March, 1996

Hairsplitting Under I.R.C. Section 2035(d): The Cause and the Cure

Jeffrey G. Sherman, Chicago-Kent College of Law
HAIRSPITTING UNDER I.R.C. SECTION 2035(d):
THE CAUSE AND THE CURE

Jeffrey G. Sherman

TABLE OF CONTENTS

I. INTRODUCTION 111

II. HISTORICAL BACKGROUND 114

III. SECTION 2035(d)(2) EXAMINED 126

IV. ANOMALIES ENGENDERED BY SECTION 2035(d)(2) 131
  A. The Life Insurance Anomaly 131
  B. The Revocable Trust Anomaly 137
  C. Why These Anomalies Are Undesirable 146

V. PROPOSED SOLUTION 148

VI. CONCLUSION 154

I. INTRODUCTION

Imagine an estate tax regime in which section 2033 of the Internal Revenue Code ("the Code") was the only operative Code section directing the inclusion of property in a decedent's gross estate. There would be no section 2038 (applicable to revocable transfers), no section 2040 (applicable to joint tenancies), no section 2042 (applicable to life insurance proceeds); only section 2033. Because only transfers of probate

---


This article has benefitted immensely from the challenging questions and thoughtful suggestions of Mark Ascher and Dale Nance, and I am grateful to them for their guidance and insights. I must also thank my student research assistants, Monica Gurgiolo and Edward Smeltzer, for their skill and diligence. I should like to thank the Marshall D. Ewell Research Fund for providing support for the writing of this article.

1 I.R.C. § 2033: "PROPERTY IN WHICH THE DECEDENT HAD AN INTEREST. 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."
assets would be subject to estate tax under such a system, planners easily could avoid the imposition of the tax simply by employing convenient nonprobate will substitutes, such as revocable trusts, joint tenancies, and life insurance. If a taxpayer must pay estate tax on property he owns at death, but not on property he has placed in a revocable trust during his life, why should he continue to own property outright when by placing it in a revocable trust he can preserve the rights and powers of outright ownership while avoiding estate tax? An estate tax relying exclusively on section 2033 soon would become a voluntary tax: if you wanted to pay the tax, you could; if you did not want to pay it, you would not have to.

This lesson has not been lost on Congress. The federal estate tax, from its very inception in 1916, reached not only transfers of probate assets at death but also a number of inter vivos will substitutes: transfers whereby the transferor retained until death the economic benefits of the transferred

---

1 See Helvering v. Safe Deposit & Trust Co., 316 U.S. 56 (1942). In simplest terms, a probate asset is an asset that the decedent owned outright in her own name at death, an asset that accordingly may pass by intestacy to her heirs or by will to her devisees; her probate estate is the conglomeration of all her probate assets. Subject to a few minor exceptions and refinements, a decedent’s probate estate at death is co-extensive with the property interests included in her gross estate pursuant to § 2033. See Richard B. Stephens, et al., Federal Estate and Gift Taxation ¶ 4.05[3] (6th ed. 1991); see also Jalkut v. Commissioner, 96 T.C. 675, 682 (1991) (holding that the assets in a revocable trust, though includable in the settlor’s gross estate pursuant to § 2038, are not includable pursuant to § 2033).

2 The conveniences of a revocable inter vivos trust do not come without cost. By placing assets in a revocable trust, the grantor incurs the expense (stock transfer fees, for instance) of effecting the transfer of legal title from himself to the trustee, as well as the fee charged by the attorney who drafts the trust instrument. Furthermore, if the grantor appoints someone other than himself as trustee, trustees’ fees will have to be paid. The attorney’s fee may be deductible pursuant to § 212, but only to the extent the fee is attributable to tax planning. See, e.g., Wong v. Commissioner, 58 T.C.M. (CCH) 1073 (1989). The trustee’s fee ordinarily will be deductible for income tax purposes pursuant to § 212. Since a revocable trust is a grantor trust, § 676, the deduction is to be claimed by the grantor himself on his own return. See Rev. Rul. 58-53, 1958-1 C.B. 152. Like any other § 212 deductions, these fees are “miscellaneous deductions” subject to the two-percent floor mandated by § 67. The § 87(c) exception to the two-percent rule is not available here, inasmuch as the deductions are claimed by the grantor, not by the trust.

3 Some scholars have argued that we already have a voluntary estate tax. See George Cooper, A Voluntary Tax?: New Perspectives on Sophisticated Estate Tax Avoidance, 77 Colum. L. Rev. 161 (1977). Though the article has dated somewhat, inasmuch as some of the tax avoidance techniques that Cooper discusses have been weakened or neutralized by subsequent Congressional action, his general observations remain pertinent and telling.

property. The first estate tax statute explicitly included in the gross estate joint tenancy property, property transferred inter vivos in contemplation of death, and inter vivos property transfers “intended to take effect in possession or enjoyment at or after [the transferor’s] death.” When this last phrase was found insufficiently broad to include property transferred with a retained life estate, Congress enacted the predecessor of section 2036(a) to reach such transfers. When the United States Supreme Court held that property subject to an unexercised general power of appointment at death was not includable in the power-holder’s gross estate, Congress amended the Code to tax such property.

---

6 The quoted language obviously presages § 2037. In 1929, the United States Supreme Court held that this rather general language also sufficed to include revocable transfers in the gross estate. Reinecke v. Northern Trust Co., 278 U.S. 339, 345 (1929). By that time Congress had amended the estate tax law to provide explicitly for the includability of revocable transfers, Revenue Act of 1924, Pub. L. No. 176, ch. 234, § 302(d), 43 Stat. 253, 304 (1924), but the 1924 amendment was not before the court in Reinecke, inasmuch as the decedent in that case had died in 1922. 278 U.S. at 343.

The 1924 amendment went further than the Supreme Court. Reinecke had also held that where the settlor’s reserved revocation power could be exercised only with the consent of a trust beneficiary, the pre-1924 estate tax did not require the inclusion of the trust property in the settlor’s gross estate. Id. at 346. The 1924 amendment provided, however, that revocable transfers were included in the gross estate whenever the revocation power could be exercised “by the decedent alone or in conjunction with any person.” Pub. L. No. 176, ch. 235, § 302(d), 43 Stat. 253, 304 (1924).


8 So urgently-felt was the need to close this loophole that Congress did so by means of a joint resolution. Joint Resolution of March 3, 1931, 46 Stat. 1516 (1931); see Hasset v. Welch, 303 U.S. 303, 309-11 (1938) (discussing the legislative history). The Resolution provided in part that the estate tax applied to “a transfer under which the transferor has retained for his life or for a period not ending before his death ... the possession or enjoyment of, or the income from, the property ...” 46 Stat. at 1516.

9 Helvering v. Safe Deposit & Trust Co., 316 U.S. 56 (1942). A power of appointment is a right, “other than as an incident of the beneficial ownership of property, to designate recipients of beneficial interests in property.” Restatement (Second) of Property (Donative Transfers) § 11.1 (1984). A power of appointment is classified as general if the donee of the power may exercise it in favor of any one or more of the following: herself, her creditors, her estate, or the creditors of her estate. Id. at § 11.4.

10 The donee of a general testamentary power has complete testamentary control over property, as much control as he has over his probate assets. Just as the probate assets of an intestate are taxable pursuant to § 2033 even though the decedent has chosen not to exercise his power to write a will, so assets subject to a general power of appointment should be taxable even if the donee of the power chooses not to make an appointment. To correct this unfortunate tax result, Congress enacted section 403 of the Revenue Act of
Yet Congress turned its back on this lesson when, in 1981, it amended section 2035 of the Code, dealing with gifts made within three years of death. Congress's purpose throughout the 1981 transfer tax amendments was to reduce gift and estate taxes, and it probably would have repealed the three-year rule altogether had it not recognized the special problems posed by assets, such as life insurance, whose value balloons at the time of death. The solution Congress chose, a partial repeal of section 2035, had the effect, in some circumstances, of reviving prior law's disparate treatment of will substitutes and the similar arrangements for which they substitute, thereby giving rise to tax-avoidance stratagems founded on hollow distinctions. This article describes two sets of problems occasioned by this ill-advised amendment and then suggests a method of restoring section 2035 to soundness.

II. HISTORICAL BACKGROUND

When Congress first enacted the estate tax in 1916,\(^\text{11}\) no gift tax accompanied and bolstered it; federal transfer taxation was avoidable by making inter vivos gifts. While the desire to preserve one's purchasing power might ordinarily dissuade a property owner from availing herself of this loophole by giving away her wealth while still alive, someone approaching death might find the loophole more tempting as the need to retain assets for long-term security became less compelling. In order to prevent tax avoidance in those circumstances and to tax gifts serving as substitutes for testamentary dispositions,\(^\text{12}\) this first estate tax statute provided that the gross estate included gifts

---

1942, Pub. L. No. 753, ch. 619, 56 Stat. 798, 942-44 (1942), codified as § 811(f) of the Internal Revenue Code of 1939, which provided that property subject to a testamentary power (general or non-general) at the decedent's death—even a special power—would, with a couple of exceptions, be includable in his gross estate, whether or not the power was exercised. Extending the estate tax to special powers proved too onerous, and in 1951 the law was changed, retroactively to 1942, to limit the reach of § 811(f) of the 1939 Code to general powers of appointment. Powers of Appointment Act of 1951, Pub. L. No. 58, ch. 165, § 2, 65 Stat. 91-93 (1951). Today's Code section dealing with powers of appointment, § 2041, is substantively the same as this 1951 version.


\(^{12}\) See United States v. Wells, 283 U.S. 102, 116-17 (1931).
“made . . . in contemplation of death.” If a gift was prompted by the donor’s desire to distribute her wealth by making partial dispositions while still alive, the gift would be regarded as having been made in contemplation of death and would be included in her gross estate. If, on the other hand, the gift was prompted by a “life motive,” such as a desire to relieve the donee’s financial distress or to see the donee enjoy the benefits of the property during the donor’s lifetime, the gift would be excluded from the estate tax base. To inject some predictability into the task of distinguishing testamentary from nontestamentary gifts, Congress established, by the 1916 Act, a rebuttable presumption that gifts of a material portion of the transferor’s property made within two years of her death were made in contemplation of death. But a gift made more than two years before death was still includable in the transferor’s gross estate if the requisite motive was proved.

In 1924, Congress, having felt the need for a gift tax to serve as a backstop to the estate tax, enacted our first federal gift tax statute. But because this new gift tax took a smaller bite than the estate tax, there remained some incentive to make end-of-life gifts as a tax-avoidance device, so the rule that included gifts made in contemplation of death in the gross estate was retained.

---

17 “Death must be ‘contemplated,’ that is, the motive which induces the transfer must be of the sort which leads to testamentary disposition.” United States v. Wells, 283 U.S. 102, 117 (1931).
18 See, e.g., Oliver v. Bell, 103 F.2d 760, 762 (3d Cir. 1939) (applying a similar provision in a later statute); Austin Nat’l Bank v. Scofield, 84 F. Supp. 483, 485 (W.D. Tex. 1948) (same).
22 See, e.g., In re Kroger’s Estate, 145 F.2d 901 (6th Cir. 1944), cert. denied, 324 U.S. 886 (1945) (applying a similar provision in a later statute and holding that a gift made 10 years before the transferor’s death was made in contemplation of death and therefore was includable in the gross estate).
24 The 1924 gift tax, unlike the current gift tax, was noncumulative. The tax rate applicable to a taxpayer’s gifts was determined by the gifts he had made during that year only, not by the total gifts he had made throughout his life.
The 1924 gift tax had proved so weak\textsuperscript{23} that Congress repealed it as part of the Revenue Act of 1926.\textsuperscript{24} To compensate for the loss of the gift tax revenue,\textsuperscript{25} Congress strengthened the estate tax rules relating to gifts in contemplation of death by replacing the presumption with a rule: gifts in excess of $5,000 made within two years of the transferor's death were not merely presumed but conclusively and irrebuttably deemed to have been made in contemplation of death and therefore to be includable in the transferor's gross estate.\textsuperscript{26} The United States Supreme Court declared that this "conclusive presumption" violated the Due Process clause of the Fifth Amendment,\textsuperscript{27} and Congress, in response, restored the pre-1926 rebuttable presumption for gifts of a material portion of the donor's property made within two years of death.\textsuperscript{28}

In 1950, Congress made three significant changes in the contemplation-of-death rule: changes that lasted for twenty-six years.\textsuperscript{29} First, the period during which the "contemplation of death" presumption applied was increased from two years to three years. Second, the presumption was to be applied even if the gift in question did not represent "a material portion" of the donor's wealth. Third, and perhaps most important, gifts made more than three years before death were conclusively deemed not to have been made in contemplation of death.

