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Estate Taxation: Power of Appointment and Common Disaster Under Section 2041(a)(2) of the Internal Revenue Code of 1954

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COMMENTS

ESTATE TAXATION: POWER OF APPOINTMENT AND COMMON DISASTER UNDER SECTION 2041 (a) (2) OF THE INTERNAL REVENUE CODE OF 1954*

Estate of Bagley v. United States, 318 F. Supp. 765 (M.D. Fla. 1970)

Decedent and her husband died in a common disaster under circumstances making it impossible to determine which one survived the other. The husband's will created a testamentary trust for decedent's benefit during her life, coupled with a general testamentary power of appointment. The will also attempted to create a presumption that the decedent survived the husband should they die in a common disaster.[1] In determining decedent's federal estate tax, her executor included in her gross estate the value of the property subject to the power of appointment but later filed a claim for refund contending the value should have been excluded. Upon disallowance of the claim, the executor brought suit for refund, contending that the decedent did not possess the power at the time of her death since she died before probate of her husband's will. Citing section 2041 (a) (2) of the Internal Revenue Code,[2] the court noted that a decedent would have a testamentary power at the time of death if an attempted exercise by will of the power would have been "valid and effective."[3] The court found such an attempt in the instant case would have been effective and HELD, the value of the property subject to such a power had been properly included in the gross estate.[4]

Although Florida law does not explicitly establish the time at which a power of appointment created by will vests, Florida statutes provide that a will becomes effective upon the death of the testator.[5] If that provision de-

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1. Brief for Appellant at 3, Estate of Bagley v. United States, 443 F.2d 1266 (5th Cir. 1971).

2. INT. REV. CODE of 1954, §2041 [hereinafter cited as CODE] provides: "(a) *In general*— The value of the gross estate shall include the value of all property. . . . (2) To the extent of any property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under sections 2035 to 2038, inclusive. A disclaimer or renunciation of such a power of appointment shall not be deemed a release of such power."

3. 318 F. Supp. 765, 767 (M.D. Fla. 1970).

4. On appeal, the Fifth Circuit Court of Appeals affirmed on the same grounds, 443 F.2d 1266 (5th Cir. 1971) (Ainsworth, J., dissenting). In his dissenting opinion, Judge Ainsworth appears to support the views of the author.

5. FLA. STAT. §731.05 (2) (1969) provides: "A will becomes effective at the time of the death of the testator, and all property, real or personal, acquired by the testator after making his will is transmissible under general expressions in the will showing such to be the intention of the testator." *See* Hurt v. Davidson, 130 Fla. 822, 178 So. 556 (1938).

termines the time at which a power created by will comes into being, it supports the court's conclusion that the power of appointment became effective upon the death of the husband. The statute, however, is directed toward the devise or bequest of property, while a *power* has been held to vest no estate in the donee.[6]

In arguing that the power did not become effective upon the death of the husband, the executor relied in part upon *Townsend v. United States*.[7] There the district court strictly interpreted the word "estate" in a similar Texas statute,[8] holding a power was "no more than a personal privilege or a mere authority."[9] As such, the court held a power was not within the statutory meaning of "estate" and therefore could not be effective until probate of the donor's will. Shortly after *Townsend*, the Texas Legislature amended section 37 of the Texas Probate Code specifically to include powers of appointment.[10] Under Florida's present statute a decision similar to *Townsend* could logically be reached.

The district court in *Jenkins v. United States*[11] took a somewhat different approach.[12] It held that a Georgia statute[13] (similar to Florida Statutes, section 732.26)[14] suspended title to all property, real and personal, passing by devise or bequest until the assent of the executor had been given. Thus, the court found that, because the donee died before the probate of the donor's will, the power given in the will was not "exercisable" at her death. On appeal,[15] however, the reviewing court reversed, finding "the process of probating a will in Georgia is essentially a formal validation of the property interests"[16] and, upon the testator's death, the donee receives an inchoate right that would enable her to immediately exercise control over the property. The

6. *See, e.g.*, United States v. Field, 255 U.S. 257 (1921); Townsend v. United States, 232 F. Supp. 219 (E.D. Tex. 1964).

