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Comments and Casenotes

The Federal Estate Tax And Sale Of A Retained Life Estate In Contemplation Of Death

United States v. Allen[1]

Settlor-decedent in May, 1932, created an irrevocable, inter vivos trust, reserving three-fifths of the income for her life, the remainder upon her death to pass to two of her children who were the beneficiaries of the other two-fifths of the trust income. After being advised in 1949 that the reservation of the life estate in the trust would result in three-fifths of the trust corpus being included within her gross estate for federal estate tax purposes, the settlor-decedent in 1950, at the age of seventy-eight, transferred her life estate, which at the time of sale was valued at approximately $135,000, to her son who paid $140,000 therefor. The son, who was not a beneficiary under the trust and who had a mere expectancy of inheritance from his mother, believed that his mother would live long enough to return him a profit on his investment. Although the settlor-decedent was in relatively good health at the time of the transfer, shortly thereafter she contracted an incurable disease which within a few months resulted in her death, causing her son to suffer a considerable loss on his investment.

The Commission of Internal Revenue determined that three-fifths of the trust corpus, which was the principal in which decedent had reserved the life estate, and which was worth approximately $900,000 at her death, was includible in her gross estate, less the $140,000 which she had received from the transfer to her son. Plaintiff-executors paid the deficiency assessment, and following disallowance of their refund claim, brought this refund action in the United States District Court for the District of Colorado. The District Judge[2] found that the 1950 transfer of the reserved life estate was in contemplation of death but that the consideration received by the decedent was adequate and full for the interest transferred, thus serving to divest the decedent of any interest in the trust and tak-

[1] 293 F. 2d 916 (10th Cir. 1961), *cert. den.* 368 U.S. 944 (1961).

[2] District Judge A. Sherman Christenson, sitting by special assignment in the District Court for the District of Colorado, delivered an oral opinion which was not reported.

ing the attributable share of the corpus out of the gross estate. On appeal, the Court of Appeals[3] for the Tenth Circuit reversed, reasoning that while the consideration was adequate and full for the life estate, indeed more than its actual value, Congress could not have intended to permit such easy avoidance of the tax consequences incident to reserved life estates. The Court of Appeals held that full and adequate consideration, sufficient to eliminate the tax consequences of the reserved life estate, must be consideration adequate to compensate for the amount the gross estate would be depleted by the transfer, and not merely a consideration adequate for the life estate which was the subject of the transfer. A concurring opinion was filed by Judge Breitenstein in which by a literal interpretation of the statute, he found that the tax liability arose upon the creation of the reserved life estate in the trust, and while acknowledging that the life estate could be subsequently transferred, he concluded that such a sale could not reduce the tax consequences which arose upon the creation of the reserved life interest.

Since the decendent died prior to the effective date[4] of the 1954 Internal Revenue Code (IRC), the decision in the instant case was controlled by Section 811, specifically 811 (c)(1)(A) and (c)(1)(B),[5] of the 1939 IRC. As the 1954 IRC has made no substantive changes in these subsections of Section 811,[6] the Court's reasoning is also applicable to estates governed by the 1954 Code.

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[3] The opinion was written by Chief Judge Alfred P. Murrah and was joined in by Judge Sam G. Bratton.

[4] The estate tax provisions of Chapter 11 of the 1954 IRC apply to estates of decedents dying after August 16, 1954. IRC of 1954, § 7851 (a)(2)(A), 68 A. Stat. 919 (1954).

[5] "§ 811. Gross estate

"The value of the gross estate of the decedent shall be determined by including the value at the time of his 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 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 * * *." IRC of 1939, § 811 (c), (26 U.S.C.A. (1955) § 811(c)).

[6] IRC of 1939, subsections 811 (c)(1)(A) and 811 (c)(1)(B), were recodified in IRC of 1954 as § 2035 and § 2036 respectively. The House and Senate Reports confirm that no substantive changes in these subsections were intended by the recodification. H.R. Rep. No. 1337, 83rd Cong., 2nd Sess., p. A. 314, 3 U.S. Code Cong. & Adm. News, p. 4457 (1954); Sen. Rep. No. 1622, 83rd Cong., 2nd Sess., p. 469, 3 U.S. Code Cong. & Adm. News, pp. 5112, 5113 (1954).