---


\textsuperscript{24} Revenue Act of 1926, ch. 27, § 1200, 44 Stat. 125. The much-strengthened precursor of the current gift tax was enacted in 1932. See Lowndes, Kramer, & McCord, supra note 23, at 639.


\textsuperscript{26} Revenue Act of 1926, ch. 27, § 302(c), 44 Stat. 70.

\textsuperscript{27} Heiner v. Donnan, 285 U.S. 312 (1932). The Court reasoned that if, within two years of a donor's death, he made a gift with a life motive but his executor was barred by the conclusive presumption from establishing the existence of that life motive, then a gift having no connection with the estate nonetheless would be subjected to estate tax; and such a circumstance, said the Court, was unconstitutional. Id. at 323-27. It is doubtful that the case would be decided the same way today. Indeed, a mere six years later, the Court held, "Since Congress may lay an excise upon gifts[,] it is of no significance that the exaction is denominated an estate tax or is found in a statute purporting to levy an estate tax." Helvering v. Bullard, 303 U.S. 297, 301 (1938); see Estate of Ekins v. Commissioner, 797 F.2d 491, 485-86 (7th Cir. 1986).

\textsuperscript{28} Revenue Act of 1932, ch. 209, § 803(a), 47 Stat. 169, 279.

Even with the enactment of a viable gift tax in 1932, the federal transfer tax regime continued to encourage lifetime giving. Although under the new, strengthened gift tax the marginal rate applicable to a donor for a given year was determined by the donor's total lifetime gifts rather than merely by the gifts he had made during the year, the applicable estate tax bracket was determined solely by the assets in his taxable estate. Thus, "a lifetime gift took the gift property out of the top estate tax bracket of the donor and taxed it for gift tax purposes at the bottom applicable bracket of the gift tax rate schedule."\(^{37}\) Intensifying the effect of this dual tax system was a disparity in gift tax and estate tax rates; the marginal gift tax rate applicable to a given amount of taxable transfers was only three-fourths of the applicable estate tax rate.\(^{38}\) Consequently, the executors of end-of-life donors often went to great lengths to establish that the gifts in question were made with a life motive and therefore subject only to the gift tax, not to the estate tax that section 2035 of the Code\(^{39}\) imposed if the contemplation-of-death presumption was not rebutted.\(^{40}\) Executors would assemble examples of the donor's sprightly behavior and offer them, in all seriousness, as evidence that the donor could not have been contemplating death at the time he made the gifts in question. In *Estate of Johnson v. Commissioner*,\(^{41}\) for example, the evidence that produced a result favorable to the taxpayer included testimony that the donor, at one time during the year before the gift, "in order to

---


\(^{39}\) For example, if a transferor's lifetime taxable gifts (after deducting the since-repealed $30,000 "specific exemption" of § 2521) amounted to $800,000, they would be subjected to a top marginal gift tax rate of 27.75%. I.R.C. § 2502 (1975). If a transferor's taxable estate (after deducting the since-repealed $60,000 exemption of § 2052) amounted to $800,000, it would be subjected to a top marginal estate tax rate of 37%. I.R.C. § 2001 (1975).

\(^{40}\) Beginning in 1954, the contemplation-of-death rule was codified in I.R.C. § 2035.

\(^{41}\) If a gift subject to gift tax was included in the donor's gross estate, the gift tax payable was credited against the estate tax. Int. Rev. Code of 1954 § 2012. This credit does not apply to gifts made after 1976, inasmuch as the enactment in 1976 of the unified transfer tax system makes such a credit unnecessary. See Int. Rev. Code of 1986 § 2001(b)(2).

\(^{42}\) 10 T.C. 680 (1948).
demonstrate his agility [at the age of 89], . . . jumped into the air and clicked his heels together 2 or 3 times before descending to the floor. In Kniskern v. United States, another case favorable to the taxpayer, the court found that the donor, who was ninety-nine years old at the time of the gift, "frequently repaired the sprinkler system on his hands and knees, after obtaining the tools himself."

By 1976, Congress was persuaded that this absurd hunt for a donor's subjective motive wasted valuable judicial resources and needed to end. Accordingly, as part of the Tax Reform Act of 1976, Congress amended section 2035(a) of the Code to provide that all gifts made within three years of the donor's death were to be included in his gross estate, regardless of his motive for the gift. This amendment required a further amendment,

Id. at 685. However, the court sounded this cautionary note regarding the search for circumstantial evidence of subjective motive:

It is possible that the verbal picture of Oliver [Johnson, the donor decedent] created at the trial by the testimony of witnesses brought out by the skillful guidance of petitioner's counsel emphasized certain of his features and left others in shadow to the extent that the Oliver Johnson of the verbal portrait has more resemblance to a synthesis of decedents whose transfers had been held in many reported cases to have been made not in contemplation of death than to the real Oliver Johnson who transferred real estate in Southern California on March 3, 1939.

Id. at 691.


Id. at 11. But see Hope v. United States, 691 F.2d 786, 791 (5th Cir. 1982) ("Although a person who expects imminent death is more likely to have acted in contemplation of death, the courts have repeatedly held that reliance upon the decedent's apparent good health, youth, and general zest for life stops short of showing that the decedent did not act in contemplation of death.").


In making this change, Congress was concerned that the new § 2035(a) might encounter the same constitutional objections encountered by the 1926 "conclusive presumption. See Heiner v. Donnan, 285 U.S. 312, 325 (1932). Accordingly, Congress took some pains to distinguish the 1976 amendment from the statute held unconstitutional in Donnan:

First, [the 1976 amendment] does not provide a presumption as to whether a transfer is in contemplation of death. The theory underlying the provision does not depend on whether the transfer was in contemplation of death as a substitute for a testamentary disposition. The donor's motive is immaterial. Second, the 1932 decision dealt with the impact of the contemplation of death rules under a taxying statute where substantial differences in tax liability would have risen, depending upon whether or not a lifetime transfer was included in a decedent's gross estate because no gift tax was imposed at that time.
however, to deal with de minimis gifts. Suppose a donor, six months before his death, gives a $100 birthday present to his daughter. Under pre-1977 law, there was no risk of such a gift being included in the gross estate, inasmuch as casual, routine gifts like birthday presents are not made in contemplation of death. But under the amended version of section 2035(a), with the elimination of the motive test, all gifts, however small and routine, made within three years of the donor’s death would be includable in the gross estate. To avoid this outcome for small gifts, Congress also amended section 2035(b) to provide that the three-year rule of section 2035(a) did not apply to gifts coming within the $3,000 (now $10,000"") annual exclusion of section 2503(b). Thus, a donor’s $100 birthday present to his

---


I Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a)(5), 90 Stat. 1520, 1848-49. As amended by the 1976 Act, § 2035(b) provided that the 3-year rule did not apply to “any gift includable in computing taxable gifts by reason of section 2503(b) (relating to the $3,000 annual exclusion for purposes of the gift tax) ....” Id. The meaning of the § 2035(b) exception, as enacted in 1976, was not altogether clear. See Reed v. United States, 743 F.2d 481, 484 (7th Cir. 1984), cert. denied, 471 U.S. 1135 (1985). Suppose an unmarried donor, within three years of death, made a gift of $3,001 to a donee. For estate tax purposes, was the gift includable in its entirety or only to the extent of $1? That is, did § 2035(b) mandate a “subtraction out” approach or an all-or-nothing “de minimis” approach? Most commentators believed that a “subtraction out” rule was intended, see, e.g., John E. Donaldson, Inter Vivos Giving in Estate Planning Under the Tax Reform Act of 1976, 18 Wm. & Mary L. Rev. 539, 543-44 (1977); Leo C. Hodges, Current Strategies for Using Lifetime Gifts to Reduce Total Estate and Gift Taxes, 47 J. Tax. 265, 267 n.3 (1977); Howard Zaritsky, The Estate and Gift Tax Revisions of the Tax Reform Act of 1976, 34 Wash. & Lee L. Rev. 353, 360 (1977), and a report prepared by the staff of the Joint Committee on Taxation shortly after the enactment of the 1976 Act likewise construed the statute to prescribe a “subtraction out” rule. General Explanation of the Tax Reform Act of 1976, reprinted in 1976-3 C.B. (vol. 2) 1, 541. At least one court likewise held that the original 1976 version of § 2035(b) prescribed a “subtraction out” rule. Estate of Ceppi v. Commissioner, 698 F.2d 17, 20 (1st Cir.), cert. denied, 462 U.S. 1120 (1983). In 1978, Congress clarified its intentions, taking the de minimis approach, by amending § 2035(b) retroactively to provide that the 3-year rule does not apply “to any gift to a donee made during a calendar year if the decedent was not required by section 6019 to file any gift tax return for such year with respect to gifts to such donee.” Revenue Act of 1978, Pub. L. No. 95-600, § 702(f)(1), 92 Stat. 2763, 2930. Thus, if an unmarried donor made a $2,999 gift to X in 1979 and died in 1980, nothing was included in the donor’s gross estate pursuant to § 2035; if the donor made a $3,001 gift to X in 1979 and died in 1980, $3,001 was included in the donor’s gross estate. See S. Rep. No. 498, 96th Cong., 2d Sess. 86-87, reprinted in 1980 U.S.C.C.A.N. 316, 395, and in 1980-1 C.B. 517, 558. This 1978 amendment originally was made retroactive to January 1, 1977, the effective date of the once-ambiguous § 2035(b),
daughter made within three years of the donor's death would not be includable in his gross estate, assuming that all of the donor's gifts to his daughter during the year in question totaled less than the annual exclusion amount. Therefore, while the 1976 amendments generally broadened the reach of § 2035(a), in this one respect they narrowed it. Under pre-1977 law, a $2,000 gift in contemplation of death made within three years of death would be included in the donor's gross estate; under the 1976 amendments, such a gift would not be included. In the same time that Congress simplified the end-of-life gift rules by removing the contemplation-of-death muddle from section 2035(a), it amended the transfer tax law to remove most of the tax incentives for making end-of-life gifts. As previously noted, pre-1977 law favored inter vivos transfers over transfers at death, inasmuch as the gift tax and estate tax were imposed separately and gift tax rates were 25% lower than the estate tax rates for the same amount of transfer. By 1976, however, Congress had come to regard this disparity of treatment as unfair:


In McCarthy v. United States, 806 F.2d 129 (7th Cir. 1986), the decedent directed her son, two days before her death in 1980, to write nine $3,000 checks on their joint bank account, checks that the decedent intended as gifts to various relatives. Id. at 130. While all of the checks were mailed or delivered to the intended donees prior to the decedent's death, none was cashed until after her death. Id. The taxpayers took the position that the nine gifts were completed for gift tax purposes on the date they were mailed or delivered and that although the donor could have revoked the gifts (by stopping payment) prior to the cashing of the checks, when the checks were in fact successfully cashed the gifts "related back" to the date of mailing or delivery. Id. at 131-132. Then the taxpayers relied on § 2035(b) arguing that because all of the gifts, though made within three years of death, were covered by the annual exclusion, nothing was includable in decedent's gross estate pursuant to § 2035(a). Id. The appellate court, refusing to apply this "relation back" doctrine, held that because the decedent retained the right to stop payment on the nine checks until her death, she had not parted with ownership of the $27,000 during her life. Id. The $27,000 was included in her gross estate pursuant to § 2033.

See supra note 31 and accompanying text.

See supra note 32.
As a matter of equity, your committee believes the tax burden imposed on transfers of the same amount of wealth should be substantially the same whether the transfers are made both during life and at death or made only upon death. As a practical matter, the preferences for lifetime transfers are available only for wealthier individuals who are able to afford lifetime transfers. The preferences for lifetime transfers are not generally available for those of small or moderate wealth since they generally want to retain their property until death to assure financial security during lifetime.