7. 232 F. Supp. 219 (E.D. Tex. 1964).

8. Tex. Prob. Code Ann. §37 (1956) stated in part: "When a person dies leaving a lawful will, all of his estate devised or bequeathed by such will shall vest immediately in the devisees or legatees . . . ."

9. Townsend v. United States, 232 F. Supp. 219, 222 (E.D. Tex. 1964).

10. TEX. PROB. CODE ANN. §37 (Supp. 1970) states in part: "When a person dies, leaving a lawful will, all of his estate devised or bequeathed by such will, and *all powers of appointment granted in such will*, shall vest immediately in the devisees or legatees of such estate and the donees of such powers . . . ." (Emphasis added.)

11. 296 F. Supp. 203 (M.D. Ga. 1968), *rev'd*, 428 F.2d 528 (5th Cir.), *cert. denied*, 400 U.S. 829 (1970).

12. *See generally* 3 GA. L. REV. 766 (1969).

13. GA. CODE ANN. §113-801 (1959) provides: "All property, both real and personal, being assets to pay debts, no devise or legacy passes the title until the assent of the executor is given to such devise or legacy."

14. FLA. STAT. §732.26 (1969) provides in part: "(1) . . . Until so admitted to probate such will shall be ineffective to convey title to, or the right to possession of, real or personal property of the testator; and, until such probate proceedings have been had, no personal representative shall acquire title to, or the right to possession of, any personal property owned by the decedent at the time of his death."

15. Jenkins v. United States, 428 F.2d 538 (5th Cir.), *cert. denied*, 400 U.S. 829 (1970). This decision was handed down after the instant decision.

16. *Id.* at 548.

court in the instant case distinguished the lower court holding in *Jenkins* and the holding in *Townsend* on the ground that those cases involved general inter vivos powers of appointment whereas the instant case involved a general testamentary power of appointment.[17] This reasoning seems incorrect since section 2041 (a) (2) does not differentiate between inter vivos and testamentary powers and appears to require application of the same test to both powers.

In the absence of express statutory law, the court in the instant case relied in part on section 20.2041-1 (3) of the Estate Tax Regulations, which state "[a] power of appointment created by will is, in general, considered as created on the date of the testator's death."[18] This provision, however, is addressed to the problem of differentiating powers created on or before October 21, 1942, from powers created after that date[19] and, at least arguably, was not intended to be used as a broad rule to determine the time of creation of testamentary powers in other situations.[20] Moreover, while the Regulations are persuasive, they are not binding on the court if at variance with the statute.[21]

Assuming a power becomes effective on the donor's death, there remains unanswered the question of whether a power of appointment vests in a donee who dies simultaneously with the donor. The common law rule regarding common disasters, expressed by the United States Supreme Court in *Young Women's Christian Home v. French*,[22] is that there is no presumption of survivorship.[23] This results in the distribution of the property of each as though he had survived the other.[24] Since a donee who predeceases the donor cannot possess a power of appointment created by the other's will,[25] it would seem that the donee in the instant case never had the power.[26]

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17. 318 F. Supp. 765, 766 (M.D. Fla. 1970), *aff'd.*, 443 F.2d 1266 (5th Cir. 1971).

18. 26 C.F.R. §20.2041-1 (e) (1961).

19. CODE §§2041 (a), (b).

20. *See* CODE §2041 (b) (2) (defining when a power qualifies as a power created after Oct. 21, 1942).

21. Mitchell v. Commissioner, 300 F.2d 533 (4th Cir. 1962).

22. 187 U.S. 401 (1903).

23. "The rule is that there is no presumption of survivorship in the case of persons who perish by a common disaster, in the absence of proof tending to show the order of dissolution." *Id.* at 410.

