax avoidance scheme that should not be permitted. *See id.* at 255, 260. The court stated:

In the instant case, we conclude that decedent's transfer of the remainder interest in her preferred stock does not fall within the bona fide sale exception of section 2036(a). Decedent's gross estate would be depleted if the value of the preferred stock, in which she had retained a life interest, was excluded therefrom. Decedent's transfer of the remainder interest was of a testamentary nature, made when she was 80 years old to a family-owned corporation in return for an annuity worth more than \$1 million less than the stock itself. Given our conclusion that decedent did not receive adequate and full consideration under section 2036(a) for her 470 shares of Vaparo preferred stock, we hold that her gross estate includes the date of death value of that stock, less the value of the annuity.

*Id.* (citing I.R.C. § 2043(a) (1994); Treas. Reg. § 20.2043-1(a) (as amended in 1990)). For a discussion of the Third Circuit's appellate review of *D'Ambrosio*, see *infra* notes 122-92 and accompanying text.

118. *See D'Ambrosio*, 105 T.C. at 252, 260 (holding that "decedent's gross estate includes the date-of-death value of the stock, reduced by the value of the consideration she received in return for the remainder interest").

119. *See* A. JAMES CASNER, ESTATE PLANNING § 6.15.2, at 149-53, 162-63 (5th ed. 1988 & Supp. 1997) (criticizing *Gradow* as lacking understanding of future interests, economics and time value of money); RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION ¶ 4.08[1], at 4-138 (6th ed. 1991) (stating that payment of full consideration for remainder interest alone is sufficient under § 2036(a)); Abendroth, *supra* note 6, at 52 (noting that measuring adequacy of consideration received against value of remainder interest determined by actuarial tables should be sufficient to meet *Gradow's* policy argument that § 2036(a)'s bona fide sale exception is to prevent depletion of gross estate); Jordan, *supra* note 5, at 689-94 (arguing that *Gradow* decision leads to double taxation and actuarial value, not fee

the fact that if the bona fide sale exception requires consideration equal to the fair market value of the underlying property, the estate will be subject to double taxation.<sup>120</sup> Lastly, one commentator addressed the *Gradow* court's lack of understanding of future interests, economics and the time value of money.<sup>121</sup>

### III. THE THIRD CIRCUIT REVALIDATES THE SALE OF A REMAINDER INTEREST: THE *D'AMBROSIO* DECISION DISMISSES *GRADOW* AND ITS PROGENY

In *Estate of D'Ambrosio v. Commissioner*, the Third Circuit addressed for the first time whether the sale of a remainder interest for its fair market value constitutes adequate and full consideration within the meaning of § 2036(a).<sup>122</sup> The Tax Court, relying on the Federal Circuit's *Gradow* decision, held that although the decedent had sold her remainder interest in closely held stock for its fair market value, § 2036(a) brought the stock's entire fee simple value back into the estate.<sup>123</sup> The Third Circuit, how-

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simple value, is amount necessary to prevent depletion of gross estate); Peter M. Weinbaum, *Are Sales of Remainder Interest Still Available in Light of a New Decision?*, 14 EST. PLAN. 258 (1987) (criticizing *Gradow* for quoting and analyzing § 2036(a) out of context and for ignoring value of life estate in wife's community property as consideration received in the transfer); Lorey, *supra* note 13, at 206 (asserting *Gradow* was judicial overreaction and any concern that remainder interest transfer for its actuarial value will deplete estate is unfounded). *But see* Joseph M. Dodge, *Transfers with Retained Interest and Powers*, in TAX MANAGEMENT A-67, A-87 (1992) (stating that *Gradow* reasoning is wrong according to financial theory, but justified on pragmatic grounds). Commentators have also faulted the reasoning of the courts that have followed *Gradow*. *See, e.g.*, Jacques T. Schlenger et al., *Cases Addressing Sale of Remainder Wrongly Decided*, 22 EST. PLAN. 305 (1995) (criticizing *Pittman* as "mindless" decision); Jacques T. Schlenger et al., *Property Included in Estate Despite Sale of Remainder Interest*, 23 EST. PLAN. 132, 133 (1996) (criticizing Tax Court's reasoning in *D'Ambrosio*).

120. *See* Jordan, *supra* note 5, at 689-90 (illustrating how requiring transferor to sell remainder interest for fair market value of underlying property results in double taxation).

121. *See* CASNER, *supra* note 119, § 6.15.2, at 149-53, 163 (rejecting *Gradow* court's reasoning).

122. *See* *D'Ambrosio*, 101 F.3d at 312.

123. *See* *D'Ambrosio*, 105 T.C. at 260. The Tax Court in *D'Ambrosio* principally relied on *Gradow* and three 1960s cases that interpreted that a remainder interest must be sold for the fair market value of the underlying property to meet the bona fide sale exception of § 2036(a). *Id.* at 255-60 (citing *United States v. Past*, 347 F.2d 7 (9th Cir. 1965); *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961); *Gradow v. United States*, 11 Cl. Ct. 808 (1987), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990); *Estate of Gregory v. Commissioner*, 39 T.C. 1012 (1963)).

For a discussion of the facts, holding and reasoning of *Gradow*, see *supra* notes 93-108 and accompanying text. For a discussion of the facts, holding and reasoning of *Past*, see *supra* notes 62-65 and accompanying text. For a discussion of the facts, holding and reasoning of *Allen*, see *supra* notes 51-56 and accompanying text. For a discussion of the facts, holding and reasoning of *Gregory*, see *supra* notes 57-61 and accompanying text. For further discussion of the Tax Court's reasoning in *D'Ambrosio*, see *supra* notes 116-18 and accompanying text.



ever, determined that the sale of a remainder interest for its fair market value is sufficient consideration to fall within the bona fide sale exception of § 2036(a).<sup>124</sup>

The Third Circuit reasoned that its interpretation of § 2036(a) was consistent with the congressional intent to avoid depletion of the estate.<sup>125</sup> In addition, the cases that provided support for the Tax Court's and Commissioner's arguments were "inapposite or unpersuasive."<sup>126</sup> Moreover, the Third Circuit considered it difficult to fathom the Commissioner's "abusiveness" concerns about a taxpayer exchanging a remainder interest for an annuity that has an actuarial value equal to the remainder interest's value.<sup>127</sup> Finally, the court found no evidence that the decedent made this transfer in contemplation of death or testamentary motivation.<sup>128</sup>

The Commissioner asserted that the Treasury Regulations indicate that the bona fide sale exception only applies to transfers of fee simple interests.<sup>129</sup> The IRS examined the phrase "[t]he use, possession, right to the income, or other enjoyment of the transferred property" in the Treasury Regulations and argued that because one cannot retain a life interest in a remainder, "property" must refer to the fee simple interest.<sup>130</sup> Therefore, under this analysis, the bona fide sale exception would only exclude trans-

124. See *D'Ambrosio*, 101 F.3d at 312 (concluding that "sale of remainder interest for its fair market value constitutes 'adequate and full consideration' within the meaning of § 2036(a)"). Therefore, because the decedent sold the remainder interest in her Vaparo stock for its actuarial value, the fee simple value of the underlying property is not included in the estate. See *id.* at 318 (concluding Tax Court erred as matter of law by holding that consideration decedent received for her remainder interest was not adequate and full).