Under Section 811 (c)(1)(B),[7] by reserving the life interest in the 1932 trust,[8] three-fifths of the corpus, valued at the date of decedent's death,[9] clearly would be includible within the decedent's gross estate, had there been no subsequent transfer of the life estate.

Judge Breitenstein, in his concurring opinion, concluded that once the decedent had reserved the life estate, she could not by a subsequent transfer thereof divest the gross estate of three-fifths of the trust corpus. This result may be reached by giving literal effect to the language of 811 (c)(1)(B) which includes "any interest * * * under which he [decedent] has retained for 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 . . . the right to income from, the property * * *." Comparing this wording with that of the revocable transfer subsection, 811 (d),[10] which includes interests transferred "where the enjoyment thereof was subject *at the date of his death to any change* * * *"[11] it is possible to conclude that "retained" in subsection 811 (c)(1)(B) means retained at the time of the transfer, not retained at the time of death, thus directing the conclusion that once a reserved life estate has been created, no subsequent transfer will remove the corpus thereof from the gross estate. Such an interpretation is not, however, consistent with the purpose of the estate tax provisions which seek basically to prevent tax

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[7] *Supra*, n. 5.

[8] IRC of 1939, § 811 (c), (now IRC of 1954, § 2036 (a)) as amended by the Technical Changes Act of 1949, Ch. 720, § 7 (a), 63 STAT. 894 (1949), provides that § 811 (c)(1)(B), shall not apply to retained life estates created before March 4, 1931, or to retained life estates created after March 3, 1931, and before June 7, 1932, unless the property would have been includible under the language of the Joint Resolution of March 3, 1931 (46 STAT. 1516 (1931)). As the reserved life estate was created in May, 1932, and fell within the language of the Joint Resolution (46 STAT. 1516 (1931)), it came within Section 811 (c)(1)(B). See Estate of Robert J. Cuddihy, 32 T.C. 1171 (1959) for discussion of the estate tax consequences of reserved life estates prior to and subsequent to 1931.

[9] IRC of 1939, § 811, *supra*, n. 5, provides for valuation as of the date of death (now IRC of 1954, § 2031 (a)). The "value" of the property includible in the gross estate is that portion of the corpus in which the decedent reserved a life interest. See McNichol's Estate v. C.I.R., 265 F. 2d 667 (3d Cir. 1959), *cert. den.* 361 U.S. 829 (1959) and Estate of Robert J. Cuddihy, *id.*, 26 C.F.R. (1961) § 20.2036-1 (a) (ii) provides:

> "If the decedent retained or reserved an interest or right with respect to a part only of the property transferred by him, the amount to be included in his gross estate under section 2036 is only a corresponding portion of the amount described [entire corpus]. . . ."

[10] Now, IRC of 1954, § 2038.

[11] Emphasis supplied.

avoidance by taxing inter vivos transfers which have testamentary characteristics.[12]

Considering this purpose together with the contemplation of death presumptions[13] and the contemplation of death subsection, a subsequent transfer of the reserved life estate, which is not in contemplation of death and under which the transferor retains no interest thereafter, should effectively divest the gross estate of the trust corpus. Since the contemplation of death subsection[14] and the statutory presumptions thereof[15] are not limited to any particular interests,[16] and as the purpose of the estate tax is consistent with the application of the contemplation of death provisions to the transfer of reserved life interests, compliance with these provisions may properly serve to remove trust corpus, otherwise includible, from inclusion in the gross estate. Thus, had the decedent transferred her life estate more than three years prior to her death, the three-fifths of the corpus otherwise includible within the gross estate would have been removed therefrom.[17]

The District Judge found, however, that the 1950 transfer of decedent's life estate was made in contemplation of death,[18] and this finding was not objected to on the appeal. The Internal Revenue Service had previously ruled that a gratuitous transfer of a reserved life estate in contemplation of death does not prevent the corpus, otherwise in-

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[12] In Helvering v. Hallock, 309 U.S. 106, 112 (1940) the Supreme Court adopted the following reasoning:

> "[T]he statute taxes not merely those interests which are deemed to pass at death according to refined technicalities of the law of property. It also taxes *inter vivos* transfers that are too much akin to testamentary dispositions not to be subjected to the same excise."

[13] IRC of 1939, § 811 (1) (now IRC of 1954, § 2035 (b)), added by Ch. 994, Title V, § 501 (a), 64 STAT. 962 (1950), provides that if a transfer is made prior to three years before decedent's death, the transfer is not in contemplation of death, but that if the transfer is within the three year period, it shall, unless shown otherwise, be deemed to have been in contemplation of death.

