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Sales of Remainder Interests: Reconciling Gradow v. United States and Section 2702

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SALES OF REMAINDER INTERESTS: RECONCILING
GRADOW v. UNITED STATES AND SECTION 2702

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I. INTRODUCTION

This article seeks to answer the question of whether the sale of a remainder interest for its actuarial value is exempt from transfer tax. Generally, when a taxpayer sells property for its fair market value, the taxpayer has been adequately compensated and, therefore, should not be subject to transfer tax. The sale of a remainder interest, however, raises various questions that are not present when property is sold outright. The sale of a remainder interest divides the underlying property into two split-interests: the remainder interest and the retained or present interest. The fair market value of split-interests is commonly determined using actu-

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1. The term split-interest encompasses life estates, term interests, remainders, and reversions. For purposes of this article, split-interest means the division of property into a present interest, which the taxpayer retains, and a remainder interest, which the taxpayer transfers. The retained interest may be a life estate or a term interest, such as an annuity interest, a unitrust interest, or an income interest, according to the appropriate context.
Because the actuarial value of a remainder interest is substantially less than the fair market value of the underlying property, the sale of a remainder interest for its actuarial value is viewed by many as allowing the taxpayer to transfer property to the remainderman for less consideration than is required in an outright sale. Consequently, the sale of a remainder interest for its actuarial value, although such value represents the fair market value of the remainder interest, raises the question of whether the seller has been adequately compensated for the transfer of the underlying property to the remainderman. If the actuarial value of the remainder interest does not represent adequate compensation for the transfer of the underlying property to the remainderman, the taxpayer may be subject to both the gift tax and the estate tax. If the taxpayer does not receive adequate and full consideration, the gift tax applies at the time the remainder interest is sold. If the taxpayer holds the retained interest until death, section 2036(a) of the Internal Revenue Code of 1986 (the “Code”) pulls the underlying property back into the taxpayer’s gross estate, unless the transfer is a bona fide sale for adequate and full consideration.

The rules for determining the amount of consideration necessary to avoid imposition of the gift tax are clear. Generally, consideration equal to the actuarial value of the remainder interest constitutes adequate consideration for purposes of the gift tax. If the remainder interest is sold to a family member, the special valuation rules of section 2702 of the Code require the taxpayer to receive consideration equal to the fair market value of the underlying property, unless the transfer falls within one of the clearly defined exceptions to the general rule of section 2702 of the Code.

In contrast to the gift tax treatment, the rules for determining the amount of consideration necessary to avoid imposition of the estate tax are unsettled. Specifically, the unresolved question relates to the amount of consideration necessary to prevent section
2036(a) of the Code from pulling the underlying property back into the taxpayer's gross estate. Commentators have generally adopted the position that the sale of a remainder interest for its actuarial value constitutes a sale for adequate consideration and precludes inclusion of the underlying property in the taxpayer's gross estate. Yet case law, particularly *Gradow v. United States*, implies that the remainder interest must be sold for an amount equal to the value of the underlying property to be excepted from section 2036(a) of the Code.

This article analyzes when it is appropriate for the sale of a remainder interest to be excepted from transfer tax in light of the purposes of the gift tax and the estate tax. Part II provides an overview of the transfer tax treatment of sales of remainder interests. Parts III and IV then examine the gift tax and estate tax systems' different definitions of adequate and full consideration for the sale of a remainder interest and suggest that a single definition be adopted. Part V of this article determines that the purposes of the transfer tax system may be served only if adequate and full consideration means, for purposes of both the gift tax and the estate tax, consideration sufficient to prevent depletion of the taxpayer's gross estate. Part V explores the methodology used by the actuarial tables to value split-interest and explains why, as long as the actuarial tables accurately value the split-interests, consideration equal to the actuarial value of the remainder interest prevents depletion of the gross estate. Part V concludes that as a general rule consideration equal to the actuarial value of a remainder interest equals adequate and full consideration for purposes of both the gift tax and the estate tax.

Part VI addresses an opportunity for abuse created by the general rule of section 2702 of the Code. The methodology used by the actuarial tables is vulnerable to manipulation by a taxpayer who desires to circumvent the transfer tax system. Particularly when the remainderman is a member of the taxpayer's family, the taxpayer may manipulate the investment of the underlying property

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*11 Cl. Ct. 808 (1987), aff'd, 977 F.2d 516 (Fed. Cir. 1990).*
to defeat the actuarial assumptions and cause the actuarial tables to understate the value of the remainder interest. Section 2702 of the Code recognizes this problem and provides a solution for purposes of the gift tax. If a taxpayer sells a remainder interest to a family member and retains the ability to manipulate the investment of the underlying property so that the actuarial value of the remainder interest is understated and the gift tax avoided, section 2702 of the Code ensures that the taxpayer's gross estate is not depleted by treating the sale of the remainder interest as a sale of the underlying property.\(^\text{10}\)

Part VI also argues that the valuation rules of section 2702 of the Code should be extended to the estate tax to preclude circumvention of section 2036(a) of the Code. Taxpayers who are motivated to avoid the gift tax system may also be motivated to elude estate tax. Sales of remainder interests to family members also represent situations in which the taxpayer is likely to desire to circumvent the estate tax. Although the special valuation rules of section 2702 of the Code do not specifically apply for purposes of section 2036(a) of the Code,\(^\text{11}\) the courts should look to the valuation rules of section 2702 of the Code for guidance to determine whether a taxpayer, who sells a remainder interest to a family member, has received adequate consideration for purposes of the estate tax pursuant to section 2036(a) of the Code. The receipt of consideration equal to the gift tax value of the remainder interest ensures that the taxpayer's gross estate is not depleted. Therefore, if the taxpayer sells a remainder interest and receives consideration equal to the gift tax value of the remainder interest, the taxpayer has received full and adequate consideration for purposes of both the gift tax and the estate tax.

Finally, in Part VII, this article considers the requirements necessary to except the sale of a remainder interest from the gift tax and the estate tax. The gift tax exists to tax only those transfers that deplete the gross estate, regardless of the donative nature of the transfer.\(^\text{12}\) If the gross estate is not depleted, the gift tax does

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\(^{10}\) See infra notes 136-209 and accompanying text.

\(^{11}\) Section 2702 limits its scope to determining the value of split interests for purposes of the gift tax. I.R.C. § 2702(a).

not apply.\footnote{I.R.C. § 2512(b).} For this reason, section 2512 of the Code excludes all transfers of remainder interests from the scope of the gift tax as long as the transfer is made for adequate consideration.\footnote{I.R.C. § 2512(b).} The scope of the estate tax pursuant to section 2036(a) of the Code is not, however, confined only to those transfers that deplete the gross estate. If the transfer of a remainder interest is donative in character and the taxpayer retains an interest in the property until death, section 2036(a) of the Code includes the underlying property in the taxpayer's gross estate, even though the taxpayer is adequately compensated for the remainder interest.\footnote{I.R.C. § 2036(a).} The sale of property subject to an interest that is retained until death may only remove the underlying property from the taxpayer's gross estate if the sale is both bona fide (i.e., free from donative intent) and made for adequate and full consideration.\footnote{Id.}

II. Transfer Tax Treatment of Sales of Remainder Interests

When a taxpayer transfers property to a trust, retaining a present interest and transferring a remainder interest,\footnote{Id.} the transfer to the trust is subject to the gift tax unless adequate consideration is received for the remainder interest.\footnote{Id.} Inadequate consideration is received whenever the value of the consideration is less than the gift tax value of the remainder interest.\footnote{I.R.C. § 2512(b).} The amount that is considered a gift is the amount by which the gift tax value of the remainder interest exceeds the value of the consideration.\footnote{Id.}

When the retained interest expires, the underlying property passes to the remainderman without further imposition of the gift tax.\footnote{Id.} Although additional gift tax is avoided, the remainder inter-

\footnote{Id. The transfer tax consequences of transferring a remainder interest are the same for transfers in trust and direct transfers. For convenience, this article discusses all transfers as if made in trust.}

\footnote{I.R.C. § 2512(b).}

\footnote{Id. For a discussion of the gift tax value of a remainder interest, see infra notes 158-209 and accompanying text.}

\footnote{Id.}

\footnote{Gans, supra note 3, 11 Va. Tax Rev. at 763.}
Sales of Remainder Interests

If the retained interest is a life estate, or if the taxpayer dies prior to the expiration of a retained term interest, section 2036(a) of the Code pulls the date of death value of the remainder interest into the taxpayer's gross estate, unless the original transfer was a bona fide sale for adequate consideration. When section 2036(a) of the Code pulls the value of the remainder interest back into the taxpayer's gross estate, the computation of the taxpayer's estate tax is adjusted so that any amount taxed as a gift at the time of the transfer of the remainder interest is not taxed twice. In addition, the amount included in

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** Strictly construed, § 2036(a) of the Code only applies if the taxpayer retains the right to the income from the property or the right to possess and enjoy the property. The Internal Revenue Service, however, interprets § 2036(a) of the Code as encompassing a retained annuity and a retained unitrust interest, even though neither interest encompasses a right to the income from the property. The Internal Revenue Service has adopted the position that retaining an annuity interest or a unitrust interest is equivalent to retaining the right to receive the income from a portion of the underlying asset. Rev. Rul. 82-105, 1982-1 C.B. 133; Rev. Rul. 76-273, 1976-2 C.B. 268. A retained life estate or term interest that pertains to only a portion of the underlying property results in the inclusion of only a corresponding portion of the underlying property in the transferor's gross estate. Treas. Reg. § 20.2036-1(a). Consequently, if the taxpayer dies holding a retained annuity interest, § 2036(a) of the Code includes that portion of the transferred property necessary (when capitalized at the appropriate interest rate) to yield the guaranteed annuity payment. Rev. Rul. 82-105, 1982-1 C.B. at 134. If the amount necessary to yield the annuity payment exceeds the value of the underlying property, the amount included by § 2036 of the Code is limited to the value of the underlying property. Id. Additionally, if the taxpayer dies holding a retained unitrust interest, the amount included in the taxpayer's gross estate is that portion of the underlying property that bears the same ratio to the underlying asset as the unitrust payment bears to the payment that would be received if an income interest had been retained. Rev. Rul. 76-273, 1976-2 C.B. at 269. The entire value of the underlying property is included if the unitrust payment exceeds the amount that would be paid if an income interest had been retained. Id.