125. See *id.* at 316-17 (dismissing "abusiveness" concerns of remainder interest sale and illustrating how transfer of remainder interest for its fair market value does not deplete decedent's estate).

126. See *id.* at 312 (criticizing decisions in *Past, Allen and Gregory*). For a discussion of the Third Circuit's criticism of these cases, see *infra* notes 138-50 and accompanying text.

127. See *D'Ambrosio*, 101 F.3d at 316-17 (providing hypothetical to dismiss "abusiveness" concerns). For further discussion of the Third Circuit's response to the Commissioner's "abusiveness" concerns of the remainder-interest sale, see *infra* notes 173-79 and accompanying text.

128. See *D'Ambrosio*, 101 F.3d at 311 (discussing facts of case and finding no evidence that decedent made transfer in contemplation of death or with testamentary consideration, which would show that transfer was "abusive").

129. See *id.* at 315. The Treasury Regulations for § 2036(a) provide, in pertinent part:

A decedent's gross estate includes under section 2036 the value of any interest in property transferred by the decedent . . . except to the extent that the transfer was for an adequate and full consideration in money or money's worth if the decedent retained or reserved (1) for his life . . .

(i) The use, possession, right to the income, or other enjoyment of the transferred property . . . .

Treas. Reg. § 20.2036-1(a) (as amended in 1990).

130. *D'Ambrosio*, 101 F.3d at 314, 315 (emphasis added) (quoting Treas. Reg. § 20.2036-1(a)) (analyzing interpretation of regulation by Commissioner).

fers for the full fee simple value.<sup>131</sup> The estate, however, emphasized the words “interest” and “transferred” in the regulation.<sup>132</sup> The estate asked if the drafters of the regulation meant to include the full value of the property, why did the regulation refer to the value of any “*interest* in the property transferred?”<sup>133</sup> Thus, the estate maintained that “‘adequate and full consideration’ must be measured against the interest transferred.”<sup>134</sup>

The Third Circuit recognized that the regulation does not clearly support either contention, but concluded that the more reasonable interpretation is to “render inoperative” the word “transferred.”<sup>135</sup> Thus, for a property transfer to meet the bona fide sale exception of § 2036(a), the *interest* transferred, whether fee simple or remainder, must be for adequate and full consideration.<sup>136</sup> Therefore, the Third Circuit interpreted the phrase in § 2036(a) “to the extent of any interest therein” to signify that the gross estate must include the value of the remainder interest unless the decedent sold the remainder interest for adequate and fair consideration.<sup>137</sup>

The Commissioner principally relied on four cases.<sup>138</sup> The Third Circuit found the *Allen*, *Gregory*, *Past* and *Gradow* decisions to be either “inap-

131. *See id.* at 314-15 (comparing parties arguments and concluding that “interest in property” means “property” for purposes of Treasury Regulations). The Commissioner used the Court of Claims’s statutory interpretation in *Gradow v. United States* as its primary support. *See id.* at 312, 314 (citing *Gradow v. United States*, 11 Cl. Ct. 808, 813 (1987), *aff’d*, 897 F.2d 516 (Fed. Cir. 1990)). The Third Circuit disapproved of the *Gradow* court’s analysis and noted that when the *Gradow* court quoted § 2036(a), it omitted significant portions of the language. *See id.*

For further discussion of the Third Circuit’s criticism of the *Gradow* court’s reasoning, see *infra* notes 149-52 and accompanying text. For a discussion of the facts, holding and reasoning of *Gradow*, see *supra* notes 93-108 and accompanying text.

132. *See D’Ambrosio*, 101 F.3d at 314-15 (explaining estate’s argument for interpretation of Treasury Regulation).

133. *Id.* at 315 (emphasis in original) (discussing estate’s argument regarding intent of regulation drafters).

134. *Id.*

135. *See id.* The Third Circuit recognized that the IRS was correct that one cannot retain a life interest in a remainder. *See id.* The court states that if the drafters of § 2036(a) meant to include the full value of the property, they would have referred to the value of any “property,” not any “*interest* in property” transferred. *See id.* Thus, the *D’Ambrosio* court reasoned that if some words of the regulation are surplusage, it is more “reasonable and faithful” to the statutory text to render the word “transferred” inoperative in the regulation rather than to strike “interest” from section 20.2036-1(a)(i) of the Treasury Regulations. *Id.* Therefore, the court concluded that “the drafters meant merely to refer to the ‘transferred’ property so as to distinguish it from other property owned by the estate.” *Id.*

136. *See id.* (interpreting bona fide sale exception of § 2036(a) to apply to all property interests).

137. *Id.* at 314 (quoting I.R.C. § 2036(a) (1994)). For the text of § 2036(a), see *supra* note 13.

138. *See id.* at 312 (citing *United States v. Past*, 347 F.2d 7 (9th Cir. 1965); *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961); *Gradow v. United States*, 11

posite or unpersuasive.”<sup>139</sup> First, the Third Circuit found *Allen* to be inapposite because the decedent sold a life estate after the remainder interest had already been disposed of as a gift.<sup>140</sup> Thus, the Third Circuit found that such a testamentary transaction had a tax evasion motive.<sup>141</sup> Second, the Third Circuit stated that the *Gregory* court erred by comparing the consideration received with the value of the underlying property as of the transferor’s death.<sup>142</sup> The Third Circuit based its opinion on the fact that when a transferor sells his or her remainder interest, it is impossible to know what the actual value will be as of his or her death, and thus, no

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Cl. Ct. 808 (1987), *aff’d*, 897 F.2d 516 (Fed. Cir. 1990); Estate of Gregory v. Commissioner, 39 T.C. 1012 (1963)).

139. *See id.* For a discussion of the facts, holding and reasoning of *Gradow*, see *supra* notes 93-108 and accompanying text. For a discussion of the facts, holding and reasoning of *Past*, see *supra* notes 62-65 and accompanying text. For a discussion of the facts, holding and reasoning of *Allen*, see *supra* notes 51-56 and accompanying text. For a discussion of the facts, holding and reasoning of *Gregory*, see *supra* notes 57-61 and accompanying text.

140. *See D’Ambrosio*, 101 F.3d at 312 (discussing and distinguishing facts of *Allen*) (citing *Allen*, 293 F.2d at 916-17).