[14] *Supra*, n. 5.

[15] *Supra*, n. 13.

[16] IRC of 1939, § (L), *supra*, n. 13, applies *inter alia*, to transfers of interests in property.

[17] For discussion of this point, see: Lowndes, *Cutting the "Strings" on Inter Vivos Transfers in Contemplation of Death*, 43 Minn. L. Rev. 57, 58-59 (1958); In Re Thurston's Estate, 36 Cal. 2d 207, 223 P. 2d 12 (1950).

[18] IRC of 1939, § 811 (c) (1) (A), *supra*, n. 5, and (1), *supra*, n. 13, (now IRC of 1954, § 2035). For discussion of the contemplation of death provisions and their application to various factual situations, see LOWNDES AND KRAMER, FEDERAL ESTATE AND GIFT TAXES (1956), pp. 64-83; 148 A.L.R. 1051 *et seq.* (1944).

cludible, from inclusion in the gross estate.[19] In the instant case, however, the decedent did not gratuitously transfer her life interest but instead sold it for $140,000. The issue thus posed was whether this sale was "a bona fide sale for an adequate and full consideration in money or money's worth,"[20] and as such effectively removed the corpus from the gross estate.

Generally, the exemption for bona fide sales for adequate and full consideration, found in several of the estate tax sections,[21] is to avoid double taxation, *i.e.,* to prevent taxing the interest transferred as well as the consideration received therefor.[22] To qualify for this exception the transfer must, (1) be made for money or money's worth, (2) be a bona fide sale and, in addition, (3) the consideration must be full and adequate.

While the estate tax sections of the IRC do not define these terms, except to state in Section 811 (m)[23] that marital rights are not deemed consideration for "money or money's worth," there is no question that the payment of $140,000 met the requirement of "money or money's worth." There was, however, more question whether this was a "bona fide sale." Since the decedent relinquished her entire claim to the life interest in return for a lump sum payment, as opposed to receiving periodic installment payments which would suggest a *sub rosa* agreement whereby the transferee-son might have agreed to take over the payment of his mother's life income, this was not a sham transaction, but a sale.[24] Although the issue of

[19] Revenue Ruling 56-324, 1956 — Cum. Bull. 999, after quoting from two decisions which had construed local statutes similar to the federal statute, concluded that a gratuitous transfer of a reserved life interest in contemplation of death, did not prevent the inclusion of the corpus in the gross estate; *i.e.,* for tax purposes such a transfer was to be treated as if the decedent had retained the life interest until death. See also, 26 C.F.R. (1961) § 20.2035-1 (b).

[20] *Supra,* n. 5.

[21] In addition to the exception under § 811 (c)(1), *supra,* n. 5, (now IRC of 1954, §§ 2035, 2036), the exception also appears in other subsections of 811, which are now recodified in IRC of 1954 as, § 2037 (transfers taking effect at death), § 2038 (revocable transfers); § 2040 (joint interests), and incorporated by reference in § 2041 (powers of appointment) and § 2043 (transfers for insufficient consideration). The exception also appears in the deduction subsections of the 1939 IRC, now codified in the 1954 IRC as § 2053 (c)(1)(A), and § 2056 (b)(1)(A).

[22] LOWNDES AND KRAMER, *op. cit. supra,* n. 18, pp. 310-311.

[23] Now codified in the IRC of 1954, as § 2043 (b).

[24] Where decedent-transferor unequivocably severs his interest in the trust, by transferring his life estate, even to his children, and receiving therefor a lump sum equivalent to the value of the interest transferred, the transfer is deemed to be a transfer of a capital asset. Blair v. Commissioner, 300 U.S. 5 (1937); Estate of Robert J. Cuddihy, 32 T.C. 1171 (1939). However, where, in substance the transferor merely exchanges

whether the sale is bona fide has been held to be inextricably bound with the question of whether the consideration was adequate and full,[25] the sale was not lacking in bona fides because the decedent's son was the transferee[26] or because the sale was made for the purpose of reducing the decedent's taxable estate.[27]

The dispositive issue thus becomes whether to meet the test of adequate and full consideration, the consideration moving to the decedent-transferor must be adequate and full for the interest transferred or adequate and full for the amount that the gross estate will be depleted due to the transfer. No federal cases[28] were found presenting the construction of the full consideration exception with respect to sales of reserved life estates in contemplation of death, but prior to the instant case other courts had construed the full consideration exception with respect to other interests transferred in contemplation of death.