** I.R.C. § 2036(a). If I.R.C. § 2036(a) applies, the date of death value of the trust corpus is included in the taxpayer's gross estate. I.R.C. § 2036(a). The date of death value of the trust corpus equals the sum of the value of the retained interest plus the value of the remainder interest. If the retained interest is a life estate, the date of death value is zero. Further, if the taxpayer dies holding a retained term interest, the date of death value of the term interest is included in the taxpayer's gross estate regardless of whether I.R.C. § 2036(a) applies or not. I.R.C. § 2033. Thus, the real effect of I.R.C. § 2036(a) is to pull the value of the remainder interest into the gross estate.

** I.R.C. § 2001(b). In order to prevent taxpayers from using inter vivos gifts to circumvent the graduated rate schedule contained in § 2001(c) of the Code, the estate tax is cumulative. I.R.C. § 2001(b)(1). To ensure that an estate is taxed at the proper marginal rate, a "tentative tax" is computed on the aggregate value of the gross estate plus all adjusted taxable gifts. Id. The "tentative tax" is then reduced by the gift tax paid with respect to gifts made after December 31, 1976 to ensure that the gifts are not taxed twice. Id. Adjusted taxable gifts are defined as "the total amount of the taxable gifts . . . made by the decedent."
the gross estate by section 2036(a) of the Code is reduced by the amount of consideration received for the remainder interest.\(^a\)

III. THE PROBLEM: DEFINING ADEQUATE CONSIDERATION

The bona fide sale of a remainder interest for adequate and full consideration is exempt from both the gift tax and the estate tax.\(^a\) Neither the gift tax provisions nor the estate tax provisions, however, define what constitutes adequate consideration. This omission appears to have resulted in the adoption of two different definitions: one for purposes of the gift tax; and, based on current analogous authority, a second definition for purposes of the estate tax.

A. Adequate Consideration: Two Distinct Definitions

For gift tax purposes, adequate consideration is defined as consideration equal to the value of the remainder interest.\(^b\) As a general rule, the fair market value of a remainder interest equals its actuarial value.\(^c\) Section 2702 of the Code complicates the analysis by equating the gift tax value of a transferred remainder interest with the value of the underlying property in certain situations.\(^d\)

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\(^a\) I.R.C. § 2043(a). Unlike the value of the remainder interest that is pulled back into the gross estate, the consideration offset is not calculated by reference to the date of death value of the consideration. See Ithaca Trust Co. v. United States, 279 U.S. 151, 155 (1929); Estate of Vardell v. Commissioner, 307 F.2d 688, 693 (5th Cir. 1962). Instead, the consideration offset is limited to the value of the consideration at the time of receipt. Vardell, 307 F.2d at 693.

\(^b\) I.R.C. §§ 2036(a), 2512.

\(^c\) I.R.C. § 2702(a). Under the special valuation rules of § 2702 of the Code, the value of a remainder interest depends on the identity of the transferee, the nature of the interest retained by the taxpayer, and the nature of the underlying asset. Id. See infra notes 158-209.
The ultimate conclusion, however, remains the same—adequate consideration equals the value of the remainder interest. The special valuation rules of section 2702 of the Code merely redefine the gift tax value of a remainder interest in certain circumstances.

For estate tax purposes, adequate consideration for the sale of a remainder interest has not been definitively determined. Current case law, particularly a line of cases concerning the application of section 2036(a) of the Code to the transfer of a surviving spouse's community property share under what is commonly called a widow's election will, indicates that adequate consideration for purposes of section 2036(a) of the Code requires the receipt of consideration equal to the fair market value of the underlying property. A surviving spouse who elects to take under a widow's election will, in effect, exchanges a remainder interest in her share of community property for a life estate in her deceased husband's share of community property. Because the surviving spouse retains a life estate in her community share, section 2036(a) of the Code pulls the date of death value of the surviving spouse's community share back into her gross estate, unless the exchange is a bona fide sale for adequate and full consideration. The widow's election will cases hold that section 2036(a) of the Code applies unless the value of the consideration received by the widow (i.e., the value of the life estate in the husband's community share) equals the value of the widow's community share.

and accompanying text.

** In a community property state, one-half of the community property becomes part of the deceased spouse's probate and gross estate, and the remaining one-half belongs to the surviving spouse. A widow's election will attempts to control both shares of community property, typically by creating a trust to hold the community property. Because the deceased spouse cannot legally devise the surviving spouse's share of the community property, the surviving spouse must choose between keeping her share of the community property and receiving nothing from the deceased spouse, or transferring her community share to the trust in exchange for accepting the benefits of the will. If the surviving spouse elects to transfer her community share to the trust, she receives a life estate in the income from the trust and the remainder interest typically passes to the couple's children. See generally Stanley M. Johanson, Revocable Trusts, Widow's Election Wills, and Community Property: The Tax Problems, 47 Tex. L. Rev. 1247 (1969).


** I.R.C. § 2036(a).

** Gradow, 11 Cl. Ct. at 813-16.
The most articulate argument for the proposition that adequate consideration for estate tax purposes requires that a remainder interest be sold for the fair market of the underlying property is set forth in \textit{Gradow v. United States}. In \textit{Gradow}, the value of the consideration received by the widow exceeded the actuarial value of the remainder interest in her community share that she relinquished in exchange. The value of the consideration received by the widow did not, however, exceed the value of her community share. The \textit{Gradow} court framed the issue as "whether the consideration flowing from [Mrs. Gradow] was merely the remainder interest left to [her son] . . ., or the entire value of the property she placed into the trust, i.e., her half of the community property." According to the court, the "most natural reading of Section 2036(a)" dictated that the property Mrs. Gradow transferred was the property that section 2036(a) of the Code included in the gross estate if that section applied. Concluding that section 2036(a) of the Code pulled the date of death value of the trust corpus, and not simply the date of death value of the remainder interest, back into the gross estate, the court found that the property she transferred was not the remainder interest, but the entire property transferred to the trust, i.e., the underlying property.

\footnote{11 Cl. Ct. 808 (1987), affd, 897 F.2d 516 (Fed. Cir. 1990). \textit{Gradow} is the only widow's election will case to challenge the idea that adequate consideration for purposes of § 2036(a) of the Code equals the value of the underlying property. Id. at 813-16. In the other widow's election will cases, the real dispute concerned the appropriate way to measure the consideration received for the remainder interest. The taxpayers never challenged the Internal Revenue Service's definition of adequate consideration. See Estate of Vardell v. Commissioner, 307 F.2d 688, 692-93 (5th Cir 1962); Estate of Gregory v. Commissioner, 39 T.C. 1012, 1016-20 (1963).

In the only widow's election will case prior to \textit{Gradow} in which adequate consideration was defined as the actuarial value of the remainder interest, the Internal Revenue Service conceded this point. The true controversy, however, was the appropriate measure of the consideration received by the widow. See Estate of Christ v. Commissioner, 54 T.C. 493, 495 (1970), affd, 480 F.2d 171 (9th Cir. 1973). In \textit{Christ}, the issue of whether adequate consideration was measured by reference to the value of the underlying asset or the actuarial value of the remainder was immaterial, which may explain the Internal Revenue Service's failure to contest the point. Under either standard, the consideration received by the widow was inadequate. Id. at 520.