141. *See id.* The court considered *Allen* inapposite because the *D’Ambrosio* case involved the sale of a remainder for its fair market value, a fact that the IRS conceded. *Id.* The Third Circuit agreed with the *Allen* court’s rationale, however, that the “consideration should be measured against the value that would have been drawn into the gross estate absent the transfer.” *Id.* Referring to the persuasive reasoning in a previous Tax Court case, the *D’Ambrosio* court stated:

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

In short, unless replaced by property of equal value that could be *exposed to inclusion* in the decedent’s gross estate, the property transferred in a testamentary transaction of the type described in the statute must be included in his gross estate.”

*Id.* at 312-13 (emphasis added) (quoting Estate of Frothingham v. Commissioner, 60 T.C. 211, 215-16 (1973)). For a further discussion of the facts, holding and reasoning of *Allen*, see *supra* notes 51-56 and accompanying text.

142. *See D’Ambrosio*, 101 F.3d at 313 (stating that *Gregory* court erred in its analysis, but still reached correct result). The *Gregory* court compared what the decedent’s property had appreciated to at her death to the consideration she had received eight years earlier. *Gregory*, 39 T.C. at 1015-16. The Third Circuit responded:

There is no way to know *ex ante* what the value of an asset will be at the death of a testator; although the date of death can be estimated through the use of actuarial tables, the actual appreciation of the property is unknowable, as are the prevailing interest, inflation and tax rates. Consequently, there is no way to ever be certain in advance whether the consideration is adequate and thus no way to know what tax treatment a transfer will receive.

*D’Ambrosio*, 101 F.3d at 313.

one would ever have incentive to sell a remainder interest.<sup>143</sup> Therefore, because Congress did not expressly provide for how the consideration should be measured, the Third Circuit determined that courts should compare the value of the consideration received with the fair market value as of the date of the transfer.<sup>144</sup> Additionally, the Third Circuit considered the Commissioner's use of *Gregory* as support to be misplaced because the consideration given to the *Gregory* decedent was grossly inadequate, regardless of the valuation date.<sup>145</sup>

Third, the Third Circuit found that the *Past* court erred when analyzing a divorce settlement transaction by comparing the value of the life estate that the decedent received under the divorce settlement with the value of the whole property.<sup>146</sup> The Third Circuit reasoned that the *Past* court should have compared the value of the remainder interest that the decedent relinquished under the divorce settlement with the value of the

143. See *D'Ambrosio*, 101 F.3d at 313 (concluding that incentive for sale of remainder interest is destroyed if *Gregory* court was correct in its analysis).

144. See *id.* (stating that court "will compare the value of the remainder transferred to the value of the consideration received"). The Third Circuit asserted that Congress never said in § 2036(a) that all remainder-interest transfers will be taxed at their fee simple value or that those transfers are illegal. See *id.*; see also I.R.C. § 2036(a) (1994) (discussing when remainder-interest sale is included in estate, but not expressing blanket aversion to remainder-interest transfers). Rather, the court stated that Congress clearly contemplated situations in which a remainder-interest sale would not cause the full value of the property to fall into the estate. See *D'Ambrosio*, 101 F.3d at 313; see also I.R.C. § 2036(a) (providing exception for bona fide sales of "interest" in property estate for "adequate and full consideration in money or money's worth"). Therefore, the court concluded that it would compare the value of the remainder that the decedent transferred to the value of the consideration received, measured as of the date of transfer. See *D'Ambrosio*, 101 F.3d at 313.

145. See *D'Ambrosio*, 101 F.3d at 313 (finding that *Gregory* court erred and that inadequacy of consideration made case inapplicable to present issue). In *Gregory*, the decedent exchanged property worth \$66,000 for a life estate worth \$12,000. *Gregory*, 39 T.C. at 1017. The Third Circuit reasoned that because of this gross inadequacy, the *Gregory* holding does not extend to the issue in *D'Ambrosio* of "whether, when a remainder is sold for its stipulated fair market value, the consideration received is inadequate because it is less than the fee simple value of the property." *D'Ambrosio*, 101 F.3d at 313. For a further discussion of the facts, holding and reasoning of *Gregory*, see *supra* notes 57-61 and accompanying text.

146. See *D'Ambrosio*, 101 F.3d at 314 (finding that *Past* court's valuations were analytically incorrect). In *Past*, the decedent, in a "widow's election" will, sold her half of community property in exchange for a life estate in the whole. *United States v. Past*, 347 F.2d 7, 13-14 (9th Cir. 1965). The *D'Ambrosio* court reasoned that because the decedent already owned the life estate in her half of the property, she essentially exchanged the remainder interest in her half of the property for a life estate in her husband's half. *D'Ambrosio*, 101 F.3d at 314. The *Past* court, however, compared the entire portion of the decedent's property with the life estate that she received and as a result, it held that the consideration was inadequate. *Past*, 347 F.2d at 14. The *D'Ambrosio* court reasoned that this analysis was incorrect because the decedent never relinquished her half of the community property. *D'Ambrosio*, 101 F.3d at 314. Rather, she contributed only her remainder interest in that half. See *id.*

life estate.<sup>147</sup> The Third Circuit concluded that the *Past* court misunderstood the nature of property interests and compared “apples and oranges.”<sup>148</sup>

Finally, for three reasons, the Third Circuit rejected the *Gradow* court’s reasoning that *Allen*, *Gregory* and *Past* were consistent with the “most natural reading” and purposes of § 2036(a).<sup>149</sup> First, the Third Circuit noted that *Allen*, *Gregory* and *Past* were either inapposite or based on faulty analysis.<sup>150</sup> Next, the court held that the most natural reading of § 2036(a) is consistent with the estate’s argument and not the *Gradow* court’s argument that the bona fide sale exception includes remainder interests sold for their fair market value.<sup>151</sup> Finally, the Third Circuit reasoned that the application of *Gradow* to a remainder-interest transfer for adequate and full consideration would subject the transferor to double taxation.<sup>152</sup>

147. See *D’Ambrosio*, 101 F.3d at 314 (discussing what *Past* court could have done in analyzing value). The court noted that alternatively, the *Past* court could have used the fee simple value of the wife’s share, but it would then have to measure that against the value of the life estate in both halves of the property. See *id.* (noting that if *Past* court had used proper method, it would have found decedent received consideration in excess of property value that she had transferred).

148. *Id.* (stating that *Past* court reached wrong result because it “compared ‘apples and oranges’”). For a further discussion of the facts, holding and reasoning of *Past*, see *supra* notes 62-65 and accompanying text.

149. See *D’Ambrosio*, 101 F.3d at 314 (discussing why *Gradow* court considered *Gregory*, *Past* and *Allen* persuasive) (citing *Gradow v. United States*, 11 Cl. Ct. 808, 813 (1987), *aff’d*, 897 F.2d 516 (Fed. Cir. 1990)).

150. See *id.* at 312-14 (analyzing *Allen*, *Gregory* and *Past*). For a discussion on why the Third Circuit found these cases unpersuasive, see *supra* notes 138-48 and accompanying text.