In *Sullivan's Estate v. Commissioner of Internal Revenue*,[29] decedent and his wife held property as joint tenants, decedent having paid the consideration therefor, which under Section 811 (e)[30] would have resulted in the full

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his interest for a substitution of future income flowing from the transferee, the Courts will strike down the purported transfer as a sham transaction. McNichol's Estate v. C.I.R., 265 F. 2d 667 (3d Cir. 1959), *cert. den.*, 361 U.S. 829 (1959); Harter v. United States, (N.D. Okla.), decided December 29, 1954, 48 A.F.T.R. 1964, 1955-1 U.S.T.C., 503.

[25] Estate of Frank K. Sullivan, 10 T.C. 961 (1948), rev'd 175 F. 2d 657 (9th Cir. 1949).

[26] While there is authority under the Gift Tax that the sale to be bona fide must be an "arm's length" transaction, 26 C.F.R. (1961), § 25.2512-8, Commissioner v. Wemyss, 324 U.S. 303, 306 (1945), and while the Gift Tax provisions and the Regulations thereunder have had some influence upon the construction of the estate tax sections, Merrill v. Fahs, 324 U.S. 308 (1945), sales between family members under both the gift and estate tax sections have not been held lacking in bona fides, where the consideration received by the transferor was of the quality and quantity which would result from arms-length bargaining, *e.g.*, Peoples First National Bank & Tr. Co. v. United States, 241 F. 2d 420 (3d Cir. 1957); Sullivan's Estate v. Commissioner of Internal Rev., 175 F. 2d 657 (9th Cir. 1949); Gladys Cheesman Evans, 30 T.C. 798 (1958).

[27] In Gregory v. Helvering, 293 U.S. 465, 469 (1935), the Supreme Court stated, "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." See also, Gladys Cheesman Evans, *id.*

[28] In Re Thurston's Estate, 36 Cal. 2d 207, 223 P. 2d 12, 17 (1950), although involving state inheritance taxes, contains dictum on point which supports the Commissioner's contention. The California Court of Appeals, by Traynor, J., stated, "A tax measured by the value of the entire corpus transferred cannot be avoided by the payment of a consideration equal to the value of the interest relinquished."

[29] 175 F. 2d 657 (9th Cir. 1949).

[30] IRC of 1939, § 811 (e) (now IRC of 1954, § 2040), provides that an interest held in joint tenancy, which had originally been acquired by one of the tenants and which has not subsequently been transferred for full

value of the property being included in decedent-husband's gross estate. In contemplation of death, the decedent and his wife converted their joint tenancy into a tenancy in common. The Court of Appeals for the Ninth Circuit, in reversing the Tax Court, held that the transfer, although in contemplation of death, was within the full consideration exception of Section 811 (c)(1), resulting in the inclusion in the gross estate of only the decedent's interest as a tenant in common. The Court of Appeals in arriving at their decision, *inter alia,* rejected the Commissioner's contention that the consideration was not adequate and full since it was not the equivalent of the extent to which the gross estate would be depleted by the transfer, and held that, as the consideration moving to decedent was the equivalent of the property value he transferred, the test of full and adequate consideration in Section 811 (c)(1) had been complied with. The *Sullivan* case's construction of the full consideration exception has been adhered to in the joint tenancy field[31] and has received the Commissioner's acquiescence.[32]

The *Sullivan* rationale has not, however, been restricted to the joint tenancy field but has been applied in the construction of the full and adequate consideration exception with respect to other interests.[33] Thus, prior to the decision in the instant case the test was whether the consideration received was adequate for the interest transferred, not whether it was adequate for the amount the gross estate would be depleted by the transfer.

As the full and adequate consideration exception apparently applies to transfers of reserved life estates, it can be argued that the common sense meaning of adequate and

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and adequate consideration in money or money's worth, is includible in full in the original payor's gross estate.

[31] Baltimore National Bank v. United States, 136 F. Supp. 642 (D. Md. 1955), applied to stock held as tenants by entirety; Estate of Edward Carnall, 25 T.C. 654 (1955) applied to stock held as tenants by entirety; Estate of Don Murillo Brockway, 18 T.C. 488 (1952), aff'd on other grounds, 219 F. 2d 400 (9th Cir. 1954) applied to realty held as joint tenants.