\footnote{11 Cl. Ct. at 810.}
\footnote{Id.}
\footnote{Id. at 813.}

\footnote{\textit{Gradow v. United States}, 11 Cl. Ct. 808, 813 (1987), affd, 897 F.2d 516 (Fed. Cir. 1990).}
Consequently, the court determined that adequate consideration for purposes of section 2036(a) of the Code meant consideration equal to the value of the underlying property.\(^4\)

Gradow is the only widow’s election will case in which the taxpayer supported the argument that adequate consideration for purposes of the estate tax equalled the actuarial value of the remainder interest by drawing an analogy between the exchange resulting from a widow’s election to take under her husband’s will and the sale of a remainder interest.\(^4\) The Gradow court distinguished the sale of a remainder interest from the factual situation before the court, determining without explanation that the sale of a remainder interest is “obviously not testamentary, unlike the actual circumstances here.”\(^4\) The court determined, however, that the practical effect of the sale of a remainder interest was identical to that of a transfer under a widow’s election will; the gross estate was depleted by the value of the underlying property, and not simply by the actuarial value of the remainder interest.\(^4\) The court implied that if it were faced with a sale of a remainder interest, it would conclude that the transfer was for inadequate consideration, unless the remainder interest was sold for consideration equal to the value of the underlying property.\(^4\)

### B. Reconciling the Two Definitions

A problem arises if a taxpayer tries to structure the sale of a remainder interest to avoid transfer tax. If both definitions of adequate consideration apply, it is impossible to sell a remainder interest without one party to the transaction incurring transfer tax. Except when the general rule of section 2702 of the Code applies, a taxpayer may avoid gift tax on the transfer of the remainder interest by selling the remainder interest for its actuarial value.\(^4\) According to Gradow, the sale of the remainder interest for its actuarial value does not prevent section 2036(a) of the Code from

\[^{4} \text{Gradow v. United States, 11 Cl. Ct. 808, 815 (1987), aff’d, 897 F.2d 516 (Fed. Cir. 1990).} \]

\[^{4} \text{I.R.C. § 2702(a). If the general rule of § 2702 of the Code applies, to avoid the gift tax, the sale price must be the value of the underlying asset.} \]
pulling the underlying property back into the taxpayer's gross estate, if the taxpayer still has the retained interest at death.\textsuperscript{46} Under the rationale of \textit{Gradow},\textsuperscript{47} if the remainder interest is sold for its actuarial value, the taxpayer pays estate tax on the date of death value of the trust corpus less the consideration received for the remainder interest.\textsuperscript{48}

If a taxpayer follows \textit{Gradow} and sells the remainder interest for the value of the underlying property, the taxpayer avoids both the gift tax and the estate tax. The taxpayer escapes the gift tax because regardless of whether the gift tax value of the remainder interest is its actuarial value or the value of the underlying property,\textsuperscript{49} the taxpayer receives consideration equal to, if not in excess of, the gift tax value of the remainder interest. The taxpayer escapes the estate tax because, under \textit{Gradow}, the sale qualifies as a sale for adequate consideration. Therefore, section 2036(a) of the Code does not pull the remainder interest into the taxpayer's gross estate. The sale, however, does create transfer tax problems for the purchaser. The value of the remainder interest, viewed from the purchaser's perspective, equals its actuarial value.\textsuperscript{50} Thus, the purchaser pays more for the remainder interest than it is worth. Consequently, the sale of a remainder interest at the fair market value of the underlying property, while exempting the seller from transfer tax, results in a gift from the purchaser to the seller and the imposition of the gift tax on the purchaser. The amount of the gift equals the excess of the fair market value of the underlying property over the actuarial value of the remainder interest.\textsuperscript{61}

An example illustrates the dilemma faced by a taxpayer who wishes to sell a remainder interest. Assume that forty-year-old Parent owns Blackacre. Blackacre is Parent's personal residence and has a current fair market value of $500,000, which will remain constant until Parent's death. Parent transfers Blackacre to a

\textsuperscript{46} 11 Cl. Ct. 808, 810 (1987), aff'd, 897 F.2d 516 (Fed. Cir. 1990).
\textsuperscript{47} Id. at 810-12.
\textsuperscript{48} I.R.C. § 2043(a).
\textsuperscript{49} See infra notes 158-65 and accompanying text.
\textsuperscript{50} This result holds even if the special valuation rules require that the remainder interest be valued at the fair market value of the underlying property for purposes of determining the transferor's tax consequences. The special valuation rules only apply for purposes of valuing a remainder interest to determine if it is a gift from the transferor and, therefore, do not affect the value of the purchaser's interest. I.R.C. § 2702(a).
\textsuperscript{61} I.R.C. § 2512(b).
qualified personal residence trust,\textsuperscript{59} retaining a life estate and selling the remainder interest to Child. Assuming that the table rate in effect at the time of the sale is ten percent,\textsuperscript{60} the actuarial value of the remainder interest is $35,275.\textsuperscript{61} If Child pays $35,275 for the remainder interest, Parent receives adequate consideration for purposes of the gift tax and no gift tax is due.\textsuperscript{62} Under Gradow, however, Parent must receive $500,000 for the remainder interest in order to prevent section 2036(a) of the Code from pulling the trust corpus back into Parent's gross estate. Since Parent received less than $500,000, Parent's gross estate includes $464,725, the date of death value of the trust corpus less the consideration received by Parent for the remainder interest.\textsuperscript{63}

If Parent charges Child $500,000, Gradow's definition of adequate consideration for purposes of section 2036(a) of the Code is satisfied. Consequently, section 2036(a) of the Code does not pull the value of Blackacre back into Parent's gross estate. Child, however, has paid $500,000 for a remainder interest that is worth only $35,275.\textsuperscript{64} As a result, Child has made a gift to Parent in the amount of $464,725, the excess of the consideration paid by Child over the value of the remainder interest.\textsuperscript{65}

IV. Suggested Reform: Redefine Adequate and Full Consideration

As long as the gift tax and the estate tax adopt different definitions of adequate consideration, any transfer of a remainder interest results in the imposition of a transfer tax on at least one party to the transaction. Is this result appropriate in view of Congress' manifest intent to except sales for adequate consideration from

\textsuperscript{66} See infra notes 198-209 and accompanying text.

\textsuperscript{67} I.R.C. § 7520(a). The appropriate interest rate for valuing split-interests is determined under § 7520 of the Code and changes monthly. Id. Valuations in this article will be based upon a table rate of ten percent.

\textsuperscript{68} Table R(1), I.R.S. Notice 89-60, 1989-1 C.B. 700, 703.

\textsuperscript{69} The gift tax value of the remainder interest in Parent's personal residence equals the actuarial value of the remainder interest. I.R.C. § 2702(a)(3)(A)(ii). See infra notes 198-209 and accompanying text.

\textsuperscript{70} I.R.C. §§ 2036(a), 2043.

\textsuperscript{71} If Child dies prior to the termination of the retained interest, Child's gross estate includes the actuarial value of the remainder interest. I.R.C. § 2033.

\textsuperscript{72} See supra notes 19-30 and accompanying text.
both the gift tax and the estate tax? Would Congress have placed such an exception in both transfer taxes if its intention were simply to shift the tax burden from one party to another or to shift the time of the taxable transfer from a point during the taxpayer's life to the time of the taxpayer's death?

A. Defining the Property Interest Subject to Tax

One reason that two different definitions of adequate consideration have developed is that the courts have drawn a distinction concerning the property interest that is transferred by the sale of a remainder interest. For purposes of the gift tax, the courts define the property interest transferred as the remainder interest. For purposes of section 2036(a) of the Code, however, the Gradow court focused on the property interest removed from the gross estate. The Gradow court's analysis began with the premise that the transfer of a remainder interest removed not only the remainder interest, but the underlying property from the gross estate.

Regardless of which definition is correct, the conclusion that the gift tax attaches to a different property interest than the estate tax contradicts the teachings of the Supreme Court that the gift tax and the estate tax, although distinctly different taxes, serve the same purpose—to tax donative transfers that deplete the gross estate. In fact, the gift tax was enacted as a supplement to the estate tax to prevent circumvention of the estate tax through inter vivos transfers. Consequently, the gift tax and the estate tax are to be construed in pari materia, and where "the two taxes concern... the same subject matter," the phrase "adequate and full consideration in money or money's worth" should be given an "identical construction."

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See I.R.C. §§ 2036(a), 2512.
11 Cl. Ct. at 810.
See Wemyss, 324 U.S. at 305.
If the transfer of a remainder interest depletes the taxpayer's gross estate by more than the value of the remainder interest, inter vivos transfers of remainder interests may be utilized to bypass the estate tax. When a remainder interest is transferred, the gift tax only applies to the extent that the gift tax value of the remainder interest exceeds the consideration received. If the retained interest terminates during the taxpayer's life, the underlying property passes to the remainderman without the additional imposition of a transfer tax. If the transfer of a remainder interest depletes the taxpayer's gross estate by more than the value of the remainder interest, the transfer tax system is evaded every time property is transferred subject to a retained term interest that expires during the transferor's life. In order for the gift tax to serve its intended purpose, the gift tax must attach to the value of the property removed from the gross estate. Thus, if the gift tax is to serve its intended function, adequate consideration for purposes of the gift tax must mean consideration sufficient to prevent depletion of the gross estate. Adequate consideration for purposes of the gift tax, however, is currently defined as value equal to that of the remainder interest. Is the current gift tax definition of adequate consideration wrong? Alternatively, does consideration equal to the gift tax value of the remainder interest prevent depletion of the gross estate? If consideration equal to the gift tax value of the remainder interest prevents depletion of the gross estate, the property interest transferred for gift tax purposes (i.e., the remainder interest), must equal the property interest transferred for estate tax purposes under section 2036(a) of the Code (i.e., the property removed from the gross estate).