Accordingly, Congress merged the gift tax and estate tax into a single, unified tax system. Gift tax and estate tax rates were equalized, and the estate tax was imposed cumulatively: the highest marginal estate tax rate to which transfers were (and still are) subjected was determined by the sum of the transferor’s inter vivos transfers and transfers at death.

Even with these changes, transfer tax law still offers significant tax-saving opportunities to those who make inter vivos gifts. First, the annual exclusion (now $10,000) is available for inter vivos gifts of present interests; no comparable estate tax exclusion exists. Second, because the gift tax is based on the asset’s value at the time of the gift while the estate tax is based on the asset’s value at death, the owner of appreciating property will pay less transfer tax if he transfers it inter vivos; the donee can enjoy the post-gift appreciation without the donor’s having to pay transfer tax respecting such enjoyment. Third, because the annual exclusion and the unified credit are not indexed for inflation, their value to a transferor decreases over time. Fourth, the payment of gift tax removes from the transfer tax base the dollars used to pay the gift tax.

---

* H.R. Rep. No. 1380, 94th Cong., 2d Sess. 11 (1976). Not only did the pre-1977 preference for inter vivos gifts favor persons of great wealth, it favored those whose wealth was held in a readily divisible form. A person whose wealth was held in the form of cash or marketable securities could more easily make inter vivos gifts of, say, one-third of her wealth than could a person whose wealth was held in the form of an unincorporated farm or shop.


* I.R.C. §§ 2010, 2505. The Revenue Reconciliation Bill of 1995, part of the Balanced Budget Reconciliation Bill of 1995, would have indexed for inflation the annual

* The estate tax, like the income tax, is "tax inclusive," that is, the dollars used to pay estate tax are themselves subject to estate taxation. The gift tax, on the other hand, is "tax exclusive." The dollars used to pay gift tax are not subject to gift taxation; the donor must pay the gift tax out of assets other than those transferred. Therefore, even if the stated gift tax rates and estate tax rates are the same, the effective estate tax rate, calculated by dividing the amount of tax by the value of the property received by the transferee, is higher than the effective gift tax rate. Because the estate tax is reduced dollar for dollar by any gift taxes paid by the transferor, inter vivos gifts reduce the transferor's total transfer tax liability.

For purposes of illustration, assume that there is no annual exclusion or unified credit and that the gift and estate tax rates are a flat 20%. Suppose A's total wealth is $120,000, and B is A's sole intended beneficiary. Case One: A makes an inter vivos gift of $50,000 to B and pays a gift tax of $10,000. This leaves A with $60,000 remaining. On A's death, her $60,000 taxable estate must pay an estate tax of $12,000, leaving a net estate of $48,000 to pass to B. Thus, A has paid a total of $22,000 in transfer taxes, and B has received a total of $98,000. Case Two: A makes no inter vivos gifts. On A's death, her $120,000 taxable estate must pay an estate tax of $24,000, leaving a net estate of only $96,000 to pass to B. By making an inter vivos gift of a substantial portion of her wealth (Case One), A paid $2,000 less in transfer taxes and conferred $2,000 more on B. This $2,000 saving represents the transfer tax that would have been paid on the dollars used to pay the gift tax: 20 percent of $10,000 is $2,000. Of course, that $2,000 saving must be weighed against the loss of the use of that $2,000 between the date of gift and the date of death. Moreover, income tax considerations—the opportunity to reduce B's potential capital gain by giving him a stepped-up basis pursuant to § 1014(a)—may also argue for a purely testamentary approach.

There is a fifth tax incentive to make lifetimes gifts: the so-called "bracket effect" that results from the transfer tax's progressive rate structure.

If property is the subject of a gift, its transfer tax value is frozen, and the gift is subject to the gift tax rate schedule. If the same property were not the subject of a gift, it would (except to the extent consumed) presumably augment itself, directly or indirectly, in the fashion of compound interest until death. Due to the progressive rate structure, the property will be taxed (in part) in higher marginal rate brackets than would have applied if the transfer had been treated as a completed gift when made. It follows that the estate tax on the property will be greater than what would have been the compounded forward gift tax on the same property.

Joseph M. Dodge, Redoing the Estate and Gift Taxes Along Easy-to-Value Lines, 43 Tax. L. Rev. 241, 340 (1988) (footnote omitted). For example, consider the case of an individual who has never before made a taxable transfer. She owns Blackacre, now worth $700,000, and is trying to decide whether to make an inter vivos gift of the property or to retain it until her death. If she opts for an inter vivos gift, the gift tax due will be $37,000. Suppose, instead, she decides to keep Blackacre until her death. If she dies four years later, and we assume a 7% interest rate, Blackacre will have appreciated to $917,557, and the estate tax due will be $120,847. Financially, the gift tax result is clearly preferable. At that same 7% interest rate assumption, $120,847 of tax payable in four years is the financial equivalent of $92,194 payable now; the inter vivos transfer of Blackacre requires the individual to pay a tax of only $37,000 now.

A non-progressive transfer tax system produces no bracket effect. Again, assume a flat 20% transfer tax with no credits or exclusions. The gift tax on a current gift of $700,000 would be $140,000. The estate tax on $917,557 (the value to which Blackacre will have appreciated in four years under our 7% interest rate assumption) would be $183,512. At a 7% interest rate assumption, a $183,512 tax payable in four years is the financial equivalent of $140,000 payable today.
In crafting the Tax Reform Act of 1976, Congress was content to retain all but one of these incentives to make lifetime transfers. In the case of gifts made within three years of death, Congress enacted a "gross up" rule, section 2035(c), requiring that any gift taxes paid by the donor (or her estate) with respect to the gift be included in the gross estate so that individuals would not be tempted to make end-of-life gifts as a device for removing from the transfer tax base the dollars used to pay gift tax. There was now nothing to be gained by making an end-of-life gift. If death occurred within three years of the gift and the transferred property accordingly was included in the gross estate, the benefit of the annual exclusion would be lost,

---

In the interests of simplicity, this article will ignore the bracket effect.


It is generally considered socially desirable to encourage those having property more than sufficient for their needs to pass some of their wealth on to the next generation or to others as early as possible, instead of waiting until death causes them to relinquish control.

Hearings before the Committee on Ways and Means, House of Representatives, on the Subject of Tax Reform, 91st Cong., 1st Sess. pt. 11, at 3992 (1969) (statement of Mr. George Craven, arguing for the retention of the disparate rate structure under which gift tax rates were only 75% as high as the parallel estate tax rates). Moreover, "society profits from having property transferred to those who have a greater need and, perhaps, a greater willingness to make property productive." Max Gutierrez, Jr., Taxation of Wealth Transmission: Problems and Reforms, in Death, Taxes and Family Property 71, 74 (Edward C. Halbach, Jr., ed. 1977).

The "gross up" rule of § 2035(c) does not quite close the gap it was intended to close: the gap between a tax-inclusive tax and a tax-exclusive tax. See supra note 49. When an individual makes a taxable gift, the gift property is removed from her potential taxable estate, but the cost of that removal is the accompanying surrender of transfer tax dollars: she must pay transfer tax at the time of the gift rather than waiting until her death to pay it. Section 2035(c), though it ultimately subjects to transfer tax the dollars used to pay the gift tax on gifts made within three years of death, permits the taxpayer to defer until her death the transfer tax on that gift tax. A sounder rule, a rule that would more effectively close the gap, would include in the amount of the gift the gift tax paid and thus subject that gift tax to gift tax. Again, assume that there is no annual exclusion or unified credit and that the gift and estate tax rates are a flat 20%. Suppose A gives $100,000 to B in Year 1 and dies in Year 3. Under the present § 2035(c) system, A will pay $20,000 of gift tax in Year 1. The $20,000 will be brought back into the transfer tax base and subjected to a $4,000 transfer tax (20% of $20,000), but not until A's death in Year 3. A better result would be achieved if the transfer tax on that $20,000 of gift tax were paid in Year 1: that is, if the total gift tax paid in Year 1 were $24,000. Congress has enacted a similar gap-closing rule in § 2515, which treats any generation-skipping transfer tax paid on account of certain inter vivos gifts as an additional transfer subject to gift tax.

The "gross up" rule also applies to gift taxes paid by the donor (or her estate) on gifts made by the donor's spouse within three years of the donor's death.
post-gift appreciation would be taxed,\textsuperscript{52} and the dollars used to pay the gift tax would be subject to estate taxation.

Current law dates from 1981. Congress became persuaded that the 1976 adoption of the unified transfer tax system severely limited the role that section 2035(a) could play. Apart from the section 2035(c) gross-up, the only difference in treatment between a gift made four years before death and a gift made two years before death was that in the latter case, the property's post-gift appreciation was included in the gross estate.\textsuperscript{53} Congress concluded that inclusion of such appreciation was unwarranted, and accordingly, as part of the Economic Recovery Tax Act of 1981, it repealed section 2035(a) with respect to decedents dying after 1981.\textsuperscript{54} With two exceptions, gifts made within three years of death are no longer included in the donor's gross estate, but the gross-up rule of section 2035(c) has been retained.\textsuperscript{55}

Section 2035(d) now provides as follows:

(d) Decedents dying after 1981.—

(1) In general.—Except as otherwise provided in this subsection, subsection (a) [the 3-year includability rule] shall not apply to the estate of a decedent dying after December 31, 1981.

\textsuperscript{52} When property transferred inter vivos is brought back into the transferor's gross estate pursuant to § 2035(a), the property is included at its date-of-death value or its value as of the § 2032 alternate valuation date. See infra note 82 and accompanying text.

\textsuperscript{53} That is what Congress said.

Under the unified transfer tax system adopted in the Tax Reform Act of 1976, the inclusion in the gross estate of gifts made within 3 years of death generally has the effect of including only the property's post-gift appreciation in the gross estate (because the gift tax paid with respect to the transfer is allowed as a credit against the decedent's estate tax).

H.R. Rep. No. 201, 97th Cong., 1st Sess. 186 (1981). Another effect of such inclusion, of course, was the loss of the annual exclusion, since the property was included in the gross estate at its full date-of-death or alternate valuation date value, without regard to any annual exclusion.


\textsuperscript{55} The repeal of I.R.C. § 2035(a) does not necessarily work to the advantage of taxpayers when viewed after the fact. By keeping the gift property out of the donor's gross estate, Congress precluded the donee from obtaining a stepped-up basis pursuant to I.R.C. § 1014(a) upon the donor's death.
(2) Exceptions for certain transfers.—Paragraph (1) of this subsection and paragraph (2) of subsection (b)\(^a\) shall not apply to a transfer of an interest in property which is included in the value of the gross estate under section 2036, 2037, 2038, or 2042 or would have been included under any of such sections if such interest had been retained by the decedent.\(^b\)

(3) 3-Year rule retained for certain purposes.—Paragraph (1) shall not apply for purposes of—

(A) section 303(b) (relating to distributions in redemption of stock to pay death taxes),

(B) section 2032A (relating to special valuation of certain farm, etc., real property), and

(C) subchapter C of chapter 64 (relating to lien for taxes).

(4) Coordination of 3-year rule with section 6166(a)(1).—An estate shall be treated as meeting the 35-percent of adjusted gross estate requirement of section 6166(a)(1) only if the estate meets such requirement both with and without the application of paragraph (1).

The first exception to the repeal of section 2035(a) involves several Code provisions designed to give relief to estates whose assets consist largely of farm or closely-held business interests. In determining the estate’s qualification for special use valuation under section 2032A, the availability of capital gains treatment pursuant to section 303 for redemptions to pay death taxes, and the identity of the property that is subject to estate tax liens (under subchapter C of Chapter 64), gifts made within three years of death are included in the gross estate.\(^c\) The

---

\(^a\) Paragraph (2) of subsection (b) is the de minimis rule discussed in the text at note 42, supra.


\(^c\) I.R.C. § 2035(d)(3). For example, in order for a redemption of stock in a closely held corporation to be eligible for capital gains treatment pursuant to § 303, the closely held corporate stock interests included in the decedent’s gross estate must exceed 35% of his adjusted gross estate (which is the gross estate reduced by allowable expenses, debts, and
second exception, section 2035(d)(2), maintains the includability rule for certain section 2036-, 2037-, 2038-, and 2042-type transfers. We now turn to a discussion of this second exception.