24. "The question of actual survivorship is regarded as unascertainable, and descent and distribution take the same course as if the deaths had been simultaneous." *Id.*

25. FLA. STAT. §731.20 (1) (1969) states in part: "If a devisee or legatee dies during the lifetime of the testator, the testamentary disposition to such devisee or legatee lapses . . . ." The "antilapse" clause of the statute would not apply to a power since the donor wishes only the donee to direct the distribution of his estate. Such a provision is subject to the same frailties discussed in the text accompanying note 6 *supra*. *See* 57 AM. JUR. *Wills* §15 (1948); 25 FLA. JUR. *Powers* §11 (1959); 2 L. SIMES & A. SMITH, LAW OF FUTURE INTEREST §979 (2d ed. 1956).

26. A similar result would probably be reached under Florida's Simultaneous Death Statute, FLA. STAT. §736.05 (1) (1969), which would raise a presumption that the deaths were simultaneous so "the property of each person shall be disposed of as if he had survived." Here again, there are two problems with the statutory language. The statute covers "property or the devolution thereof," which does not specifically cover powers. Also, subsection (6) states the section shall not apply if a will provides otherwise. Query whether this is only

To avoid this result in the instant case, the court may have found the common disaster clause[27] in the donor's will effective to create a presumption that the donee survived although the opinion makes no reference to the clause. There is, however, a distinction between according effect to the donor's intent regarding the distribution of his property through such a clause and the effect to be accorded a provision in the donor's will regarding the vesting of a power in the donee.[28] This distinction was discussed in *In re Will of Fowles*,[29] in which the husband, by will, gave a testamentary power of appointment to his wife. The will also contained a common disaster clause that created a presumption that the wife survived. Both died in a common disaster, and the wife's will purported to exercise the power. Speaking for the court, Justice Cardozo observed that while the common disaster clause was ineffective in giving the power to the donee,[30] the clause clearly showed the donor's intent to incorporate in his will instructions for disposition in his wife's will.[31] Thus, the court held the instructions to be effective based on the doctrine of incorporation by reference. Recently, courts have rejected the doctrine of incorporation by reference in such cases because the donee's instructions for distribution of the appointive property may not be in existence at the creation of the power in the donor's will.[32] Courts have, however, effectuated the donor's intent through the doctrine of independent significance.[33] Florida seems to embrace the latter view.[34] In light of these doctrines, the instant court seems to apply the wrong test since the instructions for the distribution of the appointive property given in the attempted exercise of the power by the wife could be given effect although the power had not vested in her within the meaning of section 2041 (a) (2).

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in relation to the distribution of property or is meant to cover other items that may be included in the gross estate.

27. *See* 6 W. PAGE, LAW OF WILLS §61.30 (W. Bowe & D. Parker ed. 1962) suggesting the possible use of a clause, such as the one appearing in the husband's will, which is the reverse of the usual, stating: "In the event my wife and I die under such circumstances that there is no sufficient evidence to establish who survived the other, I hereby declare my wife shall be presumed to have survived me and that this Will and all its provisions shall be construed upon that assumption and basis."

28. *In re* Will of Fowles, 222 N.Y. 222, 118 N.E. 611 (1918).

29. *Id.*

30. *Id.* at 230, 118 N.E. at 612. This point was stressed in the dissenting opinions that expressed the view that the wife could exercise such a power only if she had actually survived the donor. Since, however, it could not be proved that she did, her power was a nullity and should not have been given any effect in the donor's will. *Id.* at 234, 238, 118 N.E. at 614, 616.

31. *Id.* at 230-31, 118 N.E. at 612-13.

32. Clark v. Citizens Nat'l Bank, 38 N.J. Super. 92, 118 A.2d 108 (1955).

33. *See, e.g.*, First Nat'l Bank v. Klein, 285 Ala. 505, 234 So. 2d 42 (1970) (holding a power of appointment invalid but giving effect to the instruction found in the donee's will through the doctrine of independent significance); Clark v. Citizens Nat'l Bank, 38 N.J. Super. 92, 118 A.2d 108 (1955) (holding that the theory of independent significance is now used in such cases instead of incorporation by reference); South Carolina Nat'l Bank v. Copeland, 248 S.C. 203, 214, 149 S.E. 2d 615, 619 (1966).