151. See *D’Ambrosio*, 101 F.3d at 314-15 (“[W]e think the statutory text better supports appellant’s argument.”). The IRS used the *Gradow* court’s statutory analysis as its support for the proper reading of § 2036(a). *Id.* For a further discussion of the Third Circuit’s critical analysis of the *Gradow* court’s interpretation of § 2036(a) and the IRS’s reliance thereon, see *supra* notes 131-37 and accompanying text.

152. See *D’Ambrosio*, 101 F.3d at 316 (evaluating aspect of hypothetical that would cause double taxation). For a discussion of the Third Circuit’s view that the application of *Gradow* would result in double taxation, see *infra* notes 180-83 and accompanying text.

The *Gradow* court also expressed a concern that, if the bona fide sale exception of § 2036(a) includes remainder-interest transfers at their actuarial value, “[a] young person could sell a remainder interest for a fraction of the property’s worth, enjoy the property for life, and then pass it along without estate or gift tax consequences.” *Gradow*, 11 Cl. Ct. at 815. The Third Circuit considered this *Gradow* reasoning problematic because it ignored the time value of money. *D’Ambrosio*, F.3d at 316. The court hypothesized:

Assume that a decedent sells his son a remainder interest in . . . Blackacre, which is worth \$1 million in fee simple, for its actuarial fair market value of \$100,000 (an amount which implicitly includes the market value of Blackacre’s expected appreciation). Decedent then invests the proceeds of the sale. If the rates of return for both assets are equal and decedent lives exactly as long as the actuarial tables predict, the consideration that decedent received for his remainder will equal the value of

Prior to the Third Circuit's ruling in *D'Ambrosio*, the IRS had successfully employed the *Gradow* reasoning as its primary support against the sale-of-remainder-interest technique.<sup>153</sup> For example, in *Pittman v. United States*, the Eastern District of North Carolina cited *Gradow* and held that § 2036(a) measures the value of the *entire property* against the consideration received.<sup>154</sup> Although the United States District Court for the Northern District of Georgia had reservations about *Gradow* in *Parker v. United States*,<sup>155</sup> the court concluded that the estate did not meet its burden of proving that the IRS's use of *Gradow* was wrong.<sup>156</sup>

The *Gradow* decision and its progeny have inspired critical legal commentary.<sup>157</sup> A primary assertion is that the inclusion of the full value of the property in the estate when the remainder interest was sold for its fair market value will result in double taxation.<sup>158</sup> One commentator stresses that the *Gradow* court's definition of adequate consideration for estate tax purposes is inconsistent with the definition of adequate consideration for gift tax purposes.<sup>159</sup> Therefore, all remainder-interest transfers result in

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Blackacre on the date of his death. The equivalent value will, accordingly, still be included in the gross estate. Moreover, decedent's son will have only a \$100,000 basis in Blackacre, because that is all he paid for it. He will then be subject to capital gains taxes on its appreciated value if he decides to ever sell the property. Had Blackacre been passed by decedent's will and included in the gross estate, the son would have received a stepped-up basis at the time of his father's death or the alternate valuation date.

*Id.* Therefore, the Third Circuit had great difficulty understanding how a remainder interest sold for its actuarial value would be abusive. *See id.* at 316-17. For a discussion of the facts, holding and reasoning of *Gradow*, see *supra* notes 93-108 and accompanying text.

153. *See, e.g., Parker v. United States*, 894 F. Supp. 445, 447 (N.D. Ga. 1995) (citing *Gradow* and concluding that value of what decedent received must be compared to entire value of underlying property); *Pittman v. United States*, 878 F. Supp. 833, 835 (E.D.N.C. 1994) (same); *Estate of Magnin v. Commissioner*, 71 T.C.M. (CCH) 1856, 1862 (1996) (stating that, to determine whether consideration is adequate, court must compare value decedent received with total value of property decedent transferred, rather than just remainder-interest value).

154. *Pittman*, 878 F. Supp. at 835. For a further discussion of *Pittman*, see *supra* notes 111-15 and accompanying text.

155. 894 F. Supp. 445 (N.D. Ga. 1995).

156. *Id.* at 447. For a further discussion of *Parker*, see *supra* note 115.

157. For a listing of legal commentators criticizing *Gradow* and the court decisions supporting *Gradow*, see *supra* note 119.

158. *See Jordan, supra* note 5, at 689-92 (illustrating how requirement that remainder interests be sold for fair market value of underlying property creates double taxation); *Lorey, supra* note 13, at 196 (arguing that result of *Gradow* is to cause double taxation "without doing anything to further the goal of preventing estate depletion").

159. *See Jordan, supra* note 5, at 678-83 (stating that, following *Gradow*, adequate and full consideration has two distinct definitions for gift and estate tax purposes). For gift tax purposes, adequate consideration is defined as consideration equal to the actuarial value of the remainder interest. *See id.* at 678 (citing I.R.C. § 2512(a) (1994)). This commentator argues that these definitions should be reconciled to promote the neutrality of the tax policy. *See id.* at 683-85 ("Interpreting

either a gift tax or estate tax, regardless of whether the sale was for adequate consideration.<sup>160</sup>

The Third Circuit became the first court to be persuaded by the legal commentary and to reject *Gradow*.<sup>161</sup> The court declined to follow the subsequent case law supporting *Gradow* and stated that none of these opinions provide a “cogent” analysis of § 2036(a).<sup>162</sup> In addition, the Third Circuit found the negative legal commentary to be “well-taken.”<sup>163</sup>

In contrast to the legal commentary, the *D'Ambrosio* dissent asserted that the Third Circuit thwarted § 2036(a)'s intended purpose to prevent

adequate consideration identically for purposes of the two transfer taxes adheres to the principle of neutrality, which is an important concern in the formulation of transfer tax policy.” (citing Gans, *supra* note 7, at 765)).

Adequate consideration should be consideration sufficient to prevent depletion of the estate. *See id.* at 689 (stating that “defining adequate and full consideration as consideration sufficient to prevent depletion of the gross estate” coincides with Supreme Court teachings on purposes of two taxes). For a remainder interest, the commentator asserted that adequate consideration is its actuarial value. *See id.* at 693-95 (discussing adequate consideration as determined based on assumption of taxpayer's retention and investment of proceeds from sale of remainder interest).

160. *See id.* at 681-82 (stating that if both definitions of adequate consideration apply, then one party will inevitably incur transfer tax). The commentator notes that under the *Gradow* rationale, “if the remainder interest is sold for its actuarial value, the taxpayer pays estate tax on the date of death value of the . . . [property] less the consideration received for the remainder interest.” *Id.* at 682 (citing I.R.C. § 2043(a) (1994)). If a taxpayer follows *Gradow* and sells the remainder interest for the fee simple value of the property, the taxpayer avoids both the gift tax and the estate tax. *See id.* (stating that this avoidance occurs whether gift tax value of remainder interest is its actuarial value or value of underlying property because taxpayer receives adequate consideration).