III. SECTION 2035(D)(2) EXAMINED

Section 2035(d)(2) of the Code presents a number of interpretive puzzles. It provides, in part, that notwithstanding the general repeal of the three-year rule, section 2035(a) continues to bring into the gross estate two kinds of property interests: first, any property interest "which is included in the . . . gross estate under [sections 2036-2038 or 2042]," and second, any property interest which "would have been included [in the gross estate under sections 2036-2038 or 2042] if such interest had been retained by the decedent."

In considering the first clause, the question naturally arises: if section 2035(d)(2) permits section 2035(a) to reach property included in the gross estate under sections 2036-2038 or 2042, what does section 2035(d)(2) do that is not already done by those other sections? The one possible explanation offered by scholars produces a harsher tax result than Congress could have intended.** One is compelled reluctantly to conclude that

---

** Assume A creates a trust to pay income to B for life, then income to A for life, remainder to C (the value of B's life estate exceeds $10,000). In the absence of section 2035(d)(2), if A died immediately after creating the trust, the trust corpus less the value of
this first clause of section 2035(d)(2) has no meaning at all. Indeed, the Revenue Reconciliation Bill of 1995,60 vetoed by President Clinton on December 6, 1995, would have removed this first clause from the statute.61

The second clause of section 2035(d)(2) does have meaning, but the meaning is imperfectly expressed. The clause provides that, notwithstanding the general repeal of the three-year rule, section 2035(a) continues to bring into the gross estate the value of any property interest that “would have been included [in the gross estate under sections 2036-2038 or 2042] if such interest had been retained by the decedent.” The clause purports to prevent a property-owner from circumventing sections 2036-2038 or 2042 through gratuitous transfers within three years of death. Read literally, however, the statute contemplates that the property whose value section 2035(a) brings into the gross estate will be identical to the property transferred within three years of death. Congress could not have intended this result. For example, suppose A, five years before her death, transfers property in trust, income to herself for life and remainder to B. Were there no further transfers with respect to the trust, upon her death the entire value of the trust property would be included in her gross estate pursuant to section 2036. Suppose further, however, that one week before her death A makes a gift of her life estate to C. Section 2035(d)(2) clearly is intended to provide that, notwithstanding the gift of the life estate, the entire trust property will be

---

of B's life estate would be includible in A's gross estate under section 2036(a)(1). The value of B's life estate, less the present interest exclusion, would be includible in A's adjusted taxable gifts.... Section 2035(a) would cause inclusion of the entire trust corpus, because it requires inclusion of "all property to the extent of any interest therein" which the decedent has transferred within three years of death. Section 2035(d)(2) makes section 2035(a) applicable "to a transfer of an interest in property" which is included in the decedent's gross estate under section 2036. If section 2035(d)(2) [makes] section 2035(a) applicable only to the interest which is included under section 2036, it has no independent meaning (and the value of B's life estate would not be included in A's gross estate in the above example). Rather, the provision has independent meaning only if section 2035(a) is applicable to the entire property in which the decedent retained an interest resulting in estate tax inclusion (thus, including in A's gross estate the value of B's life estate in the above example). Stanley S. Surrey, et al., Federal Wealth Transfer Taxation 263-64 (Successor ed. 1987) (emphasis in original).

61 Id. § 11612. See note 48, supra.
included in A's gross estate. Yet section 2035(d)(2) purports to reach only the interest transferred within three years of death: the life estate rather than the trust corpus.

In its present form, the language of section 2035(d)(2) must be freely interpreted if it is to have its intended effect. The Revenue Reconciliation Bill of 1995 would have clarified the original language and more perfectly expressed the intent of the original section 2035(d)(2). Section 11612 of the Act would have replaced section 2035(d)(2) with a new section 2035(a) as follows:

(a) Inclusion of Certain Property in Gross Estate. —If—

1. the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a

---

* Congress thus preserved the result of United States v. Allen, 293 F.2d 916 (10th Cir.), cert. denied, 368 U.S. 944 (1961). In Allen, the grantor, within three years of her death, sold her retained life estate for about $140,000, which was slightly more than the life estate's actuarial value at the time of the sale but considerably less than the value of the trust corpus (about $900,000). Upon her death, the court held that §§ 2035 and 2036, acting together, required the inclusion in her gross estate of the difference between the amount that she received for the life estate and the amount that would have been inculcable had she not made the sale. Although both §§ 2035 and 2036 exclude from their reach "bona fide sale[s] for an adequate consideration in money or money's worth," the court reasoned that in order for these two sections to retain their effectiveness, the adequacy of consideration must be measured by the value of the property that would otherwise have been included in the gross estate ($900,000), not by the value of the property interest transferred in the purported "sale" ($140,000). 293 F.2d at 917-18. To hold otherwise would allow the taxpayer, close to her deathbed, to remove $900,000 from her potential taxable estate without paying gift tax (since the gift tax value of the transferred life estate equaled the $140,000 that she received in exchange) and replace it with an asset worth only $140,000 (the cash received upon sale of the life estate).

* With respect to § 2038-type transfers, the literal wording of § 2035(d)(2) generally works quite nicely, since in § 2038 cases the property brought into the gross estate usually is identical to the property transferred within three years of death. See T.A.M. 90-15-001 (Dec. 29, 1989). But see infra note 140. For example, suppose A, five years before her death, transfers property in trust, income B for life and remainder to C. In addition, A retains the power to revoke the trust at any time prior to the earlier of her death or B's. So far, no transfer for gift tax purposes has taken place. Were there no further dealings with respect to the trust, upon A's death during the term of B's life estate the entire value of the trust property would be included in A's gross estate pursuant to § 2038. If, however, one year before A's death, A relinquished her revocation power, she would at that point have made a gift for gift tax purposes equal to the full value of the trust corpus (valued as of the date of relinquishment). Burnet v. Guggenheim, 288 U.S. 250 (1933). And, pursuant to § 2035(d)(2), the full value of the trust corpus (valued as of the date of death or the alternate valuation date) would be includable in her gross estate.

* See supra note 60 and accompanying text.
power with respect to any property, during the 3-year period ending on the date of the decedent's death, and

(2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death, the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.

With respect to sections 2036(b) (concerning retained voting rights) and 2038 (concerning revocable transfers), section 2035(d)(2) seems merely to confirm pre-existing statutory law. With respect to section 2036(a)(1) (concerning retained life interests), it confirms prior case law, and with respect to sections 2036(a)(2) (concerning lifetime powers over income) and 2037 (concerning transfers intended to take effect at death), it confirms the position long taken by the Treasury Department. With respect to section 2042 (concerning life insurance), however, section 2035(d)(2) has made important changes. We shall discuss these changes below.

The 1995 proposed version of section 2035(d)(2) is not only clearer than the original 1981 version, it is more comprehensive. The 1981 version addresses only the relinquishment of "interests," not the relinquishment of "powers." Since the "right[s]" described in section 2036(a)(2) and the "incidents of ownership" described in section 2042(2) do not constitute "interests," the 1981 language does not appear to cover the end-of-life avoidance of section 2036(a)(2) or section 2042, even though Congress plainly intended to cover

---

* See I.R.C. § 2036(b)(2) ("and during the three-year period ending on the date of the decedent's death"); I.R.C. § 2038 (a)(1) ("or where any such power is relinquished during the three-year period ending on the date of the decedent’s death").
* See supra note 62.
* See Reg. § 20.2035-1(b) (1958).
* See infra notes 73-90 and accompanying text.
* See, e.g., University Nat'l Bank v. Rhoardner, 827 P.2d 561, 564 (Colo. App. 1991) (holding that an unexercised power of appointment was not a garnishable interest in trust assets); Tax Commission of Ohio v. Oswald, 141 N.E. 678, 682 (Ohio 1923) ("a power [of, in this case, conveyance] is not property, but a mere authority"); Norris v. Oklahoma Tax Commission, 350 P.2d 246, 249 (Okla. 1960) (noting that the donee of a power of appointment over property is not the owner of the property).
those two sections in section 2035(d)(2). The 1995 language expressly refers to powers as well as interests.

In another respect, however, Congress's 1995 proposed version falls short of the current version in preventing tax-avoidance through end-of-life relinquishments. Suppose A transfers property in trust, income to B for life, remainder to C. Suppose further that under the terms of the transfer, A has the power to direct that any trust income be accumulated and added to corpus, but he may exercise that power only jointly with E. If A dies during the term of B's life estate, section 2036(a)(2) provides that A must include in his gross estate the value of the entire trust corpus (as of the date of A's death or the alternate valuation date). If instead A had relinquished, within three years of A's death, his power to accumulate income, both the 1981 version of section 2035(d)(2) and the 1995 version would still require that the value of the corpus be included in A's gross estate, inasmuch as that amount (to use the 1981 language) "would have been included under [section 2036] if such [power] had been retained by the decedent" and inasmuch as that amount (to use the 1995 language) "would have been included ... under section 2036 ... if such ... relinquished power had been retained by the decedent on the date of his death." But let us change the facts somewhat. Suppose, under the terms of local law, if E were to relinquish his power, such relinquishment would extinguish A's power, and suppose further that E relinquished his power two years before A's death. Under the 1995 language, section 2035 would not apply, because although the power was indeed relinquished within three years of A's death, A was not the one who did the relinquishing, as the 1995 language requires. Under the 1981 language, however, section 2035 would apply, inasmuch as the

---

70 Section 2036(a)(2) applies to powers exercisable by the decedent "either alone or in conjunction with any [other] person." Section 2038 also would apply to this transfer, but the amount includable would be only the value (at death or alternate valuation date) of B's remaining life estate. Because, on these facts, § 2036 results in a larger includable amount than § 2038, the Service would rely on § 2036.

71 Cf. Mass. Gen. Laws Ann. ch. 204, § 30 (West 1990) (providing that if a power of appointment is, by its terms, exercisable jointly, a release by one power-holder does not impair the rights of the other unless the instrument creating the power otherwise provides).
1981 statute applies to "property which ... would have been included under section 2036 if such [power] had been retained by the decedent." Because Congress presumably would want A to be estate-taxed on the corpus even where E was the one who relinquished the power, the 1981 language comes closer to Congress's intent in this respect.

IV. ANOMALIES ENGENDERED BY SECTION 2035(D)(2)

A. The Life Insurance Anomaly

If a decedent, at the time of his death, possesses any incidents of ownership in a policy of life insurance on his own life, the amount receivable by the beneficiary is included in the decedent's gross estate upon the decedent's death, pursuant to section 2042. The decedent may not avoid this result by assigning to another his incidents of ownership within three years of death; the amount receivable by the beneficiary would be included in the decedent's gross estate notwithstanding the end-of-life assignment.

[a] Prior to 1936, the predecessor of I.R.C. § 2038 applied to transfers that were subject, at the decedent's death, to a power of revocation exercisable by the decedent alone or in conjunction with any other person and transfers "where the decedent relinquished any such power in contemplation of his death...." Revenue Act of 1934, ch. 277, 48 Stat. 680, 752-53 (1934) (emphasis added). This quoted language more closely resembles the vetoed 1995 version of I.R.C. § 2035, since it applies only when the relinquishment was effected by the decedent himself rather than by a co-powerholder. In 1936 Congress amended the Code so as to reach deathbed relinquishments by the decedent's co-powerholder: "where any such power is relinquished in contemplation of the decedent's death," Revenue Act of 1936, ch. 690, 49 Stat. 1648, 1745; see Reg. § 2039-1(e)(2) (1958). The current text of I.R.C. § 2038 continues to include such relinquishments, although a flat three-year period has replaced the "contemplation of death" concept.

[b] The term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy.


[c] Under pre-1982 law, this clearly was the result. Peters v. United States, 572 F.2d 851 (Ct. Cl. 1978); Reg. § 20.2042-1(a)(2) (1979). As for post-1981 law, the language of I.R.C. § 2035(d)(2), particularly as "clarified" by Congress (see supra note 64 and accompanying text), likewise directs this result. See T.A.M. 93-23-002 (Feb. 24, 1993) ("Accordingly, in situations involving decedents dying after 1981, [life insurance proceeds will] be subject to inclusion under section 2035(d)(2) of the Code [where it is] determined that the
Suppose, however, that when the decedent procured the insurance policy on his life within three years of his death, he instructed the insurer to list a transferee as the owner of the policy, rather than first procuring the policy in his own name and then transferring it. One would think that a decedent ought not to be able to avoid includability through this device. Let us consider two cases.