34. *See, e.g., In re* Gregory's Estate, 70 So. 2d 903 (Fla. 1954) (upholding the purported exercise of a power in the donee's will even though it was made several years after the donor's will and even though the donee predeceased the donor).

To understand the scope of section 2041, it is necessary to review briefly its history.[35] Before 1918 the Code contained no express provisions dealing with powers of appointment. This omission raised the question of whether property subject to a power might be included in the gross estate as a property interest within the meaning of what is now essentially section 2033.[36] In 1921, however, the United States Supreme Court in *United States v. Field*[37] held a power of appointment was not an interest in property and therefore could not be taxed under section 2033. Even before the decision in *Field*, Congress had responded to this problem by enacting the predecessor of section 2041 (not applicable in *Field*), which taxed the value of property passing under a general power of appointment that was *exercised* by the decedent's will.[38] This provision was amended in 1942 by defining a "general power" and imposing a tax on the value of the property subject to the power if the decedent had the power at death, even if not exercised.[39]

A later amendment recognized that there may be a tax-free disclaimer of a power should the donee wish to avoid the estate tax attributable thereto.[40] The Treasury Department has indicated by regulation that a power can be effectively disclaimed if the disclaimer is made by the donee within "a reasonable time after learning of its existence."[41] The regulation supports the executor's argument in the instant case that the decedent's estate should not be taxed since she did not have a reasonable time in which to disclaim the power.[42] Although this view was rejected in *Jenkins v. United States*,[43] that opinion discloses: (1) the donee knew of the provisions creating the power in the donor's will; (2) she knew they would become effective upon the donor's death; and (3) she had sufficient time after the donor's death (14

35. *See, e.g.*, Stephens, *The* Clifford *Shadow over the Federal Estate Tax*, 4 GA. L. REV. 233 (1970).

36. CODE §2033 provides: "The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."

37. 255 U.S. 257 (1921).

38. Revenue Act of 1918, ch. 18, §402 (3), 40 Stat. 1097.

39. Revenue Act of 1942, ch. 619, §403 (a), 56 Stat. 942.

40. Powers of Appointment Act of 1951, ch. 165, 65 Stat. 91.

41. Treas. Reg. §20.2041-3 (d) (6) (1958).

42. The importance of such an argument can be emphasized by the following example: *A* cordially dislikes *B* who, he learns, is in a coma on his death bed with no chance of recovery. *A* executes an inter vivos gift to *B*, giving him a general testamentary power of appointment over certain property, with a provision that should *B* fail to exercise the power in his will, such property shall revert to *A*. The gift is executed on January 1, 1971, and as expected, *B* dies January 2, 1971. *B* had the power at death but no provision in his will could exercise that power. (Note that in Florida specific reference to a power and the property subject thereto is required before the exercise of such a power is valid. Pattillo v. Glein, 150 Fla. 73, 7 So. 2d 328 (1942); Depass v. Kansas Masonic Home, 132 Fla. 455, 181 So. 410 (1938)). It would appear that *B*'s estate could properly be taxed on the property subject to the power unless the statute were amended to give the executor of *B's* estate a reasonable time to disclaim under such circumstances. Absent the bad motives, this is the result reached in the instant case although it may be improper to overlook the benefit to the family unit resulting from the marital deduction.

43. 428 F.2d 538 (5th Cir.), *cert. denied*, 400 U.S. 829 (1970).

days) to execute a document disclaiming the power of appointment.[44] None of these facts appear in the instant case, therefore the contention rejected in *Jenkins* is far more cogent here.

Several courts have held that a donee "has" a power of appointment only if it is "exercisable" at the time of the donee's death.[45] In *United States v. Merchants National Bank*,[46] for example, the court held a power must be exercisable in order for its mere possession to be taxed. There, the court found the decedent's power was not exercisable because it was conditioned upon an event that had not occurred at the time of the decedent's death.[47] The court in the instant case seems to misapply the holding of *Merchants National Bank* by assuming that an affirmative answer to the question of whether an attempted exercise would have been effective regarding the distribution of the appointive property decides the question of whether decedent's power was exercisable within the meaning of section 2041.[48] Such a test seems questionable in light of the preceding discussion.[49]

Assuming the donee in the instant case survived her husband, the difficulty of applying the right to disclaim within a reasonable time under such cir-

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44. *Id.* at 551.