This sale, however, creates problems for the purchaser. *See id.* (noting tax problems that arise). Viewed from the purchaser's perspective, the remainder interest's worth is equal to its actuarial value. *See id.* at 682 & n.50 (discussing fact that this disparity from purchaser's perspective occurs even if special valuation rules require remainder interest to be valued at fair market value of underlying property to determine tax consequences for transferor). Thus, the commentator concluded that:

[T]he purchaser pays more for the remainder interest than it is worth. Consequently, the sale . . . results in a gift from the purchaser to the seller and the imposition of the gift tax on the purchaser. The amount of the gift equals the excess of the fair market value of the underlying property over actuarial value of the remainder interest.

*Id.* at 682 (citing I.R.C. § 2512(b)).

161. *See Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309, 314-17 (3d Cir. 1996) (rejecting *Gradow* and citing with approval legal commentary that is critical of *Gradow*), *cert. denied*, 117 S. Ct. 1822 (1997).

162. *See id.* at 317 (concluding that courts following *Gradow* are unpersuasive). The Third Circuit said that the decisions supporting *Gradow* do not persuade it that the *Gradow* reasoning is sound because of their lack of analysis. *See id.* For a discussion of the judicial decisions following the *Gradow* interpretation of § 2036(a), see *supra* notes 110-18, 153-56 and accompanying text.

163. *See D'Ambrosio*, 101 F.3d at 317 (citing and agreeing with critical commentary on *Gradow*). For a discussion of the legal commentary criticizing the *Gradow* reasoning, see *supra* notes 119-21, 157-60 and accompanying text.

decedents from avoiding estate taxes by selling their property to a third party, while retaining the benefits of ownership during their lives.<sup>164</sup> The dissent cited *Commissioner v. Estate of Church*,<sup>165</sup> in which the Supreme Court held that an estate can only avoid estate tax if the decedent made a bona fide transfer and “absolutely, irrevocably, and without possible reservations, parts with all of his title . . . possession . . . and enjoyment of the transferred property.”<sup>166</sup> The dissent concluded that the decedent failed the *Church* requirement because all title, enjoyment and possession of the stock were not unequivocally halted.<sup>167</sup> A literal reading of the dissent’s assertion raises the question of whether it is ever possible to sell a remainder interest, while retaining a life estate, and still meet the bona fide sale exception.<sup>168</sup> The dissent, however, only used *Church* as support for its position that adequate and fair consideration must be measured against the property that would otherwise be included in the decedent’s gross estate without the remainder-interest transfer.<sup>169</sup> The dissent, however, did

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164. See *D'Ambrosio*, 101 F.3d at 318 (Cowen, J., dissenting). The dissent stated that “[w]hen a taxpayer makes a transfer with a retained life interest, the powerful arm of section 2036(a) pulls into the gross estate the full value of the transferred property, not merely the value of the remainder interest.” See *id.* (Cowen, J., dissenting). Judge Cowen noted that the majority accepted the view that the decedent “sold” only her remainder interest in the stock to Vaparo. See *id.* (Cowen, J., dissenting). “This view of section 2036 sanctions tax evasion: It enables strategic segmentation of the property into multiple interests, with ‘adequate and full consideration’ now required only for a specific transferred segment . . . .” *Id.* (Cowen, J., dissenting). The dissent concluded that such an interpretation thwarts § 2036(a)’s paramount purpose to prevent the depletion of estate assets when individuals retain the use and enjoyment of those assets until death. See *id.* (Cowen, J., dissenting).

165. 335 U.S. 632 (1949).

166. *D'Ambrosio*, 101 F.3d at 319 (Cowen, J., dissenting) (citing *Church*, 335 U.S. at 645). For additional discussion of the Supreme Court’s reasoning in *Church*, see *supra* note 43.

167. See *D'Ambrosio*, 101 F.3d at 319 (Cowen, J., dissenting) (concluding that decedent failed to meet “requirement that all title, enjoyment and possession of the transferred property be unequivocally halted”). The dissent then referred to a 1940 case commenting on a predecessor to § 2036(a), in which the Supreme Court stated that the law “taxes not merely those interests which are deemed to pass at death according to refined technicalities of the law of property,” but also “taxes *inter vivos* transfers that are too much akin to testamentary dispositions not to be subjected to the same excise.” *Id.* (Cowen, J., dissenting) (citing *Helvering v. Hallock*, 309 U.S. 106, 112 (1940)). Therefore, Judge Cowen concluded that the bona fide sale analysis cannot focus merely on the limited property interest that is sold. See *id.* (Cowen, J., dissenting). Instead, it must also consider the property that would otherwise be included in the decedent’s gross estate. See *id.* (Cowen, J., dissenting).

168. See *id.* at 318-20 (Cowen, J., dissenting) (discussing requisites of bona fide sale analysis). *But cf. id.* at 313 (noting that Congress never said in § 2036(a) that remainder-interest transfers are illegal).

169. See *id.* at 319 (Cowen, J., dissenting) (implying that *Church* demonstrates that courts must construe § 2036(a) to prevent testamentary-type transfers from evading estate tax). The *D'Ambrosio* dissent also cites *Gradow* as well-reasoned case law that correctly tests the adequacy of the consideration that a taxpayer received



say that § 2036(a) does not exempt property transfers in which the transferor retains an income interest in his or her underlying assets.<sup>170</sup> Thus, under this reasoning, the decedent's remainder-interest transfer in *D'Ambrosio* would fail the bona fide sale exception simply because she received an annuity that retained her income interest in the stock.<sup>171</sup>

The Third Circuit's holding in *D'Ambrosio* recognizes the economic reality of a remainder interest transfer for fair market value.<sup>172</sup> The court did not agree with the Commissioner's abusiveness concerns with such a transaction.<sup>173</sup> The court consequently held that a remainder-interest

against the amount that the taxpayer's gross estate would otherwise include. *Id.* at 318, 320 (Cowen, J., dissenting).

170. *See id.* at 320 (Cowen, J., dissenting) ("[C]ourts have consistently held that section 2036(a) does not exempt transfers of property in which the taxpayer retains an income interest . . ."). The dissent concluded that, as the Tenth Circuit held in *Allen*:

"It does not seem plausible . . . that Congress intended to allow such an easy avoidance of the taxable incidence befalling reserved life estates. This result would allow a taxpayer to reap the benefits of property for his lifetime and, in contemplation of death, sell only the interest entitling him to the income, thereby removing all of the property which he has enjoyed from his gross estate. . . . [I]n a situation like this, Congress meant the estate to include the corpus of the trust or in its stead, an amount equal in value."

*Id.* (Cowen, J., dissenting) (quoting *United States v. Allen*, 293 F.2d 916, 918 (10th Cir. 1961)).

171. *Id.* at 320 (Cowen, J., dissenting) ("Even if the annuity . . . were not an attempt to deplete her property . . . section 2036(a) does not exempt transfers of property in which the taxpayer retains an income interest . . ."). Under the dissent's interpretation, the estate value would include the value of the stock less the consideration that the decedent received. *See* I.R.C. § 2043 (1994) (reducing amount includible in gross estate by amount of consideration received).