Case One: A, two years before his death, purchases a fully paid-up $200,000 life insurance policy on his own life; he is designated as the owner of the policy and accordingly possesses all incidents of ownership. The next day, A transfers to B all incidents of ownership in the policy.

Case Two: A, two years before his death, purchases a fully paid-up $200,000 life insurance policy on his own life; he directs the insurer to designate B as the owner of the policy and possessor of all incidents of ownership.

In substance, no difference exists between these two transfers; in each case, an insured, within three years of his death, has gratuitously transferred to another the effective ownership of a life insurance policy on the insured's life. Inasmuch as Case One results in the includability of the $200,000 proceeds in A's gross estate, so should Case Two. Recent court decisions have held, however, that section 2035(d)(2) compels a different result in Case Two.

Under pre-1982 law, courts held consistently that Case Two, like Case One, required the inclusion of the life insurance proceeds. The leading case so holding was Bel v. United States, where the decedent, less than one year before his death and in contemplation of death, executed an application for a

decedent actually held incidents of ownership in the policy and[,] within three years of death,) actually transferred those incidents of ownership.

* See supra note 74 and accompanying text.


* Because Bel arose under pre-1977 law (the decedent died in 1960), the proceeds were includable only if the decedent made the constructive transfer of the policy in contemplation of death. See 452 F.2d at 687-88.
$250,000 accidental death policy on his own life and paid (out of community funds) all of the premiums due. Although, from the inception of the policy, the decedent’s children were designated as the sole owners and beneficiaries thereof so that the decedent himself never possessed any incidents of ownership in the policy, the court held that the policy proceeds were includable in the decedent’s gross estate pursuant to section 2035 and showed itself to be somewhat impatient with the taxpayer’s attempts to distinguish Case Two from Case One:

In our opinion the broad legal principle enunciated by the Supreme Court in Chase [Nat’l Bank v. United States, 278 U.S. 327 (1929)] is that the word “transfer” is not limited to the passing of property directly from the donor to the transferee, but encompasses a donation “procured through expenditures by the decedent with the purpose, effected at his death, of having it pass to another.” [Id. at 337.] Like the Supreme Court, we perceive little seriousness in the argument that a decedent should be permitted to evade the provisions of section 2035 by funneling property to various beneficiaries through a third-party conduit. Judicial sanctioning of such evasion, we think, would so frustrate the attempted taxation of testamentary substitutes that section 2035 would stand emaciated and skeletonized beyond congressional recognition. We recognize, of course, that John Bel never formally possessed any of the incidents of ownership in the accidental death policy. As noted above, however, we conclude that section 2042 and the incidents-of-ownership test are totally irrelevant to a proper application of section 2035. We think our focus should be on the control beam of the word “transfer.” The decedent, and the

---

* The court held that only the decedent’s “community share of the proceed value of the policy” was includable in his gross estate, 452 F.2d at 692, presumably because the policy was procured with community funds. Under the laws of most community property states, that would be the correct result; when a married person uses community funds to purchase in his own name a policy of insurance on his life, the policy proceeds are community property, and accordingly he possesses incidents of ownership in only half the policy proceeds. *See Reg. § 20.2042-1(c)(5) (1979); see also Estate of Cavenaugh v. Commissioner, 51 F.3d 597 (5th Cir. 1995) (applying Texas law); Hope v. United States, 691 F.2d 786, 787-88 (5th Cir. 1982) (same).* Bel, however, arose in Louisiana, whose treatment of life insurance differs from that of most community property states. In Louisiana, a life insurance policy purchased with community funds is *not* community property. *See Catalano v. United States, 429 F.2d 1069 (5th Cir. 1970); Saia v. Commissioner, 61 T.C. 515 (1974); Rev. Rul. 94-69, 1994-2 C.B. 241.* The proper amount includable in John Bel’s gross estate may have been the full $250,000 policy proceeds, less one-half the amount of the premiums paid with community funds. *See Leon S. Cahn, Louisiana Civil Law as Applied to Life Insurance, 12 La. L. Rev. 56, 61 (1951).*
decendent alone, beamed the accidental death policy at his children, for by paying the premium he designated ownership of the policy and created in his children all of the contractual rights to the insurance benefits. These were acts of transfer. The policy was not procured and ownership designated and designed by some goblin or hovering spirit. Without John Bel’s conception, guidance, and payment, the proceeds of the policy in the context of this case would not have been the children’s. His actions were not ethereally, spiritually, or occultly actuated. Rather, they constituted worldly acts which by any other name come out as a “transfer.” Had the decedent, within three years of his death, procured the policy in his own name and immediately thereafter assigned all ownership rights to his children, there is no question but that the policy proceeds would have been included in his estate. In our opinion the decedent’s mode of execution is functionally indistinguishable. Therefore, we hold that the action of the decedent constituted a “transfer” of the accidental death policy within the meaning of section 2035.

Thus, Bel treated the case as one arising under section 2035, not section 2042. The theory of Bel was that the decedent, in contemplation of death, transferred an asset—“insurance protection”—and that whatever that asset’s value may have been at the time of transfer, its value at the time of death was the full community share of the insurance proceeds.

---

79 452 F.2d at 691-92.
80 The Bel court never quite succeeded in identifying and labeling the property interest that the decedent transferred when he listed his children as the initial owners of the insurance policy for which he applied. This failure is perhaps understandable “given that the thrust of the opinion sought to overcome the more difficult obstacle of demonstrating the functional equivalence of the decedent’s actions to an actual transfer, than to identify the interest being transferred.” Malcolm L. Morris, An “Imputed Interest” Corollary to the “Constructive Transfer” Doctrine: Pay the Tax or Follow the Leder?, 54 Mo. L. Rev. 599, 637 (1989). The characterization of the transferred property interest as “insurance protection” belongs to a later court. See Detroit Bank & Trust Co. v. United States, 467 F.2d 964, 966 (6th Cir. 1972).
81 If A, within three years of A’s death, gave money to B, who thereupon decided to use the money to purchase an insurance policy on A’s life naming B as the policy owner, the proceeds would not be included in A’s gross estate under a “beamed transfer” theory; the only asset that A transferred (and therefore the only asset includable pursuant to I.R.C. § 2035) would be the money A gave B. See Tracy’s Estate v. United States, 82-2 U.S.T.C. ¶ 13,499 (W.D.N.C. 1982); Clay v. Commissioner, 86 T.C. 1266 (1986); see also Hope v. United States, 691 F.2d 786 (5th Cir. 1982). If, however, B, in using A’s money to purchase the insurance, was acting as A’s agent, then the “beamed transfer” analysis would apply, and the insurance proceeds would be included in A’s gross estate. See
analysis is quite in keeping with the traditional resolution of valuation issues arising under section 2035: if D, in contemplation of death, transfers twenty shares of General Motors stock to A, the amount includable in D's gross estate pursuant to section 2035 (the pre-1981 version) is the value of the shares at the date of D's death (or D's alternate valuation date), not their value at the time of gift.\textsuperscript{a2}

The "beamed transfer" doctrine of Bel and its progeny was held, much to the surprise of the Service, to have been overturned by the 1981 amendments to section 2035. The first and most reflective post-1981 shot across the Service's bow was Leder's Estate v. Commissioner,\textsuperscript{a3} a case all but indistinguishable from Bel. Within three years of the decedent's death, a life insurance policy was applied for and issued naming decedent's wife as the owner and beneficiary and naming decedent as the insured. The premiums were paid by the decedent's wholly-owned corporation,\textsuperscript{a4} which treated the payments as loans made to the decedent. When the decedent died in 1983, the Service sought, on the authority of Bel, to include the policy proceeds in his gross estate, but the court disagreed. The court stated, correctly, that Bel had relied on section 2035, not section 2042,\textsuperscript{a5} that the inquiry in Bel was whether the decedent had, in substance, made a transfer of wealth in contemplation of death. But, continued the Leder court, section 2035 was largely repealed in 1981, and, as a result of that repeal, wealth transferred within three years of death is no longer includable in the gross estate except to the extent section 2035(d)(2) preserves the three-year rule. The court

\textit{Kurihara's Estate v. Commissioner, 82 T.C. 51 (1984); see also Estate of Schnack v. Commissioner, 848 F.2d 933 (9th Cir. 1988).}

\textsuperscript{a2} Reg. § 20.2035-1(e) (1958); Rev. Rul. 72-282, 1972-1 C.B. 306. "For example, if in contemplation of death, a decedent transferred stock which ultimately appreciated in worth by the time of his death, the stock would be valued for estate tax purposes at its increased value." First Nat'l Bank of Oregon v. United States, 488 F.2d 575, 578 (9th Cir. 1973).

\textsuperscript{a3} 893 F.2d 237 (10th Cir. 1989), aff'd 89 T.C. 235 (1987).

\textsuperscript{a4} Cf. Levine v. United States, 86-1 U.S.T.C. ¶ 13,667 (Ct. Cl. 1986) (where the decedent owned 51% of the corporation that purchased insurance on his life within three years of his death and was therefore regarded as having "transferred" (for I.R.C. § 2035 purposes) the insurance to his wife even though it was she who "applied" for the insurance and was named as owner).

\textsuperscript{a5} 893 F.2d at 241.
concluded that section 2035(d)(2) applies only if the decedent, at some time, possessed incidents of ownership and then, within three years of death, transferred them.

The plain language of section 2035(d)(2) requires as a threshold issue that there be an interest in property under the terms of the sections it lists (e.g., sec. 2042). It requires that the decedent transfer an interest ... that would have been included [in the gross estate] if the decedent had retained such an interest. The decedent must have had at some time such an interest in property, or else there is nothing for him to retain or transfer, and section 2035(d)(2) cannot apply.\footnote{86}

If, from its inception, the insurance policy named someone other than the decedent as owner, then the decedent never possessed the incidents of ownership and therefore could not have transferred them. More generally, in order for section 2035(d)(2) to apply, the decedent must have made a transfer that left him in possession of a section 2036 interest or power, a section 2037 reversion, a section 2038 power, or a section 2042 incident of ownership, and then within three years of his death transferred that retained interest, power, or incident. In such a case, section 2035(d)(2) would include in his gross estate the value of the asset that would have been included in his gross estate pursuant to sections 2036-2042 but for the end-of-life relinquishment of the interest, power, or incident. Without the initial creation and retention of the interest, power, or incident, section 2035(d)(2) would not apply, and therefore section 2035(d)(1) would hold that nothing was to be brought into the gross estate pursuant to section 2035.

This was not an implausible reading of section 2035(d)'s partial repeal of section 2035(a), but given the clumsy drafting of subsection (d) and the interpretive problems it presents,\footnote{87} \textit{Leder} would have done better to focus less on wording and more on substance.\footnote{88} Nonetheless, the \textit{Leder} result was

\footnote{86}{89 T.C. at 240, aff'd, 893 F.2d 237 (10th Cir. 1989).}
\footnote{87}{See supra notes 59-62 and accompanying text.}
\footnote{88}{It is unlikely that Congress, in crafting § 2035(d)(2), sought to overrule \textit{Bel}. Indeed, the Senate Finance Committee's explanation of the 1981 amendment suggests that Congress did not envision post-amendment law on this point to be appreciably different from pre-amendment law. "For example, if one year prior to death, a decedent}
adopted so promptly by the courts of two other circuits\textsuperscript{88} that the Service reluctantly acquiesced:

Although we continue to believe that substance should prevail over form and that such indirect transfers should be included in a decedent's gross estate, in light of the three adverse appellate opinions . . . we will no longer litigate this issue.\textsuperscript{89}

The Service's reluctance was understandable. If an individual of advanced years intends to purchase a life insurance policy that he wishes to transfer to a family member, now he can readily avoid the inconvenience of estate taxation through the simple but hollow device of placing the family member's name rather than his own on the line in the insurance application marked "owner." No justification exists for treating such a transaction more generously than a transfer of a policy (within three years of death) originally "owned" by the decedent-insured, but section 2035(d)(2), as currently written and applied, dictates that very distinction.\textsuperscript{81}

\textbf{B. The Revocable Trust Anomaly}

Suppose in Year 1 D transfers $500,000 in trust. The income is to be paid to A for life, remainder to B; but D retains the right to revoke the trust at any time during its existence. Suppose in Year 5 D wishes instead to grant A and B an irrevocable right to their respective interests in the $500,000 (let us assume that the

\begin{flushright}
\textsuperscript{88} Perry Estate v. Commissioner, T.C. Memo 1990-123, aff'd, 927 F.2d 209 (5th Cir. 1991); Heddrick Estate v. Commissioner, 93 T.C. 171 (1989), aff'd, 918 F.2d 1263 (6th Cir. 1990).