B. A Single Definition Accords with the Tax Policy of Neutrality

Interpreting adequate consideration identically for purposes of the two transfer taxes adheres to the principle of neutrality, which is an important concern in the formulation of transfer tax policy.

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66 I.R.C. § 2512(b).
67 The underlying asset is not pulled back into the taxpayer's gross estate because the retained interest is not held by the taxpayer at death. I.R.C. § 2036(a).
68 See supra notes 27-29 and accompanying text.
69 See Gans, supra note 3, 11 Va. Tax Rev. at 812, citing 1 U.S. Treasury Dep't, Tax
One aspect of neutrality seeks to remove, or at least minimize to the extent possible, the impact of tax law on estate planning decisions. A transfer tax provision is considered neutral to the extent that it does not affect the timing or method of a taxpayer’s decision to transfer property. A transfer tax provision that influences a taxpayer’s decision whether to transfer property during life or to wait until death is non-neutral. To the extent that the transfer tax cost of an inter vivos transfer differs from that of a testamentary transfer, a taxpayer will take this difference into account in deciding when to transfer the property. Neutrality requires that the advantages and disadvantages associated with making an inter vivos gift be comparable to the advantages and disadvantages of a testamentary transfer so that the incentives or disincentives inherent in one tax system do not influence the taxpayer’s decision.


See Gans, supra note 3, 11 Va. Tax Rev. at 813, citing 2 U.S. Treasury Dep’t, Tax Reform for Fairness, Simplicity, and Economic Growth—General Explanation of the Treasury Department Proposals, 85-9257, 85-11352, at 376 (Nov. 1984). Prior to 1976, an inter vivos gift was taxed much more advantageously than a testamentary transfer. Theodore S. Sims, Timing Under a Unified Wealth Transfer Tax, 51 U. Chi. L. Rev. 34, 34 (1984). In 1976, however, the gift tax and estate tax were integrated. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, 1846-48 (codified, as amended, at I.R.C. § 2001). This new interpretation of the gift tax and the estate tax eliminated much of the favoritism afforded the gift tax under the prior system. Sims, supra, at 34. Now, the same rate schedule applies to both inter vivos gifts and testamentary transfers. I.R.C. §§ 2001(c), 2502(a). Additionally, taxpayers are entitled to a unified credit, which permits a taxpayer to transfer by inter vivos transfer, by testamentary transfer, or by a combination of inter vivos and testamentary transfers, $600,000, without the imposition of a transfer tax. I.R.C. §§ 2001(c), 2010, 2505.

To prevent taxpayers from taking advantage of the tax schedules' graduated rates, both the gift tax and estate tax are cumulative. I.R.C. §§ 2001(b), 2502(a). Moreover, prior transfers are taken into account in determining the tax bracket to which a subsequent transfer is subject. Id. To determine the transfer tax liability from an inter vivos gift, the amount of the gift is increased by the value of all prior gifts and a tentative tax is computed for the total. I.R.C. § 2502(a)(1). The gift tax liability attributable to the prior gifts is then subtracted from the tentative tax. I.R.C. § 2502(a)(2). This same approach is taken to calculate the estate tax liability. More specifically, the gross estate is “grossed up” by the value of taxable inter vivos gifts and reduced by the gift tax applicable to the inter vivos gifts. I.R.C. § 2001(b). See supra note 24 and accompanying text.


Id.

Id. Although the gift tax and the estate tax are integrated, inter vivos gifts enjoy certain advantages over testamentary transfers. The principal advantage of making an inter
the tax consequences of an inter vivos transfer are significantly more favorable than the tax consequences of a testamentary transfer, the tax provision is non-neutral because a taxpayer will take the disparity between the two tax systems into account and will allow that disparity to affect his or her decision.\footnote{\textsuperscript{76}}

Current authority creates distortion by interpreting "adequate and full consideration" differently for gift tax purposes than for estate tax purposes. Under current law, a taxpayer who sells property subject to a retained interest is treated in one manner if the retained interest is a term interest and in another manner if the retained interest is a life estate.\footnote{\textsuperscript{76}} The taxpayer who sells a remain-

vivos gift is that any future appreciation in the value of the transferred property is removed from the taxpayer's tax base. See, e.g., Gans, supra note 3, \textit{11 Va. Tax Rev.} at 813. A second advantage is that inter vivos gifts of present interests qualify for the annual exclusion, which permits a taxpayer to transfer tax-free, $10,000 per donee, per year. I.R.C. \textsection 2503(b). A final advantage is that the gift tax, unlike the estate tax, is a net tax. The gift tax only applies to the value of the transferred property; assets used to pay the gift tax are not subject to transfer tax. Gans, supra note 3, \textit{11 Va. Tax Rev.} at 813. In contrast, the estate tax applies to the value of the entire estate, including the assets used to pay the tax itself.

There are also disadvantages associated with making an inter vivos gift. Gans, supra note 3, \textit{11 Va. Tax Rev.} at 814. The primary disadvantage associated with making an inter vivos gift has to do with the time value of money. Id. at 813-14. The taxpayer who makes an inter vivos gift is effectively forced to pay an accelerated estate tax. Id. at 813-14 & n.114. The second disadvantage is that the donee's basis in property transferred by inter vivos gift equals the basis of the property in the hands of the donor. I.R.C. \textsection 1015. If the property is appreciated at the date of the gift, a subsequent sale by the donee creates income tax liability and reduces the benefit of removing subsequent appreciation from the donor's estate. Gans, supra note 3, \textit{11 Va. Tax Rev.} at 813-14. In contrast, property transferred at death receives a "stepped-up" basis. Id. at 814 n.115. In other words, the basis of the property in the hands of the recipient is stepped up to the property's fair market value at the time of the donor's death. I.R.C. \textsection 1014. Consequently, the recipient of a testamentary transfer may sell the property without paying income tax on any unrecognized gain inherent in the property at the date of the donor's death. Gans, supra note 3, \textit{11 Va. Tax Rev.} at 813. The disadvantages associated with making an inter vivos gift are considered to offset the advantages of an inter vivos gift, which makes the gift tax non-distortionary. Id. at 814. To the extent that the disadvantages cancel out the advantages, a taxpayer is influenced by non-tax considerations, such as the desire to retain control of the property. Id. at 815. When a taxpayer's decision to make an inter vivos gift is influenced solely by non-tax considerations, the transfer tax is neutral. Id. at 814-15.


\footnote{\textsuperscript{76}} Some commentators have argued that transfer tax treatment of gratuitous transfers of property subject to a retained life estate is itself distortionary. Gans, supra note 3, \textit{11 Va. Tax Rev.} at 814. A taxpayer, who for non-tax reasons wishes to transfer property subject to a retained life estate, is dissuaded by the knowledge that not only is the value of the remainder interest subject to the gift tax, but \textsection 2036(a) of the Code pulls the post-transfer appreciation of the remainder interest back into the taxpayer's gross estate. Faced with
der interest for its gift tax value completely escapes transfer tax, both the gift tax and the estate tax, on the post-transfer appreciation in the remainder interest, if the taxpayer retains and survives a term interest in the underlying property. If, however, the taxpayer retains a life estate, the taxpayer is subject to transfer tax, the estate tax, on the post-gift appreciation in the remainder interest, even though the remainder interest is sold for fair market value. The taxpayer who sells a remainder interest and for non-tax reasons and wishes to retain a life estate in the underlying property will opt for a term interest because the retained term interest offers the possibility of avoiding estate tax on the post-transfer appreciation. This disparate treatment of the post-transfer appreciation when a remainder interest is sold subject to a retained term interest, as opposed to a retained life estate, is distortionary and affects a taxpayer's decision about whether to retain a life estate or a term interest. It also causes the taxpayer to engage in a form of transfer-tax Russian roulette, transferring property

these potential tax consequences, a taxpayer is likely to disregard the non-tax reasons for retaining a life estate and simply make an outright gift of the property. An outright gift of the property, although subject to gift tax, removes the subsequent appreciation from the taxpayer's estate tax base. Gans, supra note 3, 11 Va. Tax Rev. at 814-15. This argument ignores the purpose of § 2036(a) of the Code, which is to treat donative inter vivos transfers of property that are essentially testamentary in nature as if they are consummated at death. See Commissioner v. Estate of Church, 336 U.S. 632, 646 (1949); Helvering v. Hallock, 309 U.S. 106, 112 (1940). An inter vivos gratuitous transfer of property subject to a retained life estate should not be treated the same as an outright gift of the property. Section 2036(a) exists to prevent a taxpayer from depleting his or her gross estate by an inter vivos transfer and then retaining the use of the property until death.

If the transfer is for inadequate consideration, the value of the remainder interest is subject to the gift tax.