172. *See D'Ambrosio*, 101 F.3d at 316 (illustrating how remainder interest transferred for its actuarial value will not deplete decedent's estate); *see also* Abendroth, *supra* note 6, at 52 (asserting remainder interest sold for its value under the IRS tables is sufficient to prevent depletion of transferor's gross estate); Jordan, *supra* note 5, at 692-93 (arguing consideration equal to actuarial value of remainder interest prevents depletion of estate). *But see D'Ambrosio*, 101 F.3d at 320 (Cowen, J., dissenting) (citing *Gradow* to criticize "economic reality" argument).

173. *See D'Ambrosio*, 101 F.3d at 316. The Third Circuit stated that even looking at the estate's argument in policy terms, it is "difficult to fathom either the Tax Court's or the Commissioner's concerns about the 'abusiveness' of this transaction." *Id.* The court then used a hypothetical to illustrate its point:

Returning to the widow's election cases, assume that the surviving spouse's share of the community property is valued at \$2,000,000. Assuming that she decides not to accept the settlement and to keep that property, its whole value will be available for inclusion in the gross estate at death, but only as long as the widow lives entirely on the income from the property. If she invades principal and sells some of the property in order to meet living expenses or purchase luxury items, then at least some of that value will not be included in the gross estate. . . .

Next, assume that same widow decides to sell her remainder and keep a life estate. As long as she sells the remainder for its fair market value, it makes no difference whether she receives cash, other property, or an annuity. All can be discounted to their respective present values

transfer for its fair market value prevents the depletion of the estate and does not evade taxation.<sup>174</sup> Therefore, the policy behind § 2036(a) and the integrity of the estate tax system are not undermined by the remainder-interest transfer.<sup>175</sup> The IRS may argue that the consideration received for the remainder interest may disappear before the transferor's death, but even the spending of the sale proceeds, however, does not deplete the estate.<sup>176</sup> The IRS may also assert that the consideration will not be sufficient if the transferor dies shortly after the sale.<sup>177</sup> Although this conclusion is correct, it ignores situations in which the taxpayer lives well beyond his or her life expectancy.<sup>178</sup> Thus, as long as the IRS tables are accurate, the fair market value consideration received for the remainder interest will be adequate, on average.<sup>179</sup>

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and quantified. If she continues to support herself from the income from her life estate, the consideration she received for the remainder, *if properly invested*, will still be available for inclusion in the gross estate. . . . On the other hand, if her life estate is insufficient to meet her living expenses, the widow will have to invade the consideration she received in exchange for her remainder, but to no different an extent than she would under the previous hypothetical in which she retained the fee simple interest. In sum, there is simply no change in the date-of-death value of the final estate, regardless of which option she selects, at any given standard of living.

*Id.* (emphasis added). *But see id.* at 320 (Cowen, J., dissenting) (arguing that this view ignores Congress's judgment that transfers with retained life estates are generally testamentary transactions). The dissent states that "the fond hope that a surviving spouse would take pains to invest, compound, and preserve inviolate all life income from half of a trust, knowing that it would thereupon be taxed without his having received any lifetime benefit, is a slim basis for putting a different construction on Section 2036(a) . . . ." *Id.* (Cowen, J., dissenting) (quoting Gradow v. United States, 11 Cl. Ct. 808, 815-16 (1987), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990)).

174. *See id.* at 316 (illustrating why remainder interest transfer for its fair market value does not deplete estate); *see also* Abendroth, *supra* note 6, at 52 (showing how *D'Ambrosio* transaction does not deplete decedent's estate); Jordan, *supra* note 5, at 693-94 (using annuity hypothetical to illustrate same).

175. *See* Abendroth, *supra* note 6, at 52-53 (noting *D'Ambrosio* transaction did not undermine policy of § 2036(a) to prevent depletion of gross estate).

176. *See id.* at 52 (asserting that "this [IRS argument] is an attack on the sufficiency of form of the consideration, not an attack on the method for calculating what constitutes adequate consideration"); *see also* Jordan, *supra* note 5, at 695 (discussing how proceeds from remainder-interest sale creates substitute for value of underlying property, regardless of whether proceeds are retained or consumed).

177. *See D'Ambrosio*, 101 F.3d at 317 (discussing IRS assertion that decedent's estate plan is "calculated to deplete decedent estate in the event she should not survive as long as her actuarially projected life expectancy" and noting decedent equally likely to outlive life expectancy (quoting Commissioner's Brief at 34-35, *Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309 (3d Cir. 1996) (No. 95-7643))); *see also* Abendroth, *supra* note 6, at 52-53 (discussing potential IRS arguments).

178. *See D'Ambrosio*, 101 F.3d at 317 (stating that it is equally possible that any decedent will outlive actuarial expectancy, causing gross estate to be larger and IRS to benefit); Abendroth, *supra* note 6, at 52 (same).

179. *See* Abendroth, *supra* note 6, at 52 (concluding that, on average, consideration for remainder interest will be adequate).

The Third Circuit's *D'Ambrosio* decision also avoids the double taxation effect of *Gradow*.<sup>180</sup> The *Gradow* court held that consideration sufficient to prevent depletion of the gross estate is consideration equal to the fair market value of the underlying property.<sup>181</sup> If the decedent sells a remainder interest for its fair market value and not for the fair market value of the underlying property, *Gradow* requires that § 2036(a) bring the entire property back into the estate, subject only to an offset for the consideration received.<sup>182</sup> Thus, the postsale appreciation of the transferred asset will be taxed at death and the estate will be double taxed because the consideration that the decedent received will also have appreciated and will be subject to tax on its increased value.<sup>183</sup>

Although *D'Ambrosio* alters the application of § 2036(a) remainder-interest transfers at their fair market value, it does not change the requirement that the remainder-interest transfer must be a "bona fide" sale.<sup>184</sup> For the purposes of § 2036(a), a "bona fide" sale for adequate consideration is an arm's length sale or exchange that is free from testamentary intent.<sup>185</sup>

In *D'Ambrosio*, the Tax Court asserted that the decedent's transfer was of a testamentary nature because she made the transfer when she was eighty years old to a family-owned corporation in return for an annuity

180. See *D'Ambrosio*, 101 F.3d at 316 (illustrating how estate would be double taxed under *Gradow's* holding); see also Jordan, *supra* note 5, at 689-91 (concluding that application of *Gradow* would result in double taxation); Lorey, *supra* note 13, at 196 (same).

181. *Gradow v. United States*, 11 Cl. Ct. 808, 812-15 (1987), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990). For a discussion of the facts, holding and reasoning of the *Gradow* court, see *supra* notes 93-108 and accompanying text.

182. *Gradow*, 11 Cl. Ct. at 813-14 (concluding that reading of § 2036(a) requires gross estate to be valued with all property that decedent has ever transferred except when transfer was by bona fide sale and that "time-of-transfer consideration received is then offset against" value of transferred property).