\textsuperscript{81} As compared with Bel, Leder has at least the virtue of simplicity. If the check with which the policy is procured is drawn by the person named as owner rather than by the insured, Bel's beamed transfer doctrine requires further inquiry to determine the source of the funds and whether the payor was acting as the insured's agent. See, e.g., Estate of Schnack v. Commissioner, 848 F.2d 933 (9th Cir. 1988); Hope v. United States, 691 F.2d 786 (5th Cir. 1982); Estate of Kurihara v. Commissioner, 82 T.C. 51 (1984). No such "tracing" is required under the Leder interpretation.
\end{flushright}
value of the trust principal remains $500,000 at all times). D has at least two ways of accomplishing that result. She can revoke the trust in its entirety and then establish a new, irrevocable trust for A and B with the $500,000 she recaptured as a result of the revocation, or she can simply release her revocation power over the original trust. Both methods produce the same gift tax result for D: either the establishment of the new, irrevocable trust or the release of the revocation power over the original trust is a $500,000 gift by D (less the available annual exclusion) for gift tax purposes. Under pre-1982 law, the two methods also produced identical estate tax results if D died within three years of the irrevocable transfer. Under the first method (revocation of the first trust followed by the creation of a new, irrevocable trust), the $500,000 would be includable in her gross estate pursuant to section 2035(a); under the second method (release of the revocation power), the $500,000 would be includable in her gross estate pursuant to section 2038(a). Under post-1981 law, however, the two methods produce very different estate tax results. Under the first method, nothing is includable in D's gross estate with respect to the trust (other than the gift tax D paid with respect to the Year 5 gift), because section 2035(d)(1) has repealed section 2035(a). Under the second method, however, the $500,000 continues to be includable in D's gross estate pursuant to section 2038(a) and also, arguably, under section 2035(d)(2) on the theory that the $500,000 "would have been included" in D's gross estate under section 2038 had D retained her revocation power.

The foregoing illustration is perhaps the clearest example of what I call the "revocable trust anomaly," and the Service, at least initially, seemed quite content to live with it "[a]though there may be little substantive difference between the use of a revocable trust and a probate estate/will arrangement as

---

** See I.R.C. § 2038(a)(1) ("or where any such power is relinquished during the three-year period ending on the date of the decedent's death").

** See supra note 51 and accompanying text.

vehicles to dispose of one's assets at death... 

A 1991 Tax Court case, however, showed the Service that this anomaly was considerably more anomalous than had been suspected.

That case was *Jalkut v. Commissioner*. D was the settlor and initial trustee of a revocable trust that provided that the trustee or trustees should pay D such amounts of income and principal as D might request. It further provided that, if at any time D might be unable to manage his affairs, the successor trustees were authorized to pay income or principal not only for the benefit of D but also for the benefit of D's descendants. In 1984, D transferred certain sums from the revocable trust as gifts to a number of individuals and organizations. In 1985, the two persons designated as successor trustees under the trust instrument were informed by D's personal physician that D's deteriorating mental and physical condition prevented his continuing to serve as trustee. Later in 1985, these successor trustees, as authorized by the trust instrument, made some additional gift transfers from the revocable trust to D's descendants. When D died a month after these last transfers, the Service argued that all the property transferred out of the revocable trust in 1984 and 1985 should be included in D's gross estate pursuant to section 2035(d)(2) because those gift transfers served as a relinquishment, within three years of D's death, of D's section 2038 power over the property so transferred.

This argument was quite in keeping with a position that the Service had taken previously in *Technical Advice Memoranda*, and the attribution to D of transfers made by the successor trustees likewise comported with prior law. But the Tax Court

---

* Id. at 680-81.
* Gifts of an incompetent's property made pursuant to court order by the incompetent's court-appointed conservator are treated for gift tax purposes as gifts made by the incompetent. *Commissioner v. Greene*, 119 F.2d 383 (9th Cir.), *cert. denied*, 314 U.S. 641 (1941). In *City Bank Farmers Trust Co. v. McGowan*, 323 U.S. 594 (1945), the United States Supreme Court held that gifts of an incompetent's property made by the incompetent's court-appointed conservator within three years of the incompetent's death were includable in the incompetent's gross estate pursuant to the predecessor of I.R.C. § 2035 of the Code when made in contemplation of the incompetent's death; and
drew an unexpected distinction between the 1984 gifts made by D himself and the 1985 gifts made by the successor trustees. The 1984 gifts were made at a time when D was the sole permissible distributee of the income and corpus of the trust; consequently, the distributions of property directly from the trust to D’s donees could not properly be characterized as trust distributions. Rather, they "could only have been effected pursuant to the decedent’s power to withdraw income and principal from the trust. Accordingly, we conclude that [D] exercised his power to withdraw assets from the trust and subsequently made gift transfers in his individual capacity directly to the respective donees."100 Because transfers of an individual’s owned property within three years of death no longer produce estate taxation pursuant to section 2035(a), the 1984 gifts were not includible in D’s gross estate.

In contrast to the 1984 transfers, the 1985 transfers were effected under a distinctly different set of circumstances. . . . By virtue of the decedent’s incapacity, the trustees were authorized to distribute both income and principal from the revocable trust directly to both the decedent and his descendants. In this regard, the transfers by the trustees to persons other than the decedent cannot properly be characterized as withdrawals by the decedent. Rather, such transactions must be considered a relinquishment by the decedent, through the trustees, of his power to alter, amend, revoke, or terminate the trust with respect to the transferred assets as contemplated in section

that for purposes of determining whether the “contemplation” motive prompted the gifts, the conservator’s motive was imputed to the incompetent. The Court held that:

Literally [the incompetent] neither made the transfers nor did she have any motive with respect to them. But a court stood in her place and unquestionably had the function of effectuating a transfer of her property and of determining what motive or purpose would have actuated her had she been competent to act. It seems to us that it is sticking in the bark to say that, in the circumstances, the transfers are not within the section because Congress did not add a phrase to the effect that where a court made the transfer, acting in lieu of the incompetent owner, such a transfer should be governed by the statute.

Id. at 598-99. If a person acting under a power of attorney makes authorized gifts of the principal’s property, the property is considered to have left the principal’s estate. It is not includable in the principal’s gross estate pursuant to I.R.C. § 2033, inasmuch as the principal no longer owns the property. It is not includable pursuant to I.R.C. § 2038, inasmuch as the gift, having been sanctioned by the principal’s grant of authority, may not be revoked by the principal or by the principal’s guardian ad litem. Estate of Ridenour v. Commissioner, 36 F.3d 332 (4th Cir. 1994); T.A.M. 96-13-001 (Nov. 28, 1994).

100 96 T.C. at 685.
2038(a). Thus, because the amounts in question would have been included in the decedent’s gross estate under section 2038 if retained by [D], the gifts effectuated by the trustees are included in [his] gross estate under section 2035(d)(2).\footnote{\textit{96 T.C. at 685-86.}}

The following example illustrates \textit{Jalkut’s} repercussions. Suppose O transfers $100,000 to T in trust, the income to be paid to A for life and the remainder to B. In the trust instrument, O expressly reserves the right to revoke or amend the trust at any time. Some time later, O wishes to transfer $20,000 of trust property to C outright, and O writes a letter to T instructing T to make the transfer. One year later, O dies. \textit{Jalkut} would hold that since C was not a permissible distributee at the time of the $20,000 transfer, the $20,000 would be treated as a partial revocation (i.e., a withdrawal by O of $20,000) followed by a $20,000 gift from O to C; hence, no section 2035(a) taxation. But if the trust instrument had from its inception expressly authorized T to distribute $20,000 of corpus to C and such distribution was actually made, the $20,000 would be includable in O’s gross estate pursuant to section 2035(a) and (d).\footnote{\textit{See P.L.R. 93-18-004 (Jan. 22, 1993); T.A.M. 93-01-004 (Sept. 25, 1992).} Strictly speaking, the amount includible should be not $20,000 but rather the value that the $20,000 would have had at O’s death had it remained in the trust. Thus, if the property remaining in the trust had appreciated by a factor of 10\% between the date of the $20,000 distribution and the date of O’s death (or the alternate valuation date), the amount includible pursuant to § 2035(a) and (d) should be $22,000. \textit{See supra note 82; cf. Reg. § 20.2041-3(d)(4) (as amended 1986).} While theoretically correct, however, this analysis imposes severe record keeping problems on the practitioner attempting to apply it. If other distributions have been made between the date of the $20,000 distribution and the date of death, calculating the percentage of appreciation will be a complicated undertaking. Perhaps for this reason, the Service has been content to include in the settlor’s gross estate only the date-of-distribution value of such end-of-life trust distributions from revocable trusts.}
trust instrument as permissible distributees. Directed a distribution to a third party clearly amounts to a relinquishment of a section 2038 power within the meaning of section 2035(d)(2); a withdrawal does not. Yet if, in the latter case, the settlor makes a gift of the re-acquired property to a third party, she has produced the same effect as in the former case and ought, therefore, to abide the same tax consequences. However ill-advised the disparate tax treatment of these two cases may be, at least it is easy to distinguish the two cases so that we can apply this illogical tax rule with some confidence. That is, it is easy to tell whether the settlor actually did withdraw money from the trust and then give it to a third party; it is easy to tell whether the settlor actually did direct the trustee to make a distribution to a third party. But Jalkut clouds the tax picture considerably by holding that some distributions to third parties are actual distributions (taxable under section 2035) while other distributions to third parties are constructive withdrawals (not taxable). The distinction between the two distributions turns on whether the distributee was a permissible distributee under the terms of the trust instrument. As I have urged, this distinction is unsound. If the settlor retains the power to revoke the trust, everyone is a permissible distributee if the settlor gives permission.

The Jalkut hairsplitting soon led to the McNeely hairsplitting. In this later case, D's revocable trust provided

---

163 In Cloud v. United States Nat'l Bank of Oregon, 570 F.2d 350 (Or. 1977), the settlor established a trust whose governing instrument provided that the settlor "may, by written instrument executed by the [settlor] and filed with the trustee, revoke, alter, or amend this agreement at any time, or withdraw from the trust estate . . . the whole or any part of the capital and accumulated income." Id. at 353. During the lifetime of the settlor, the trust instrument authorized distributions only to the settlor herself. The settlor, on two occasions, requested the trustees in writing to distribute a portion of the trust assets to her granddaughter. In a later suit brought to determine whether the trustees violated their fiduciary duties when they complied with that request, the court seems to have assumed that the settlor, if competent, had the power to direct a payment to someone not expressly named as a permissible distributee; the court focused solely on the question whether the trustees had reason to know that the settlor was mentally incompetent at the time of the requests. See also William Franklin Frazier, Scott on Trusts § 330.7 (4th ed. 1989) ("Where the settlor reserves power to revoke the trust but no method of revocation is specified, the power of revocation can be exercised in any manner that sufficiently evidences the intention of the settlor to revoke the trust.").