Because the gift tax and estate tax are integrated, an inter vivos gift does not reduce the transfer tax paid with respect to the date of gift value of the property. That value is subject to transfer tax regardless of whether the taxpayer gives the property away or keeps it until death. What an inter vivos gift accomplishes, however, is to remove the subsequent appreciation from the transfer tax base. When a taxpayer transfers property in an inter vivos transaction and such property is not included in the taxpayer's gross estate, the taxpayer escapes transfer tax on all appreciation that occurs between the date of the gift and the taxpayer's death. The disadvantage to having property that is transferred inter vivos subsequently pulled back into the taxpayer's gross estate is that the post-gift appreciation becomes subject to transfer tax.

The retention of a term interest offers the possibility of removing the post-transfer appreciation from the taxpayer's transfer tax base even though the transfer of the remainder interest is gratuitous. If, however, the taxpayer dies prior to the expiration of the term interest, the transferred property is included in the taxpayer's gross estate, and as a result, post-gift appreciation is subject to the estate tax. I.R.C. § 2036(a).
subject to a retained term interest with the longest duration that the taxpayer believes he or she may outlive. As a result, the imposition of the estate tax on property transferred subject to a retained interest is entirely dependent upon chance. Taxpayers who die during the retained term interest incur estate tax on the post-transfer appreciation, while those who manage to survive the retained term interest avoid transfer tax on the post-gift appreciation. The disparity and maneuvering inherent in the current approaches to defining adequate consideration may be avoided by recognizing that the transfer of a remainder interest conveys the same property interest for the gift tax as for the estate tax.

V. ADEQUATE CONSIDERATION: CONSIDERATION SUFFICIENT TO PREVENT DEPLETION OF THE GROSS ESTATE

Adopting the same definition of adequate and full consideration for purposes of both the gift tax and the estate tax permits the sale of a remainder interest without subjecting either party to the transaction to transfer tax. This result complies with Congress' expressed intent. In addition, defining adequate and full consideration as consideration sufficient to prevent depletion of the gross estate accords with the teachings of the Supreme Court regarding the purposes of the gift tax and the estate tax. The analysis, however, cannot stop there. The unanswered question remains how much consideration is required to prevent depletion of the gross estate when a remainder interest is transferred.

A. Fair Market Value of Underlying Property Creates Double Taxation

*Gradow v. United States* held that consideration sufficient to prevent depletion of the gross estate requires the receipt of consideration equal to the fair market value of the underlying property.\(^\text{80}\) A close analysis of the sale of a remainder interest demonstrates that consideration equal to the value of the underlying property enhances the gross estate rather than simply filling the void created by the transfer of the remainder interest. For example, assume that Parent owns property having a current fair market value

of $500,000 and that the property appreciates ten percent each year. If Parent holds the property for ten years and dies, the value included in Parent's gross estate is $1,296,871.\textsuperscript{61} Now assume instead that Parent transfers the property to a trust, retaining an annuity of $50,000 per year and selling the remainder interest to Child for $500,000. If Parent invests the $500,000 received for the remainder interest at ten percent per year, compounded annually, Parent's gross estate includes $1,296,871 from the investment of the sales proceeds. This is not, however, the only amount included in Parent's gross estate as a result of the sale of the remainder interest. Parent receives $50,000 a year during the ten-year term of the trust. If Parent retains these annual payments and invests them at ten percent per year, compounded annually, Parent's gross estate includes an additional sum of $796,871.\textsuperscript{62} Consequently, the total value included in Parent's gross estate is $2,093,742. If Parent had retained the property until death, only $1,296,871 would be

\textsuperscript{61} The value included in Parent's gross estate at the end of ten years, assuming appreciation of ten percent per year, is calculated as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Appreciation</th>
<th>Property Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>50,000</td>
<td>550,000</td>
</tr>
<tr>
<td>2</td>
<td>55,000</td>
<td>605,000</td>
</tr>
<tr>
<td>3</td>
<td>60,500</td>
<td>665,500</td>
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<tr>
<td>4</td>
<td>66,550</td>
<td>732,050</td>
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<tr>
<td>5</td>
<td>73,205</td>
<td>805,255</td>
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<td>6</td>
<td>80,526</td>
<td>885,781</td>
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<tr>
<td>7</td>
<td>88,578</td>
<td>974,359</td>
</tr>
<tr>
<td>8</td>
<td>97,436</td>
<td>1,071,795</td>
</tr>
<tr>
<td>9</td>
<td>107,179</td>
<td>1,178,974</td>
</tr>
<tr>
<td>10</td>
<td>117,897</td>
<td>1,296,871</td>
</tr>
</tbody>
</table>

\textsuperscript{62} The amount included in Parent's gross estate if Parent receives an annuity of $50,000 per year and invests the annuity payments at ten percent, compounded annually, is calculated as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Annuity Payment</th>
<th>Interest</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>50,000</td>
<td>5,000</td>
<td>50,000</td>
</tr>
<tr>
<td>2</td>
<td>50,000</td>
<td>10,500</td>
<td>105,000</td>
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<tr>
<td>3</td>
<td>50,000</td>
<td>16,550</td>
<td>232,050</td>
</tr>
<tr>
<td>4</td>
<td>50,000</td>
<td>23,205</td>
<td>305,255</td>
</tr>
<tr>
<td>5</td>
<td>50,000</td>
<td>30,526</td>
<td>385,781</td>
</tr>
<tr>
<td>6</td>
<td>50,000</td>
<td>38,578</td>
<td>474,359</td>
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<tr>
<td>7</td>
<td>50,000</td>
<td>47,436</td>
<td>571,795</td>
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<td>8</td>
<td>50,000</td>
<td>57,179</td>
<td>678,974</td>
</tr>
<tr>
<td>9</td>
<td>50,000</td>
<td>67,897</td>
<td>796,871</td>
</tr>
<tr>
<td>10</td>
<td>50,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Sales of Remainder Interests

included in the gross estate. Given the Gradow court’s decision that transferring a remainder interest removes the underlying property from Parent’s gross estate, adequate consideration need only insure that Parent’s gross estate include the same amount as if Parent had kept the underlying property. Selling the remainder interest for the value of the underlying property has the effect of increasing the value of Parent’s gross estate instead of creating a substitute equal to the value that is included in Parent’s gross estate if the underlying property is retained.

Selling the remainder interest for $500,000 also results in the inclusion of a greater value than is pulled back into Parent’s gross estate by section 2036(a) of the Code if Parent gratuitously transfers the remainder interest to Child. If the trust corpus earns ten percent per year and pays Parent an annuity of $50,000, the value of the trust corpus remains constant at $500,000, since each year, the amount paid to Parent offsets the annual appreciation. Therefore, if Parent gives, rather than sells, the remainder interest to Child, the value that is pulled into Parent’s gross estate by section 2036(a) of the Code is $500,000. This amount must be combined with Parent’s $50,000 annuity, which if invested at ten percent per year, compounded annually, increases Parent’s gross estate by $796,871. The total amount included in Parent’s gross estate, then, is $1,296,871, the same amount that is included if Parent keeps the property until death. Thus, when the remainder interest is gratuitously transferred and section 2036(a) of the Code pulls the trust corpus back into the gross estate, the value included in Parent’s gross estate is $796,871 less than the amount included if Parent sells the remainder interest for the value of the underlying property.

As the above examples demonstrate, if Gradow’s definition of adequate consideration is adopted, the sale of a remainder interest augments the gross estate. The amount included in the gross estate if the remainder interest is sold for the fair market value of the underlying property exceeds the amount that is included if the remainder interest is gratuitously transferred or the underlying property is retained until death.

If adequate and full consideration is defined as the amount necessary to prevent depletion of the gross estate, consideration equal to the value of the underlying property is more than adequate con-
sideration for the sale of a remainder interest.\textsuperscript{85} Because adequate consideration merely requires that the taxpayer receive sufficient consideration to prevent depletion of the gross estate, adequate consideration is some amount less than the value of the underlying property.\textsuperscript{84} Ascertaining this amount requires an understanding of why the value of the underlying property exceeds the amount necessary to prevent depletion of the gross estate. This analysis, in turn, requires an understanding of the nature of property. Property is comprised of two components: a present value increment and an earnings increment.\textsuperscript{85} An outright transfer of property transfers both components, but a transfer of a remainder interest severs the two components with the taxpayer retaining the earnings increment and transferring the present value increment.\textsuperscript{86}

If the taxpayer transfers the present value increment in exchange for consideration equal to the value of the underlying property, the taxpayer is compensated for the earnings increment, as well as the present value increment, even though the taxpayer retains the earnings increment. The value of the earnings increment is thereby included twice in the taxpayer's gross estate. In order to receive adequate consideration, the taxpayer need only to receive consideration equal to the value of the present value increment, which is the only property interest removed from the taxpayer's gross estate.

\textbf{B. Actuarial Value Prevents Depletion of Gross Estate}

Consideration equal to the actuarial value of the remainder interest constitutes consideration equal to the value of the present value increment and prevents depletion of the taxpayer's gross es-


\textsuperscript{84} Lowndes, supra note 83, 35 Geo. Wash. L. Rev. at 51.

\textsuperscript{86} Morrison, supra note 8, 44 Tex. L. Rev. at 231. The present value of property may be defined as the right to transfer the property at a future date. James P. Spica, Federal Transfer Tax Treatment of Actuarial Appreciation, 42 Drake L. Rev. 123, 125-26 (1993).