183. See *D'Ambrosio*, 101 F.3d at 316 (discussing double-tax effect of *Gradow*). The Third Circuit observed that "if the full, fee simple value of the property at the time of death is pulled back into the gross estate under 2036(a), subject only to an offset for the consideration received, then the post sale appreciation of the transferred asset will be taxed at death." *Id.* Therefore, the court concluded that the postsale appreciation "will be double taxed; because, all things being equal, the consideration [that the decedent received] will also have appreciated and will be subject to tax on its increased value." *Id.*; see also Jordan, *supra* note 5, at 690-91 (illustrating through hypothetical that if *Gradow's* definition of adequate consideration is adopted, sale of remainder interest augments gross estate, resulting in double taxation); *Remainder Sold for FMV Not Included in Seller's Estate*, EST. PLANNER'S ALERT, Jan. 1997, at 3 (providing hypothetical to illustrate double tax effect of *Gradow* interpretation).

184. See I.R.C. § 2036(a) (1994) (stating that general rule of transfer with retained life estate is to include full value of underlying asset in decedent's estate except when transfer was bona fide sale made for full and adequate consideration); see also Jordan, *supra* note 5, at 717 (discussing requirement that to meet § 2036(a) exception, remainder interest transfer must be "bona fide" sale).

185. See Jordan, *supra* note 5, at 718 (noting that in such exchange, both parties seek to receive equal value to that which they surrender).

worth more than \$1 million less than the underlying stock.<sup>186</sup> The Commissioner argued that the estate plan was “calculated to deplete the decedent’s estate in the event that she should not survive as long as her actuarially projected life expectancy.”<sup>187</sup>

The Third Circuit, however, noted that there was no evidence that the decedent transferred the remainder interest in the stock in contemplation of death or with a testamentary motivation.<sup>188</sup> Moreover, the decedent was just as likely to outlive her actuarially projected life expectancy, thereby collecting more from her annuity and enlarging the estate to an amount greater than it would be worth absent the remainder-interest transfer.<sup>189</sup> Thus, under the Third Circuit’s analysis, the transaction in *D’Ambrosio* met the bona fide sale requirement of § 2036(a).<sup>190</sup>

With *D’Ambrosio*, there is a split between the Third Circuit and the Federal Circuit regarding the proper interpretation of § 2036(a). The Third Circuit has a stronger argument because the sale-of-remainder-interest technique does not undermine § 2036(a)’s policy of avoiding depletion of the estate.<sup>191</sup> Since *D’Ambrosio*, the United States Court of Appeals for the Fifth Circuit has agreed with the Third Circuit’s argument in *Wheeler v. United States*.<sup>192</sup>

186. Estate of D’Ambrosio v. Commissioner, 105 T.C. 252, 260 (1995) (discussing testamentary nature of transaction), *rev’d*, 101 F.3d 309 (3d Cir. 1996), *and cert. denied* 117 S. Ct. 1822 (1997). For a further discussion of the Tax Court’s decision in *D’Ambrosio*, see *supra* notes 116-18, 123 and accompanying text.

187. *D’Ambrosio*, 101 F.3d at 317 (quoting Commissioner’s Brief at 34-35, Estate of D’Ambrosio v. Commissioner, 101 F.3d 309 (3d Cir. 1996) (No. 95-7643)).

188. *See id.* at 311.

189. *See id.* at 317 (discussing idea that transferor of remainder interest could outlive actuarial tables and gross estate could become larger).

190. *Id.* at 311, 317 (holding that there is no evidence that decedent made remainder-interest transfer with donative intent).

191. For a discussion of the Third Circuit’s rationale that a remainder interest sold for its actuarial value does not deplete the estate, see *supra* notes 172-83 and accompanying text.

192. 116 F.3d 749 (5th Cir. 1997). In *Wheeler*, Elmore K. Melton, Jr. sold the remainder interest in a 376-acre ranch to his two adopted sons, John and David Wheeler, in 1984. *Id.* at 751. The parties determined the remainder interest’s purchase price of \$337,790 by “multiplying the sum of the appraised fair market value of the ranch’s fee simple interest, \$1,314,200, plus \$10,000, by .025509, the factor set forth in the appropriate actuarial table in the Treasury Regulations.” *Id.* at 752 (citing Treas. Reg. § 25.2512-5(a) (as amended in 1990)). Melton died in 1991 and John Wheeler filed an estate tax return reporting a gross estate of \$581,106, and paid the estate tax liability of \$199,936. *See id.* The gross estate did not include any amount for the ranch, because Melton’s life estate in the ranch terminated at his death. *See id.* at 752-53. The IRS subsequently charged that the “Melton estate should have included in the gross estate the difference between the date-of-death value of the ranch . . . and the consideration paid by the sons for the remainder interest,” which was \$736,200. *Id.* at 753. The estate paid the tax deficiency of \$320,831 and then filed a claim for refund. *See id.* (noting that IRS relied on § 2036(a) to bring ranch back into Melton’s estate).

The United States Court of Appeals for the Fifth Circuit recognized that the issue of *Wheeler* was “whether the phrase ‘adequate and full consideration’ . . . of

## IV. EFFECT OF THIRD CIRCUIT RULING

*D'Ambrosio* resolves the uncertainty in the Third Circuit about how remainder-interest transfers would be treated for estate tax purposes.<sup>193</sup> Before *D'Ambrosio*, the fear was that as the life tenants in the 1980s transactions passed away, the *Gradow* interpretation of § 2036(a) would unravel these transactions and include the full fee simple value in the life tenant's estate.<sup>194</sup> Now, in the Third Circuit, as long as the remainder interest was sold in an arm's length transaction for an amount equal to or greater than the remainder-interest value determined under the IRS valuation tables, the entire property is exempt from the calculation of the decedent's es-

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section 2036(a) is to be applied in reference to the value of the remainder interest transferred . . . or in reference to the value of the full fee simple interest which the transferor had immediately before the transfer." *Id.* at 754 (quoting I.R.C. § 2036(a) (1994)). To determine the proper construction of "adequate and full consideration," the court analyzed the reasoning in *Gradow*, *Allen*, *Gregory*, *Past*, *Pittman* and *D'Ambrosio*. See *id.* at 755-63 (citing *D'Ambrosio*, 101 F.3d at 309; *Gradow v. United States*, 897 F.2d 516 (Fed. Cir. 1990); *United States v. Past*, 347 F.2d 7 (9th Cir. 1965); *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961); *Pittman v. United States*, 878 F. Supp. 833 (E.D.N.C. 1994); *Estate of Gregory v. Commissioner*, 39 T.C. 1012 (1963)). Following this analysis, the *Wheeler* court concluded that "[t]he sale of a remainder interest for its actuarial value does not deplete the seller's estate." *Id.* at 762. The court explained that:

"The actuarial value of the remainder interest equals the amount that will grow to a principal sum equal to the value of the property that passes to the remainderman at termination of the retained interest. To reach this conclusion, the tables assume that both the consideration received for the remainder interest and the underlying property are invested at the table rate of interest, compounded annually." In other words, the actuarial tables are premised on the recognition that, at the end of the actuarial period, there is no discernible difference between (1) an estate holder retaining the full fee interest in the estate and (2) an estate holder retaining income from the life estate and selling the remainder interest for its actuarial value—in either case, the estate is not depleted.