165 McNeely v. United States, 16 F.3d 303 (8th Cir. 1994).
that the trustee was to pay to D or to "one or more other persons, such sums from the principal of the trust estate as [D] may from time to time request in writing."106 Within three years of her death, D directed the trustee to make trust corpus distributions to thirteen of her descendants. The Service, no doubt with Jalkut in mind, argued that inasmuch as the distributions to the thirteen descendants were authorized by the trust instrument, the distributions were not "withdrawals" by D but rather "relinquishments" of her section 2038 power over the distributed funds and includable in her gross estate. The court disagreed. It pointed out that no corpus distributions could be made to the descendants without D's express direction. Therefore, the thirteen distributions did not represent a relinquishment of her section 2038 power over the distributed funds but rather an exercise of the section 2038 power: a nice distinction indeed.107

The best way to illustrate the McNeely distinction is with a hypothetical. D transfers property to a trustee on revocable trust; the income is to be paid to A for life, remainder to B. In addition, D retains the right to direct the trustee to make corpus distributions to X, and the instrument authorizes the trustee to make corpus distributions to Y. If, within three years of D's death, D directs that $20,000 of corpus be paid to X, the $20,000 is not includable in D's gross estate;108 but if, within the same three years, the trustee distributes $20,000 of corpus to Y, that $20,000 is includable in D's gross estate.

The tax differential at stake here is only the tax on the annual exclusion amounts. Suppose O, who is unmarried and previously has made $600,000 of taxable gifts, transfers $150,000 to T on revocable trust; T has the discretionary power

106 Id. at 304.
107 In Kisling v. Commissioner, 32 F.3d 1222 (8th Cir. 1994), acq. 1995-33 I.R.R. 4, the decedent was the settlor of a revocable trust whose instrument granted her the power to create irrevocable fractional shares in the trust for her lineal descendants and their spouses. The decedent, during the last year of her life, created a total of six such shares, in the amount of $10,000 each, for her children. When she died, the Service sought to include these funds in her gross estate, arguing that the establishment of each $10,000 irrevocable share represented a relinquishment of her I.R.C. § 2038 revocation power over that $10,000. The court, relying on McNeely, Id. at 1227, disagreed with the Service and held that the $10,000 shares were not includable in the decedent's gross estate.
to distribute income or corpus to A, B, or C. The trustee makes no distributions for four years. In year five, when the property in the trust has grown by appreciation and income accumulation to $200,000, the trustee distributes $30,000 of corpus to A. That distribution is a taxable gift of $20,000 by O, and she must pay gift taxes of $7,400. In year six, when the value of the trust property is $180,000, O dies. Her taxable estate is $217,400, and we add back $600,000 of taxable gifts pursuant to section 2001(b)(1)(B) for an estate tax bill of $81,786. Therefore, her total transfer tax bill (gift tax plus estate tax) comes to $89,186. If the $30,000 distribution had been held not to be includible in her gross estate, her taxable estate would have been $187,400, and, after adding back $620,000 of taxable gifts pursuant to section 2001(b)(1)(B), we would arrive at an estate tax bill of $77,886. Her total transfer tax bill (gift tax plus estate tax) would therefore come to $85,286. The difference between those two totals—$3,900—is the amount of transfer tax imposed (at the 39% marginal rate applicable to the total amount of property transferred) on the single $10,000 annual exclusion that O claimed: the exclusion resulting from the $30,000 gift in year five. Although this tax differential may seem small, it easily can increase when a revocable trust makes distributions to many beneficiaries during the last three years of the settlor’s life. Even if the amount of tax is small, no tax system can maintain the public's

---

109 It is a well-settled principle of gift tax law that the distribution in year five is a taxable transfer by O, on the theory that O surrendered her dominion and control over the $30,000 when she permitted (by not exercising her revocation power) the trustee to distribute the $30,000 to A. For example, in Estate of George v. Commissioner, 8 T.C. 867, 868 (1947), the parties stipulated that this was the rule. The amount of O’s gift is $20,000 rather than $30,000 because $10,000 of the gift is excludable pursuant to I.R.C. § 2503(b).

110 $180,000 is includible pursuant to I.R.C. § 2038, $30,000 is includible pursuant to I.R.C. § 2035(d), and $7,400 is includible pursuant to I.R.C. § 2035(c).

111 That figure represents $180,000 pursuant to I.R.C. § 2038 plus $7,400 pursuant to I.R.C. § 2035(c).

112 That figure represents $600,000 of taxable gifts made before the trust was established plus $20,000 of taxable gift made when the trust distributed $30,000 in year five.

113 In Estate of Robinson v. Commissioner, 101 T.C. 499, 509-510 (1993), the decedent, during her life, had claimed 25 annual exclusions with respect to gifts made in each of two years. Because she failed to identify all 25 by name on the deeds of transfer, only 9 exclusions per year ultimately were allowed.
confidence when it turns on the kind of distinctions required by *Jalkut* and *McNeely*.

Together, *Jalkut* and *McNeely* create a tax regime that subjects similar transactions to wildly dissimilar treatment. Congress tried to undo some of this mischief in the Revenue Reconciliation Bill of 1995, section 11612 of which would have amended section 2035 of the Code to include the following new provision:

For purposes of this section and section 2038, any transfer from any portion of a trust during any period that such portion was treated under section 676 as owned by the decedent by reason of a power in the grantor . . . shall be treated as a transfer made directly by the decedent.  

Because, presumably, "a transfer made directly by the decedent" would not be includible in the decedent’s gross estate pursuant to section 2035, this provision effectively would have abolished the *Jalkut* distinction (between trust transfers to a beneficiary named in the trust instrument and trust transfers to a beneficiary not named in the trust instrument) by establishing that in neither case would a distribution from the trust within three years of the settlor’s death be includible in her gross estate. And, it would have abolished the *McNeely* distinction between a distribution made at the settlor’s direction and a distribution made by the trustee independently. Thus, it would have permitted the settlor of a revocable trust to make annual exclusion gifts from the trust property within three years of her death without having to include the gifted property in her gross estate. However, this bill would have left in place the barren distinction between (1) the case where the settlor expressly relinquishes her revocation power (taxable under section 2035), and (2) the case where the settlor either revokes the trust and replaces it with an identical irrevocable trust or withdraws all

---

114 See supra note 60 and accompanying text.

115 Section 676 of the Code, one of the grantor trust sections, provides, "The grantor shall be treated as the owner of any portion of a trust . . . where at any time the power to vest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both." I.R.C. § 676. Thus, a revocable trust is a grantor trust pursuant to I.R.C. § 676.
the trust property and gives it outright to the beneficiaries (not taxable). Moreover, by using a cross-reference to section 676 as a means of identifying the kind of trusts to which the new rule would apply, the drafters of the bill narrowed unnecessarily the scope of their remedy. Not every section 2038 power is a section 676 power. For example, a power to distribute corpus to nonbeneficiaries other than the settlor or a power to revoke a trust with the consent of one of the beneficiaries would be a section 2038 power but not a section 676 power. The Jalkut and McNeely anomalies would have continued unabated in the case of a trust whose settlor had retained one of these powers.

C. Why These Anomalies Are Undesirable

Other bodies of law often accord property-owners an election between substantively similar transactions that produce widely divergent legal outcomes. Why are such elections undesirable as a matter of tax policy?

For example, O may convey Blackacre “to Charity A for as long as the land is used for educational purposes; then to Charity B;” or O may convey Blackacre “to Charity A, but if the land ever should cease to be used for educational purposes, then Charity B shall have the right to enter and possess the land.” In each case, A may occupy and enjoy the land forever if A uses it for educational purposes, and in each case B has an executory interest that will mature if A ceases to use the land for educational purposes. Yet under the law of adverse possession, the consequences of these similar conveyances differ sharply. If A ceases to use the land for educational purposes but continues to possess and occupy it, under the first conveyance the period of limitations begins to run (in favor of A and against B) immediately upon such cessation, while under the second conveyance the period of limitations does not begin until such time as B affirmatively elects to claim the right to possession.116

116 The second conveyance gives a fee simple subject to a condition subsequent. (It might also be classified as a fee simple subject to an executory limitation, but the former label is narrower and more specific.) Consequently, upon breach of the condition by A, title does not vest automatically in B; rather, B must enter onto the land or take some
Compare the foregoing transaction with what I have termed "the revocable trust anomaly." If the settlor of a revocable trust relinquishes the revocation power within three years of her death, the post-gift appreciation is taxed in her gross estate but will not be subject to income taxation when the beneficiaries sell the property.\footnote{117} If instead the settlor, within three years of her death, revokes the trust and immediately thereafter creates an irrevocable trust for the same beneficiaries, the post-gift appreciation will escape estate taxation but the pre-gift and post-gift appreciation will be subject to income taxation later, inasmuch as the beneficiaries will take the settlor's basis. Since we are willing to allow a property-owner freely to choose between two different adverse possession rules, why should we be unwilling to allow her to choose between estate tax relief and income tax relief? The answer lies in the disparate roles played by intent.

Intent is central to property law; its rules are designed largely to effectuate the intent of transferors. If the owner of Blackacre, in our earlier example, wishes to impose the burden of extra vigilance upon B by giving A a fee simple determinable rather than a fee simple subject to a condition subsequent, the law should give effect to that choice even if there exists no other substantive difference between the two estates. In tax law, however, intent is and should be largely irrelevant. Once a property owner has selected a desired substantive outcome with respect to her wealth, the tax consequences of that selection must lie beyond the taxpayer's choice if we are to have anything but a voluntary tax system.

To be sure, our tax system does accord taxpayers some elections with respect to the tax consequences of their transfers,

\footnote{117} Nor will the pre-gift appreciation (that is, the appreciation produced between the date the settlor purchased the property and the date she relinquished the revocation power over it) be subject to income tax; the beneficiaries will receive a stepped-up I.R.C. § 1014(a) basis in the property included in the settlor's gross estate.
elections that do not depend upon the substantive form of the transfer, but these elections are designed to carry out other policies. For example, section 2032 gives an executor the power to choose between (1) higher estate taxes with higher basis for the beneficiaries, and (2) lower estate taxes with lower basis for the beneficiaries; and the availability of the executor's election is unaffected by the property-law choices made by the decedent. But this election serves the purpose of preventing the hardship that would otherwise arise whenever the assets in an estate depreciated sharply in value shortly after the date of death. No policy is served by the perpetuation of the revocable trust anomaly.

V. PROPOSED SOLUTION

Commentators, over the years, have expressed considerable dissatisfaction with the current federal transfer tax regime and have proposed sweeping changes to eliminate the flaws.

---

118 If the total value of the assets in the gross estate (and in the taxable estate) is higher on the date of death than on the date six months after death, the executor may elect alternate valuation pursuant to I.R.C. § 2032 as a way of reducing the estate tax burden, or he may decline the election as a way of giving the beneficiaries a higher basis. Thus, alternate valuation may be elected to save estate taxes but not to save income taxes. As a result of amendments codified as I.R.C. § 2032(c), made in 1984 and refined in 1986 to take into account the generation-skipping transfer tax, the executor may elect alternate valuation only if the value of the gross estate and of the sum of the estate tax and generation-skipping tax due would be reduced by the election. Pub. L. No. 98-369, § 1023, 98 Stat. 494, 1030 (1984); Pub. L. No. 99-514, § 1432(c)(1), 100 Stat. 2085, 2730 (1986).

119 The decedent may be able, in certain limited ways, to affect the availability of the alternate valuation date election, as, for example, by choosing to bequeath to her surviving spouse so much property qualifying for the I.R.C. § 2056 marital deduction as to reduce the taxable estate to zero. See supra note 118.

120 The provision permitting valuation of the estate as of a date after the date of death dates to 1935, which affords a clue to its purpose. At the time of the 1929 stock market crash and the attending general recession, which marked the beginning of the Depression, some persons died wealthy but, before administration of the estate could be completed, the value of their estates had shrunken to a figure less than the amount of estate tax based on the value of the estates at death. This extreme situation reflects the type of difficulty arising out of a strict date-of-death valuation rule; Section 2032 affords some tax relief from such difficulties.

Richard B. Stephens, et al., supra note 2, at ¶ 4.03[1].

These changes surely would cure the problems I have outlined on this occasion, but given the uncertain political success of any of these proposals in the near future and the relative narrowness of the problem under discussion, I propose a more modest remedy: a return to the pre-1982 version of section 2035, under which all gifts within three years of death (other than gifts excluded by section 2503) are included in the gross estate. This proposal reflects not only my dissatisfaction with the 1981 revival of distinctions between absolute ownership and will-substitute ownership, but also my more general agreement with Professor Graetz that “the nation’s [transfer] tax laws should move in the direction of the 1976 legislation, not that of the 1981 law.”