\textsuperscript{85} Morrison, supra note 8, 44 Tex. L. Rev. at 231. If the taxpayer retains an annuity interest or other interest that pays the taxpayer a sum in excess of the annual earnings of the underlying property, the taxpayer severs not only the earnings increment, but also a portion of the present value sufficient to fund the excess payments.
The actuarial value of the remainder interest equals the amount that will grow to a principal sum equal to the value of the property that passes to the remainderman at termination of the retained interest. To reach this conclusion, the tables assume that both the consideration received for the remainder interest and the underlying property are invested at the table rate of interest, compounded annually.

When property is split into a retained interest and a remainder interest, the actuarial tables value the two interests by projecting the value that the underlying property will have when the retained interest terminates and apportioning this projected value between the retained interest and the remainder interest. The actuarial tables project the future value of the underlying property by assuming that it appreciates at the table rate of interest, compounded annually. The portion of the projected value of the underlying property that is allocated to the retained interest, or the earnings increment, equals the amount derived by investing the income stream paid to the retained interest holder at the table rate of interest, compounded annually. The actuarial value of the retained interest equals the present value of this amount, discounted at the table rate of interest. The balance of the underlying property's projected value is allocated to the remainder interest and discounted at the table rate of interest to determine the actuarial value of the remainder interest.

In the preceding example, Parent divided property having a present value of $500,000 into a retained ten-year annuity paying $50,000 a year and a remainder interest. Assuming the table rate in effect at the time that the remainder interest is transferred is ten percent, the actuarial tables project a value for the underlying property of $1,296,871 at the end of ten years. The actuarial tables apportion this amount between the retained interest and the underlying property.

See generally Morrison, supra note 8, 44 Tex. L. Rev. 223; Johanson, supra note 30, 47 Tex. L. Rev. 1247.
See, e.g., Morrison, supra note 8, 44 Tex. L. Rev. at 237-38.
Id.
See, e.g., Boyle, supra note 8, 24 Ga. L. Rev. at 15.
Id.
Id.
Id.
See, e.g., Boyle, supra note 8, 24 Ga. L. Rev. at 15.
See supra note 81 for calculation.
remainder interest. The amount allocated to the retained interest equals $796,871, or the annual annuity payment of $50,000 a year, plus interest at the table rate, compounded annually. The actuarial value of the retained interest is $307,228, which equals the present value of the ten-year income stream of $50,000 per year, plus interest at the table rate compounded annually, discounted at the table rate of ten percent. The projected value of the remainder interest at the end of ten years equals $500,000, or the projected value of the trust corpus less the amount allocated to Parent’s annuity. Finally, the actuarial value of the remainder interest is $192,772, the present value of the right to receive $500,000 at the end of ten years. If Parent sells the remainder interest for its actuarial value and invests the $192,772 at the table rate of ten percent, at the end of ten years Parent has a principal balance of $500,000. Parent’s gross estate is not depleted by the sale of the

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*See supra note 82 for calculation.
‡ See, e.g., Boyle, supra note 8, 24 Ga. L. Rev. at 15.
§ Because the actuarial tables assume that the underlying asset appreciates at the table rate of interest, which in this case is ten percent or annual appreciation of $50,000, and the annual annuity payment also equals $50,000, the actuarial tables assume that the value of the trust corpus remains at $500,000. If the retained annuity (when calculated as a percentage of the initial fair market value of the trust corpus) exceeds the table rate, the actuarial tables assume that the $500,000 is consumed, as necessary, to fund the annuity. If the percent is less than the table rate, the actuarial tables assume that some of the annual appreciation is given to the remainderman and the tables value the remainder interest accordingly.

100 Table B, I.R.S. Notice 89-60, 1989-1 C.B. 706, 708.
101 See, e.g., Boyle, supra note 8, 24 Ga. L. Rev. at 15. The projected value is determined first by adding the annual return (assuming that the underlying property earns an annual return equal to the table rate of interest) and then by subtracting each annual payment to the term holder, Id.
102 The principal balance Parent holds from investing the sales proceeds of $192,772 at ten percent, compounded annually, is calculated as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Income</th>
<th>Principal Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>13,277</td>
<td>212,049</td>
</tr>
<tr>
<td>2</td>
<td>21,205</td>
<td>233,254</td>
</tr>
<tr>
<td>3</td>
<td>23,325</td>
<td>256,579</td>
</tr>
<tr>
<td>4</td>
<td>25,658</td>
<td>282,237</td>
</tr>
<tr>
<td>5</td>
<td>28,224</td>
<td>310,461</td>
</tr>
<tr>
<td>6</td>
<td>31,046</td>
<td>341,507</td>
</tr>
<tr>
<td>7</td>
<td>34,151</td>
<td>375,658</td>
</tr>
<tr>
<td>8</td>
<td>37,568</td>
<td>413,224</td>
</tr>
<tr>
<td>9</td>
<td>41,322</td>
<td>454,546</td>
</tr>
<tr>
<td>10</td>
<td>45,455</td>
<td>500,001*</td>
</tr>
</tbody>
</table>

* One dollar rounding error.
remainder interest to Child because the consideration Parent received for the remainder interest has created a substitute of equal value.\textsuperscript{108}

\textbf{C. Spending Proceeds Does Not Deplete Gross Estate}

In the preceding discussion, adequate consideration is determined based on the assumption that the taxpayer retains and invests both the proceeds from the sale of the remainder interest and the income from the retained interest. In this instance, the principal balance generated from the investment of these two property interests creates a substitute equal to the value that would have been included in the gross estate if the taxpayer retained the entire property. Must a taxpayer who transfers a remainder interest retain and invest the proceeds received for the remainder interest and the income from the retained interest in order to prevent depletion of the gross estate? The answer is no. The exception to section \textsection{2036(a)} of the Code for bona fide sales for adequate consideration \textquote{is based on the expectation that what is being added to the [taxpayer\textquotesingle s] . . . assets will be subject to inclusion in the gross estate. Even if the consideration is fungible and easily consumed, at least theoretically the rest of the estate is protected from encroachment for lifetime expenditures.}\textsuperscript{104}

The proceeds from the sale of the remainder interest create a substitute for the value of the underlying property, regardless of whether the proceeds are retained or consumed. If the proceeds from the sale of the remainder interest are expended, either for gifts or for living expenses, the gross estate is still enhanced by the receipt of the proceeds because the proceeds augment the taxpayer\textquotesingle s net worth and prevent the taxpayer from having to spend other assets to defray these expenses.\textsuperscript{108} Ultimately, the gross estate is enhanced by the value of the remainder interest because the

\textsuperscript{104} See, e.g., Morrison, supra note 8, 44 Tex. L. Rev. at 257-38.
\textsuperscript{106} Gradow v. United States, 11 Cl. Ct. at 808, 813 (1987), affd, 897 F.2d 516 (Fed. Cir. 1990).
\textsuperscript{108} If the proceeds are given away, the gifts are subject to a tax. The taxpayer, however, may use the annual exclusion or the unified credit to shelter some of the gifts from tax. To the extent that the taxpayer uses the annual exclusion or the unified credit to shelter part of the gifts from tax, there is still a detriment to the taxpayer because the taxpayer could have used the exclusion or credit to shelter other transfers.
D. Adequate Consideration and Subsequent Sales of the Retained Interest

The Gradow court cited United States v. Allen as strong support for its holding that adequate consideration requires the receipt of value equal to that of the underlying property. Allen addressed the question of adequate consideration in the context of a sale of a retained life estate for its actuarial value. The Allen court held that in order to constitute a sale for adequate consideration, the retained life estate had to be sold for an amount equal to the value of the underlying trust corpus. When the factual situation posed in Allen is analyzed, Allen supports the conclusion of this article that adequate consideration requires that the transferor of a split-interest receive sufficient consideration to prevent depletion of the gross estate, and not that adequate consideration for the sale of a remainder interest equals the value of the underlying property.