45. *Id.* at 549.

46. 261 F.2d 570, 573 (5th Cir. 1958).

47. *See also* Jenkins v. United States, 428 F.2d 538 (5th Cir. 1970), *cert. denied*, 400 U.S. 829 (1970) (holding that a power was exercisable even though the donor's will had not been probated at the time of the donee's death).

48. 318 F. Supp. 765, 767 (M.D. Fla. 1970) *aff'd*, 443 F.2d 1266 (5th Cir. 1971).

49. For the weakness of this reasoning, *see* text accompanying notes 22-26, *supra*. In attempting to determine the existence of a power of appointment some courts have applied the tests prescribed under §2056 of the CODE (relating to the marital deduction) and the corresponding regulations, Treas. Reg. §20.2056(b)-5 (1958), even though the deduction sections and the inclusion sections of the estate tax provisions are by no means perfectly integrated. In Jackson v. United States, 376 U.S. 503 (1964), the Supreme Court held that, although property passing by will to a surviving spouse was includable in her gross estate under §2033, the terminable interest rule under §2056 precluded a marital deduction in the decedent's estate. Similarly, in Security-Peoples Trust Co. v. United States, 238 F. Supp. 40 (W.D. Pa. 1965), the court applied Treas. Reg. §20.2056(b)-5(a)(4) (1958), which states: "The power in the surviving spouse must be exercisable by her alone and (whether exercisable by will or during life) must be exercisable in all events." The court held, in accordance with the statute, that to support the marital deduction the surviving spouse must not only have a power under §2041 but the power must be "exercisable in all events." Security-Peoples Trust Co. v. United States, *supra*. The court observed that §§2041 and 2056 should be correlated to insure uniform results in all cases. The instant case reinforces that observation. The lack of correlation between §§2041 and 2056 seems to encourage controversy and litigation. It is to the Treasury's advantage to argue that for marital deduction purposes the first spouse to die failed to confer a general power on his surviving spouse, but for inclusion purposes to argue that the surviving spouse had a general power at her death. The taxpayer's position, of course, is just the reverse and is aided by the fact that after the marital deduction in the donor's estate is achieved under §2056, the donee can raise the question whether she has a general power, or attempt to disclaim the power (subject to the tests of a "reasonable time") possibly avoiding tax in her estate as well. *See* Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). Unfortunately, decisions in this area are based to some extent on local law, and varying doctrines and approaches compound the uncertainty. Commissioner v. Estate of Bosch, *supra*; Blair v. Commissioner, 300 U.S. 5 (1937).

cumstances still exists. While it is clearly unfair to foreclose the disclaimer option if the donee dies on or shortly after the creation of the power,[50] it is equally unfair to force an exclusion under section 2041, which would foreclose the marital deduction in the donor's estate under section 2056. One answer to this problem is to enact a new statutory provision allowing a joint election between the executors of such estate within a reasonable time after the disaster, the decision being made on the basis of the over-all benefit to the family unit. If an election were made pursuant to such an agreement it should be binding for purposes of both the marital deduction in the donor's estate and the inclusion in the donee's estate.[51]

While the over-all test applied by the court in the instant case seems to be incorrect, the decision, in conjunction with the other decisions mentioned, clearly emphasizes the need for statutory clarification in this area. State legislation specifically including powers of appointment in the appropriate probate provisions is needed. Federal regulations overriding state law and correlating section 2041 with section 2056 including the proper test to apply to a common disaster, should also be adopted.

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50. *See* text accompanying note 42 *supra*.

51. There is some precedent for this approach in the form of statutory provisions enacted to avoid hardships when the marital deduction provision was first enacted. *See* Technical Changes Act of 1953, ch. 512, §210, 67 Stat. 624; Treas. Reg.. §20.2041-1 (c) (3) (1961).