Congress defended its 1981 repeal of section 2035(a) with respect to outright gifts by insisting that no justification exists for including post-gift appreciation in the donor’s gross estate in the case of a gift made within three years of death if such appreciation is not includable when the gift was made more than three years before death. I would argue that there is a justification for the difference in treatment: the same justification that underlies Congress’s decision to institute and preserve a “gross up” rule for gifts within three years of death when no such rule applies for gifts made more than three years before death. The rationales for taxing gifts more favorably than bequests—e.g., the desire to encourage prompt transfer of property to those who may be in greater need, or those who are likely to make the property more productive, than the transferor—simply do not obtain in the case of end-of-life gifts. Such gifts tend to have the same effect as bequests and to be prompted by the same considerations. Therefore, the policy of preventing evasion and “secur[ing] equality of taxation” dictates that end-of-life gifts be taxed like bequests.


122 Michael J. Graetz, To Praise the Estate Tax, Not To Bury It, 93 Yale L.J. 259, 284 (1983).

123 See supra notes 53-54 and accompanying text.

124 See supra note 50.

125 United States v. Wells, 283 U.S. 102, 116-17 (1931).

with regard to post-gift appreciation. Furthermore, to the extent we retain the current rule permitting outright end-of-life gifts to escape estate taxation, donors may be tempted to retain property until their last months and then make hasty and possibly improvident transfers in their eagerness to reduce transfer taxes.

As we have seen, serious anomalies spring from Congress's decision to repeal the three-year includability rule for outright gifts while retaining it for "incomplete transfers" captured by sections 2036, 2037, 2038, or 2042. If a sound basis existed for this disparate treatment, one might be willing to abide these anomalies, but in fact there is no sound basis. Congress asserted that if the three-year includability rule were repealed in the case of incomplete transfers, a taxpayer could employ such transfers to "reduce the amount subject to estate tax by more than the amount subject to gift tax, disregarding appreciation between the times of gift and death."117 For example, consider the case of an outright gift of Blackacre from D to A two years before D's death. If Blackacre was worth $150,000 at the time of gift and $165,000 at D's death, the only gain to the Treasury, were Blackacre included in D's gross estate, would be the transfer tax on the $15,000 of appreciation,118 inasmuch as gift and estate tax rates have been "unified." Compare that with a gift of life insurance. Suppose D owns a $500,000 life insurance policy on his own life. Were he to retain that policy until his death, the amount includable in his gross estate would be $500,000, the face amount of the policy. But if he made an inter vivos gift of that policy, it would be valued for gift tax purposes at its much-lower interpolated terminal reserve value.119 Thus, in the case of a section 2042 transfer, a sizable differential exists between the taxable amount for gift tax purposes and the taxable amount for estate tax purposes: a differential far in excess of mere "appreciation."

But the potential for this differential cannot serve as a sound basis for section 2035(d)(2)'s partial repeal of

---

118 As noted, another gain to the Treasury would be the opportunity to collect transfer tax on the $10,000 excluded from the gift tax pursuant to § 2503.
119 Reg. § 25.2512-6(a), Example (4) (1974).
section 2035(a), inasmuch as the section 2035(d)(2) exception applies even where the potential does not exist. For example, suppose D transfers property on irrevocable trust: income to A for life, remainder to B. Suppose that the value of the trust property is $150,000 as of two years before D’s death and $165,000 at D’s death. If D relinquished her revocation power two years before D’s death, the relinquishment would constitute a $150,000 gift for gift tax purposes, and at her death, D would have to include $165,000 in her gross estate pursuant to section 2035(d)(2). But because of the unification of the gift and estate taxes, the only effect of including the $165,000 in her gross estate is the taxation of the $15,000 of appreciation produced between the date of relinquishment and the date of death. That is, in the absence of section 2035(d)(2) (and the last clause of section 2038(a)(1)), the amount of property potentially subject to estate tax that is removed from the tax base by D’s relinquishment of the section 2038 power ($165,000) does not exceed the amount subject to gift tax ($150,000) except by the amount of post-gift appreciation.

A return to pre-1982 law also would close a loophole that has enabled owners of controlling interests in closely-held corporations to reduce their transfer tax burden through the use of end-of-life gifts. A minority interest in a closely-held corporation is valued at less than its proportionate share of the corporation’s fair market value, in view of a minority shareholder’s inability to participate effectively in corporate governance or to compel liquidation as a means of realizing his

---

130 In point of fact, inasmuch as A’s income interest constitutes a present interest for purposes of the annual exclusion, Fisher v. Commissioner, 132 F.2d 383 (9th Cir. 1942); Commissioner v. Louden, 131 F.2d 127 (7th Cir. 1942), the amount of D’s gift would be $150,000 minus the lesser of $10,000 or the present actuarial value of A’s remaining income interest.

131 See also the last clause of § 2038(a)(1).

132 The 1990 enactment of § 2702 expands the range of situations in which the amount subject to gift tax in a § 2036, 2037, or 2038-type transfer equals (but for post-gift appreciation) the amount includable in the gross estate. For example, most transfers with reserved life estates are made to a member of the transferor’s family. If D transfers property in trust, reserving a life income interest, with the remainder payable to A, § 2702 provides that the amount subject to gift tax will be the full value of the property if A is a member of D’s family (a term defined in § 2704(c)(2)); the same amount (but for post-gift appreciation) that will be includable in D’s gross estate pursuant to § 2036. See Reg. § 25.2702-6 (1992).
share of the corporation’s net worth. If the fair market value of a corporation is $1 million, properly determined, and if the corporation has but two shareholders, a 70% shareholder and a 30% shareholder, the value of the minority shareholder’s shares, for federal transfer tax purposes, is likely to be less than $300,000. A “minority discount,” which sometimes may be quite substantial, will be applied to determine their value. If the owner of a majority block of stock gives his stock to four donees, with the result that each donee receives only a minority interest, the donor is permitted to claim the minority discount with respect to each gift, since the subject matter of each gift is a minority block of stock. If, however, the majority


134 The majority shareholder’s shares, correspondingly, will be valued at more than $700,000 by applying a “control premium.”


137 See, e.g., Clark v. United States, 75-1 U.S.T.C. ¶ 13,076 (E.D.N.C. 1975); Whittemore v. Fitzpatrick, 127 F. Supp. 710 (D. Conn. 1954); cf. Rushton v. Commissioner, 498 F.2d 88 (5th Cir. 1974) (for purposes of applying the “blockage discount” in valuing gifts of stock, the stock transferred to each donee should be treated and valued separately).

Unlike the estate tax where the tax is imposed on an aggregation of all the decedent’s assets, the gift tax is imposed on the property passing from the donor to each donee[,] and it is the value of that property passing from the donor to the donee that is the basis for measuring the tax. Thus, where the donor makes simultaneous gifts of property to multiple donees, the gift tax is imposed on the value of each separate gift. Accordingly, the value of property that is the subject of multiple simultaneous gifts may be different from the value of that same property if that property were included in the donor’s gross estate at his death.

T.A.M. 94-49-001 (Dec. 9, 1994).

This result has been sharply criticized, since it allows a property-owner to extinguish wealth. See Boris I. Bittker, Federal Taxation of Income, Estates, and Gifts, ¶ 132.3.4 (1984); Mary Louise Fellows and William H. Painter, Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome, 30 Stan. L. Rev. 895, 899-900 (1978). Suppose O owns 100% of the stock of a corporation whose fair market value, properly determined, is $800,000. If O gives 25% of the stock to each of four donees, and the transferred stock is valued for gift tax purposes
shareholder retains the majority block until his death and then bequeaths the stock in equal shares to four legatees, he will not be entitled to claim the minority discount, since the estate tax is based on the aggregate value of the assets in the gross estate.\footnote{See Ahmanson Foundation v. United States, 674 F.2d 761, 768 (9th Cir. 1981); Estate of Chenoweth v. Commissioner, 88 T.C. 1577, 1582 (1987).} Because outright end-of-life gifts are no longer included in the gross estate, a controlling shareholder who wishes to (1) retain the stock for the rest of his life, (2) divide the stock into minority portions upon transfer, and (3) nonetheless enjoy a minority discount for transfer tax purposes, simply makes deathbed gifts instead of bequests. A return to pre-1982 law would foreclose this avoidance device.

The proposed return to pre-1982 law, requiring all gifts made within three years of death to be included in the donor's gross estate, would generate inconveniences of its own. First, it would require double reporting; the same property would be reported as a transfer on the gift tax return and on the estate tax return. Second, it would produce changes in a donee's basis several years after the gift was completed.\footnote{Suppose A makes a gift to B of some XYZ stock that A bought for $10,000. B's basis in the stock is $10,000. I.R.C. § 1015(a). Suppose, when A dies two years later, the XYZ stock is worth $12,000. If we returned to pre-1982 law and the stock was included in A's gross estate pursuant to § 2035(a), B's basis in the stock would increase to $12,000. I.R.C. § 1014(a).} Each of these difficulties is, however, a feature of current law. As to the first, section 2038 always has had the potential for requiring double reporting,\footnote{For example, suppose D transfers property to herself in trust; until A reaches the age of 30, D, as trustee, has the absolute discretion to distribute income or corpus in any amounts to A. Upon A's 30th birthday, the trust is to terminate (if it has not already), and all remaining corpus (and accumulated income) is to be paid to A. Upon the creation of the trust, D has made a gift of the entire amount of trust property. See Reg. § 25.2511-2(d) (1983). Upon D's death, the entire value of the trust property will be includable in D's gross estate pursuant to § 2038. See Lober v. United States, 346 U.S. 335 (1953).} and the recent enactment of section 2702 greatly increases the frequency of double reporting.\footnote{See supra note 132.} As to the second, both section 2040 and section 2036 can produce an increase in a
donee’s basis, long after the date of gift, on account of the donor’s death. 162

VI. CONCLUSION

While the federal transfer tax system is ripe for a major overhaul, certain flaws can be repaired without significant alterations in the structure of the Code. Congress’s ill-advised 1981 amendments to section 2035 should be repealed so that all gifts (other than gifts excluded by section 2503) made within three years of death will be includable in the donor’s gross estate. Such a repeal would further Congress’s goal of removing the transfer tax advantage from those whose wealth permits substantial gift-giving and would eliminate the section 2035(d)(2) anomalies that drive taxpayers into wasteful exercises in cunning.

162 To illustrate this effect in the context of § 2040, suppose that A buys Blackacre for $40,000 and takes title in her own name alone. Some time later, when Blackacre has appreciated to $50,000, A transfers Blackacre to herself and B as joint tenants. Section 1015 provides that B takes A’s basis (let us ignore the basis adjustment for gift taxes paid, required by § 1015(d)). Therefore, B’s basis in his undivided one-half interest in Blackacre is $20,000 (one-half of A’s basis). Five years later, when Blackacre has appreciated to $60,000, A dies, survived by B. Because Blackacre was included in A’s gross estate pursuant to § 2040(a), B’s basis in Blackacre is $60,000, its value for estate tax purposes upon A’s death. I.R.C. § 1014(a). Thus, B’s basis in his own undivided one-half interest in Blackacre (i.e., the interest he received prior to A’s death) increases from $20,000 to $30,000 by reason of A’s death.

For my classes, I have penned the following pastiche to illustrate the anomalous step-up in basis caused by § 2036 includability:

“But the motive, Holmes, the motive!” I remonstrated. “Why should Lady Frumpington murder the Duke when he had given her a remainder interest in a valuable parcel of land four years earlier?”

“Elementary, my dear Watson,” he replied serenely. “When the Duke transferred the land, he reserved a right to the income from the land for five years, remainder to Lady Frumpington. Therefore, if the Duke had still been alive at the end of the five-year term, Lady Frumpington would have taken the Duke’s basis in the land pursuant to § 1015. But when the Duke died four years after transferring the land, the land was included in his gross estate pursuant to § 2036. Consequently, the basis of the land in Lady Frumpington’s hands at the end of the term will be a higher, stepped-up basis pursuant to § 1014(a).”

“I suppose your theory takes into account § 2207B(a),” I ventured to inquire.

Several moments of silence followed. “Of course, of course,” he muttered with a wave of his hand, changing the subject to the polyphonic motets of Orlando di Lasso.