[32] After contesting the Sullivan holding for some time, the Commissioner acquiesced in Estate of Don Murillo Brockway, *id.*, 1955 — 2 Cum. Bull. 4.

[33] Estate of John M. Goetchius, 17 T.C. 495 (1951) while holding that the decedent had not received full consideration for the transfer of his annuity contracts, nevertheless looked to whether the consideration was the equivalent of the property transferred; Estate of James Stuart Pritchard, 4 T.C. 204 (1944) held that as transferor had more valuable incidents of ownership in his life insurance policies than their cash surrender value, consideration received by him equivalent only to the cash surrender value was not full and adequate to remove the insurance proceeds from the gross estate.

full consideration is that which a buyer would be willing to pay for the interest transferred. Since virtually no one would be willing to pay approximately $900,000 (the extent to which the gross estate would be depleted by the transfer) for a life interest worth $135,000, the argument concludes that the only meaning which is consistent with the presence of the exception in Section 811 (c)(1), is that the consideration must only be adequate for the interest transferred.[34]

The primary objection to adopting the *Sullivan* rationale and its property law concept in the instant case is a practical one. It would open up a major loophole under the federal estate tax provisions, whereby a tax-conscious decedent could enjoy the benefits of his retained life estate and then shortly prior to his death, transfer it for the *de minimus* consideration it would then be worth, thus effectively removing the corpus from which his income flowed, from his gross estate.[35]

While the insertion of the full and adequate consideration exception was to prevent double taxation, not present in the instant case, by including the corpus in the gross estate, the conclusion appears obvious that the estate tax sections, not adequately providing for the facts presented by the instant controversy, were saved from the possible loophole existing therein by the liberal construction indulged in by the Tenth Circuit. As the Tenth Circuit concluded, "It does not seem plausible . . . that Congress intended to allow such an easy avoidance of the taxable incidence befalling reserved life estates."[36]

Although it is possible that other courts may not adhere to the Tenth Circuit's construction, the result reached

[34] Note also that "adequate and full consideration in money or money's worth", appears in the Gift Tax, IRC of 1939, § 1002, (now IRC of 1954, § 2512 (b)), and that there is authority, Merrill v. Fahs, 324 U.S. 308 1945), for construing like terms in the Gift and Estate Tax Sections similarly. As consideration in money equal to the interest transferred is sufficient to prevent the imposition of the gift tax, another argument is presented, appearing to favor application of the property law concept urged by plaintiff-executors. But *cf.* the language of Commissioner v. Wemyss, 324 U.S. 303, 307-308 (1945), which would appear to add support to the Commissioner's contention.

[35] LOWNDES AND KRAMER, FEDERAL ESTATE AND GIFT TAXES (1956), pp. 314-317, discusses and recognizes the Sullivan case as representing this possible loophole; Lowndes, *Cutting the "Strings" on Inter Vivos Transfers In Contemplation of Death*, 43 Minn. L. Rev. 57, 68-71 (1958), also discusses the practical effects of an application of the Sullivan doctrine, concluding as does the Tenth Circuit, that to prevent the loophole, consideration should be construed to mean consideration sufficient to prevent depletion of the gross estate, rather than consideration sufficient for the interest transferred.

[36] United States v. Allen, *supra*, n. 1, 918.

in the instant case will go far towards discouraging any realistic hope that decedents may avoid the tax consequences of their reserved life estates by death-bed sales.[37]

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[37] Note that after the Tenth Circuit held that the $900,000 corpus was within the gross estate, the $140,000 consideration paid for the life interest was deducted therefrom. This result is based upon a construction of IRC of 1939, Section 811 (i), (now IRC of 1954, § 2043), which provides for the event that insufficient consideration is received and states that, "* * * there shall be included in the gross estate only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefore by the decedent." The wording of this section is unclear as applied to transfers of reserved life estates, but it is submitted that this section does not warrant a reduction of the $900,000 figure once it is determined it is includible in the gross estate. The section appears to apply where the decedent has received less than he transferred away, with the term property "otherwise to be included" intending to refer to property transferred away. Here there was no transfer of the $900,000 corpus, and the consideration was for the life interest only. It appears that in this situation Section 811 (i) contemplates that the $900,000 is includible and that as much of the $140,000 as decedent has not spent by the time of her death is also includible, as an addition to rather than a deduction from the includible corpus.