*Id.* (quoting *Jordan*, *supra* note 5, at 692-93). Thus, the Fifth Circuit held that "the sale of a remainder interest for its actuarial value as calculated by the appropriate factor set forth in the Treasury Regulations constitutes an adequate and full consideration under section 2036(a)." *Id.* at 767.

193. See *Gottlieb*, *supra* note 14, at 6 (noting that *D'Ambrosio* plaintiff's attorney opined that Third Circuit decision benefits estates of decedents who made remainder-interest transfers before 1987 Code revision); see also I.R.C. § 2036(c) (1988), repealed by Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, tit. XI, § 11601(a), 104 Stat. 1388, 1490 (eliminating sale of remainder interest technique for transfers to family members after December 1987). Section 2036(c) was repealed in 1990 and replaced by § 2702, which applies to transfers after October 8, 1990. See I.R.C. § 2702 (1994).

For a discussion of § 2702, see *supra* notes 74-92 and accompanying text. For a discussion of the *D'Ambrosio* decision's effect on Third Circuit transactions within the scope of § 2702, see *infra* notes 197-202 and accompanying text.

194. See *Abendroth*, *supra* note 6, at 49-54 (discussing, prior to Third Circuit ruling in *D'Ambrosio*, that IRS using *Gradow* as "battering ram" to attack sale-of-remainder-interest technique and advising practitioners to unwind previous transactions if Third Circuit upholds *Gradow* interpretation). For a discussion of the *Gradow* court's interpretation of § 2036(a), see *supra* notes 93-108 and accompanying text.

tate.<sup>195</sup> For example, the decedent in *D'Ambrosio* exchanged her remainder interest in stock for a private annuity that, at the time of the sale, had a value equivalent to the remainder interest.<sup>196</sup> Thus, the Third Circuit decision allows a decedent to realize his or her intent by using the sale-of-remainder-interest technique.

The Third Circuit ruling has no effect on remainder interests transferred to family members after the Code revision.<sup>197</sup> Under § 2702, the sale of a remainder interest to a family member is treated as a gift, even if the family member paid the fair market value for the remainder interest.<sup>198</sup> Thus, unless the transaction falls within two narrow exceptions — a sale to a qualified trust or a sale of a personal residence — § 2702 requires the taxpayer to treat the transfer as equivalent to a transfer of the entire property.<sup>199</sup>

*D'Ambrosio*, however, does apply to current transfers outside the scope of § 2702.<sup>200</sup> As long as the seller transfers the remainder interest to a buyer that the Code does not consider a family member, a remainder-interest transfer for its fair market value avoids both gift and estate tax in the Third Circuit.<sup>201</sup> For example, § 2702's rules do not apply to remainder-interest transfers to nieces and nephews.<sup>202</sup>

195. For a discussion of the Third Circuit's holding and reasoning in *D'Ambrosio*, see *supra* notes 122-92 and accompanying text.

196. *D'Ambrosio*, 101 F.3d at 311 (discussing facts of transaction). For further discussion of the *D'Ambrosio* transaction, see *supra* note 117.

197. See I.R.C. § 2702(a)(1) (treating sale of remainder interest to family member as gift); see also *Remainder Sold for FMV Not Included in Seller's Estate*, *supra* note 183, at 2-3 (implying Third Circuit effect limited by § 2702).

198. See I.R.C. § 2702(a); see also Treas. Reg. § 25.2702-4(d), ex. 2 (as amended in 1992) ("The amount of the gift is the full value of the property less the consideration received from the purchaser."). For a further discussion of the scope of § 2702, see *supra* notes 74-92 and accompanying text.

199. See I.R.C. § 2702(a)(2)(B), (a)(3)(A)(ii); see also *Jordan*, *supra* note 5, at 706-16 (discussing § 2702's narrow exceptions and consequences of not meeting these exceptions). For a further discussion of the § 2702's two exceptions, see *supra* notes 85-88 and accompanying text.

200. See *Remainder Sold for FMV Not Included in Seller's Estate*, *supra* note 183, at 2 (noting that § 2702 rules do not apply to transfers to nonfamily members). For a further discussion of who is a family member, see *supra* notes 21, 79 and *infra* notes 201-02.

201. See I.R.C. §§ 2702(e), 2704(c)(2) (1994) (defining family member for purposes of § 2702); see also *Jordan*, *supra* note 5, at 681-95 (discussing how interpretation of § 2036(a) as Third Circuit did would allow remainder interest transfer for its actuarial value to avoid estate and gift taxes).

202. I.R.C. §§ 2702(e), 2704(c)(2). Section 2704(c)(2) states that "[t]he term 'member of the family' means, with respect to any individual—(A) such individual's spouse, (B) any ancestor or lineal descendant of such individual or such individual's spouse, (C) any brother or sister of the individual, and (D) any spouse of any individual described in subparagraph (B) or (C)." *Id.* § 2704(c)(2). For an additional discussion of § 2702's application to remainder-interest transfers, see *supra* notes 74-92 and accompanying text.

Thus, in the Third Circuit, the sale-of-a-remainder-interest technique is still a viable option for transactions to individuals other than § 2702 family members.<sup>203</sup> As long as the transferor makes a bona fide sale for adequate and fair consideration to a nonfamily member, the fee simple value of the property will not be brought back into the estate and the transfer will not be subject to gift tax.<sup>204</sup> Moreover, the Third Circuit revalidated the sale-of-remainder-interest technique for transfers to family members completed prior to December 1987.<sup>205</sup>

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203. For a further discussion of how family member and nonfamily member transactions are affected differently by the Code and the Third Circuit's decision in *D'Ambrosio*, see *supra* notes 21, 200-02 and accompanying text.

204. See *Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309, 312-18 (3d Cir. 1996) (upholding remainder-interest technique), *cert. denied*, 117 S. Ct. 1822 (1997). For a detailed discussion of the Third Circuit's decision, see *supra* notes 122-92 and accompanying text.

205. See *D'Ambrosio*, 101 F.3d at 312-18 (holding that 1987 remainder-interest transfer met bona fide sale exception of § 2036(a)); see also *Gottlieb*, *supra* note 14, at 2 (noting that Third Circuit decision benefits transactions effected prior to December 1987 Code revision). See generally *Remainder Sold for FMV Not Included in Seller's Estate*, *supra* note 183, at 3 (discussing benefit of *D'Ambrosio* holding outside of Third Circuit).