In Allen, Mrs. Allen created an irrevocable inter vivos trust, whereby she retained a life estate in three-fifths of the trust income and she gave the remainder interest, as well as the remaining two-fifths of the trust income, to two of her children. Seventeen years later, when she was approximately seventy-eight, Mrs. Allen learned that the retained life estate caused three-fifths of the trust corpus to be included in her gross estate under section 811 of the

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106 See generally Morrison, supra note 8, 44 Tex. L. Rev. at 236-44.
107 293 F.2d 916 (10th Cir. 1961), cert. denied, 368 U.S. 944 (1961).
108 Gradow, 11 Cl. Ct. at 813.
109 Allen, 293 F.2d at 917. If § 2036(a) of the Code applies, the underlying property may be removed from the transferor's gross estate by a disposition of the retained interest. I.R.C. § 2036(a). If the transferor dies within three years of the disposition, § 2035 of the Code pulls the underlying property back into the gross estate unless the disposition is a bona fide sale for full and adequate consideration. I.R.C. §§ 2035(a), (b)(1). Section 2035 includes the value of the underlying property to the same extent that § 2036(a) of the Code would include the underlying property if there had been no disposition. Id. See Lowndes, supra note 83, 35 Geo. Wash. L. Rev. at 54-56.
110 Allen, 293 F.2d at 918.
111 Id. at 917-18.
112 Id. at 916.
Sales of Remainder Interests

1995]  

Internal Revenue Code of 1939 (the "1939 Code"). At the time of this discovery, the value of Mrs. Allen's life estate was approximately $135,000 and the value of three-fifths of the trust corpus was nearly $900,000. In an effort to prevent the trust corpus from being pulled back into her gross estate, Mrs. Allen sold her life estate to her son for $140,000. At the time of the sale, Mrs. Allen was in good health, and her son, who was not a beneficiary of the trust or otherwise in a position to profit from a reduction in Mrs. Allen's estate taxes, believed she would live long enough so that he would receive a profit from his investment. When Mrs. Allen died, the Internal Revenue Service (the "Service") asserted that three-fifths of the value of the trust corpus should be included in her gross estate because the sale was made in contemplation of death and for inadequate consideration. After acknowledging that it would have been virtually impossible for Mrs. Allen to sell her life estate for the value of the trust corpus includible in her gross estate, the court concluded that to permit Mrs. Allen to sell her life estate for $140,000, and thereby remove $900,000 from her gross estate, would permit circumvention of section 2036(a) of the Code (previously section 811 of the 1939 Code).

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119 Id. Section 811 of the 1939 Code, the predecessor to §§ 2035 and 2036, provided in pertinent part:

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


117 Id. at 916. The predecessor to §§ 2035 through 2038 of the Code, section 811, included in the gross estate the transfer of property in which there was a retained life estate. Int. Rev. Code of 1939 § 811.

116 Allen, 293 F.2d at 916.

115 Id. at 917.

114 Id.

113 Id.
quently, the court found that adequate consideration did not mean the value received by the son, but rather the value of the amount removed from Mrs. Allen's gross estate. This amount encompassed the value of the trust corpus includible in her gross estate at the time of the transfer.

The *Gradow* court recognized that the factual situation in *Allen* was distinguishable from the factual situation before the court. The *Gradow* court concluded, however, that the two factual situations presented the same question: whether the consideration flowing from the taxpayer was solely the value of the transferred property interest or rather was the value of the trust corpus in which the taxpayer had an interest. The *Gradow* court concluded that in both instances, the property transferred was really the trust corpus.

The *Gradow* court missed the fundamental distinction between the factual situation before it and the factual situation addressed by the *Allen* court. When Mrs. Allen transferred the remainder interest to her children, she divided the trust corpus into two property interests. The only property interest she retained was the life estate or the right to an income stream. As long as Mrs. Allen retained that income stream, however, section 811 of the 1939 Code pulled the value of the remainder interest back into her gross estate. When Mrs. Allen transferred her retained life estate, she removed from her gross estate not only the value of the transferred property interest (the life estate), but also the value of the previously transferred property interest (the remainder). The sale of the retained life estate therefore depleted Mrs. Allen's gross estate by both the value of the life estate and the value of the remainder interest. Mrs. Allen needed to receive consideration equal to the value of the two property interests removed from her gross estate.

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111 Id. at 917-18.
112 Id. at 811.
in order to prevent depletion of her estate. At the time Mrs. Allen’s life estate was sold, the aggregate value of the two property interests removed from her gross estate equalled the value of the trust corpus includible in her gross estate.\textsuperscript{127} As a result, the only way Mrs. Allen could offset the depletion of her gross estate was to receive consideration equal to the value of the trust corpus includible in her gross estate.

In contrast, when a remainder interest is transferred, the taxpayer still has the right to the income stream that will be paid during the term of the trust. These payments will be included in the taxpayer’s gross estate and, thus, there is no need for the taxpayer to be compensated for the income stream because it is not removed from the taxpayer’s gross estate.\textsuperscript{128}

The crux of the holding in \textit{Allen} is that adequate consideration requires that the consideration received be sufficient to prevent depletion of the gross estate.\textsuperscript{129} Although the court in \textit{Gradow} recognized this issue, it erroneously concluded that the value removed from the gross estate by the transfer of a remainder interest is the value of the underlying property.\textsuperscript{130} Once it is established that the transfer of a remainder interest only depletes the gross estate by the actuarial value of the remainder interest,\textsuperscript{131} \textit{Allen} supports the proposition that adequate consideration for the sale of a remainder interest equals the actuarial value of the remainder interest. The conclusion in \textit{Allen} that adequate consideration for the sale of a retained life estate equals the value of the trust corpus includible in the gross estate derives from the special punitive nature of section 2035 of the Code (previously section 811 of the 1939 Code), and not from the proposition that the transfer of a split-interest removes the entire underlying property from the gross estate. Section 2035 of the Code exists to prevent circumvention of section 2036 of the Code.\textsuperscript{132} Without section 2035, a taxpayer may gratui-
tously transfer a remainder interest and then moments before his or her death, transfer the retained life estate, "thereby removing all of the property which he [or she] has enjoyed from his [or her] gross estate." 183

VI. THE SPECIAL VALUATION RULES: ASSURING ACCURACY

The sale of a remainder interest at its actuarial value does not deplete the taxpayer's gross estate, provided the remainder interest is accurately valued by the actuarial tables. Prior to the enactment of section 2702 of the Code, 184 the actuarial valuation of remainder interests was often inaccurate because the taxpayer manipulated the investment of the underlying property to circumvent the actuarial assumptions and to shift wealth, tax-free, to the remainderman. 185 To the extent that the remainder interest was undervalued, the taxpayer's gross estate was depleted by more than the value of the remainder interest. Consequently, the sale of a remainder interest depleted the gross estate even though the taxpayer received consideration equal to the value of the remainder interest. The special valuation rules have closed this loophole for purposes of the gift tax by sanctioning only those transfers of remainder interests where the opportunity for manipulation does not exist.

A. Manipulation to Defeat Actuarial Assumptions

If the taxpayer retains an income interest, the actuarial tables value the taxpayer's retained interest based on two assumptions. First, the tables assume that the underlying property generates an annual return equal to the table rate. 186 Second, the actuarial tables assume that the entire annual return of the underlying property is realized as current income. 187 In other words, the actuarial tables presume that the underlying property produces annual income payments equal to the fair market value of the underlying

184 See infra notes 158-60 and accompanying text.
185 See Boyle, supra note 8, 24 Ga. L. Rev. at 15.
186 See, e.g., Boyle, supra note 8, 24 Ga. L. Rev. at 3, 15.
property multiplied by the table rate of interest, and that such annual payments are paid to the taxpayer. The actuarial tables value the taxpayer’s retained interest by discounting the imputed income stream, using the table rate of interest as the discount factor, to its present value. Because the actuarial tables assume that all income is distributed to the taxpayer, the actuarial value of the remainder interest is premised on the conclusion that when the trust terminates, the remainderman receives the exact amount transferred to the trust. As a result, the actuarial value of the remainder interest equals the present value of the right to receive, at the termination of the trust, an amount equal to the value of the trust corpus at creation. When an income interest is retained, the actuarial tables fail to take into account the possibility that some, or all, of the return generated by the underlying property may be realized as appreciation rather than as current income.

If the underlying property is invested so that some of the annual return is realized as appreciation, rather than current income, the income stream paid to the taxpayer is less than the amount imputed by the actuarial tables. Likewise, the value of the retained interest is less than the value assigned by the actuarial tables. More importantly, some of the income, which the actuarial tables assume the taxpayer retains, is paid to the remainderman upon termination of the trust. Instead of receiving an amount equal to the value of the property transferred to the trust at creation, the remainderman receives this amount, plus some of the income (appreciation) realized during the term, as well as interest on the appreciation. Consequently, not only has the value of the income interest been overstated, but there has also been a concomitant understatement of the remainder interest. The taxpayer’s gross estate is thereby depleted by the sale of the remainder interest, even though the taxpayer receives consideration equal to the actuarial

138 See, e.g., Boyle, supra note 8, 24 Ga. L. Rev. at 15.
139 See, e.g., Gans, supra note 3, 11 Va. Tax Rev. at 776.
140 See, e.g., Boyle, supra note 8, 24 Ga. L. Rev. at 15.
141 See, e.g., Gans, supra note 3, 11 Va. Tax Rev. at 776-77.
142 See, e.g., Boyle, supra note 8, 24 Ga. L. Rev. at 16.
143 Id.
144 Id.
145 Id.
146 See, e.g., Boyle, supra note 8, 24 Ga. L. Rev. at 16.
value of the remainder interest. Consideration equal to the actuarial value of the remainder interest only creates a substitute equal to the actuarial value of the remainder interest. If the transfer of the remainder interest depletes the gross estate by more than the actuarial value of the remainder interest, consideration equal to the actuarial value of the remainder interest does not fill the void, even if the consideration is invested and compounded at the table rate of interest.

Returning to the example in which Parent transfers property having a current value of $500,000 to a trust, while retaining a ten-year term interest and selling the remainder to Child for its actuarial value, assume that Parent retains an income interest rather than an annuity interest. Based on a table rate of ten percent, the actuarial tables value the income interest by assuming that the underlying property is invested in such a manner as to generate income of $50,000 a year and that the entire $50,000 is paid to Parent each year. Consequently, the actuarial tables assume that Parent receives ten annual payments of $50,000. Based on this assumption, the actuarial value of Parent’s income interest is $307,228, the present value of ten annual payments of $50,000, discounted at ten percent. The actuarial tables assume that all appreciation is realized as income. Thus, the actuarial tables assume that Child receives $500,000 upon the termination of ten years. Using the table rate of ten percent as the discount factor, this amount is assigned an actuarial value of $192,772, the present value of Child’s remainder interest in the right to receive $500,000 in ten years. If Parent sells the remainder interest for $192,772 and invests the proceeds at ten percent, the table rate of interest, compounded annually, Parent will have a substitute fund of $500,000 at the end of the ten-year period.

As discussed previously, the substitute fund prevents Parent’s gross estate from being depleted because only $500,000 is removed from Parent’s gross estate as a result of the transfer of the remainder interest. If the trust corpus, however, generates an annual re-

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147 See supra notes 87-103 and accompanying text.
149 Table B, I.R.S. Notice 89-60, 1989-1 C.B. at 708.
150 See supra note 102 and accompanying text.
turn of ten percent, but only one-half of it is realized as income and the rest is realized as appreciation, the transfer of the remainder interest diminishes Parent's gross estate by $814,447.\footnote{111} Thus, a substitute fund of $500,000 is insufficient. Comparing the value that is included in Parent's gross estate if Parent retains the property to the value included in Parent's gross estate from the retained income interest proves that Parent's gross estate is depleted by $814,447. If Parent retains the $500,000 for ten years, Parent's gross estate includes $1,236,871, assuming appreciation of ten percent a year.\footnote{112} If Parent transfers the property subject to a retained income interest and, then, only receives one-half of the annual appreciation, the amount included in Parent's gross estate is $482,424, assuming the income payments are invested and compounded at ten percent.\footnote{113} The difference, $814,447, is the amount

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|}
\hline
\textbf{Year} & \textbf{Annual Return} & \textbf{Amount Paid to Parent} & \textbf{Value of Trust Corpus} \\
\hline
1 & 50,000 & 25,000 & 525,000 \\
2 & 52,500 & 26,250 & 551,250 \\
3 & 55,125 & 27,562 & 578,813 \\
4 & 57,881 & 28,941 & 607,753 \\
5 & 60,775 & 30,388 & 638,140 \\
6 & 63,814 & 31,927 & 670,047 \\
7 & 67,005 & 33,502 & 703,550 \\
8 & 70,355 & 35,178 & 738,727 \\
9 & 73,873 & 36,936 & 775,664 \\
10 & 77,566 & 38,783 & 814,447 \\
\hline
\end{tabular}
\caption{Example Table}
\end{table}

\footnote{111} If the annual return of the trust is ten percent and one-half of the return is realized as appreciation, $814,447 passes to Child at termination of the trust. This is calculated as follows:

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|}
\hline
\textbf{Year} & \textbf{Annual Payment} & \textbf{Interest} & \textbf{Principal Balance} \\
\hline
1 & 25,000 & & 25,000 \\
2 & 26,250 & 2,500 & 53,750 \\
3 & 27,562 & 5,375 & 86,687 \\
4 & 28,941 & 8,669 & 124,297 \\
5 & 30,388 & 12,430 & 167,115 \\
6 & 31,927 & 16,711 & 215,733 \\
7 & 33,502 & 21,573 & 270,868 \\
8 & 35,178 & 27,081 & 333,067 \\
9 & 36,936 & 33,307 & 403,310 \\
10 & 38,783 & 40,331 & 482,424 \\
\hline
\end{tabular}
\caption{Example Table}
\end{table}

\footnote{112} See supra note 81 and accompanying text.

\footnote{113} The amount included in Parent's gross estate, assuming an annual interest rate of ten percent, is calculated as follows:

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|}
\hline
\textbf{Year} & \textbf{Annual Payment} & \textbf{Interest} & \textbf{Principal Balance} \\
\hline
1 & 25,000 & & 25,000 \\
2 & 26,250 & 2,500 & 53,750 \\
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8 & 35,178 & 27,081 & 333,067 \\
9 & 36,936 & 33,307 & 403,310 \\
10 & 38,783 & 40,331 & 482,424 \\
\hline
\end{tabular}
\caption{Example Table}
\end{table}

See supra note 151 for the calculation of the annual payments.
transferred to Child and removed from Parent's gross estate.

Under prior law, taxpayers could manipulate the investment of the underlying property to take advantage of the actuarial assumptions and understate the value of the property removed from the taxpayer's gross estate by the transfer of a remainder interest. Generally, this understatement was accomplished by one of two methods. First, taxpayers would time the transfer of the remainder interest so that the table rate used to value the retained interest exceeded the market rate of interest. To the extent that the table rate exceeded the current market yield, the actuarial tables automatically imputed an overstated income stream to the taxpayer. Second, taxpayers would invest the trust corpus in such a manner that it generated capital appreciation rather than current income. These two strategies, used individually or more typically together, understated the value of the property removed from the taxpayer's gross estate as a result of the transfer of a remainder interest.

B. Preventing Manipulation: Section 2702

Section 2702 of the Code was enacted to ensure more accurate
valuation of remainder interests and other split-interests. As a general rule, the value of a transferred remainder interest equals its actuarial value. Remainder interests transferred after October 8, 1990, “to (or for the benefit of) a member of the taxpayer’s family” must be valued for gift tax purposes using the special valuation rules of section 2702 of the Code. These rules preclude manipulating the actuarial assumptions to understate the value of a transferred remainder interest.

Under the special valuation rules of section 2702 of the Code, the value of the remainder interest depends upon the nature of the interest retained by the taxpayer and the nature of the underlying property. Unless the transfer qualifies for one of the narrowly prescribed exceptions to the general rule, the value of the remainder interest equals the value of the underlying property. The transfer of a remainder interest is excepted from the general rule of section 2702 of the Code if the taxpayer retains a qualified interest or if the underlying property is the taxpayer’s personal residence. If the transfer of the remainder interest falls within one of these two exceptions, the value of the remainder interest

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119 Treas. Reg. § 25.2512-5(a)(1)(i). The fair market value of a transferred remainder interest equals the fair market value of the underlying asset less the actuarial value of the interest or interests retained by the transferor. Id. When the underlying property is divided into two equitable interests: a retained interest and a remainder interest, as assumed by this article, the value of the underlying property less the actuarial value of the retained interest always equals the actuarial value of the remainder interest.

120 I.R.C. § 2702(a). The members of a transferor’s family include the transferor’s spouse, any ancestor or lineal descendant or spouse of an ancestor or lineal descendant of either the transferor or the transferor’s spouse, and the transferor’s brothers and sisters and their spouses. I.R.C. §§ 2702(c), 2704(c)(2).

121 I.R.C. § 2702.

122 I.R.C. § 2702(a). The general rule of § 2702 of the Code artificially sets the value of the retained interest at zero. I.R.C. § 2702(a)(2)(A). Because the value of a transferred remainder interest equals the value of the underlying asset less the value of the interest retained by the transferor, the effect of the general rule is to make the value of the remainder interest equal to the value of the underlying asset. Treas. Reg. § 25.2512-5(a)(1)(i).


124 I.R.C. § 2702(a)(3)(ii). Although § 2702 of the Code exempts all split-interests in the taxpayer’s personal residence, the Treasury Regulations (“Regulations”) take the position that the transfer of a split-interest in a personal residence is only excepted from § 2702 of the Code if the transfer is effectuated using either a personal residence trust or a qualified personal residence trust. I.R.C. § 2702(a)(3)(A)(ii); Treas. Reg. § 25.2702-5(a). See infra notes 198-200 and accompanying text.
eral rule treats the transfer of a remainder interest as if the taxpayer transfers the entire property to the remainderman and only delays the time that the remainderman takes possession of the property. Consequently, if the taxpayer structures the transfer of a remainder interest so that the taxpayer may manipulate the investment of the underlying property to yield less income to the taxpayer than is expected, the taxpayer is taxed as if the property were transferred outright. 168

D. Qualified Interests

The primary exception to the general rule of section 2702 of the Code is the retention of qualified interests. 169 If the taxpayer retains either a qualified annuity interest 170 or a qualified unitrust interest, 171 the value of the remainder interest is its actuarial value. 172 A qualified annuity interest is the irrevocable right to receive a fixed amount, payable at least annually. 173 The fixed amount may be defined in terms of a stated dollar amount or a fixed percentage of the initial fair market value of the underlying property. 174 A qualified unitrust interest is the irrevocable right to receive periodic payments, payable at least annually and calculated by reference to a fixed percentage of the annual fair market value.
of the underlying property.\textsuperscript{176}

When the taxpayer retains a qualified interest, the actuarial tables still use the residual method to determine the value of the remainder interest. The nature of the retained qualified interest, however, prevents manipulation of the actuarial assumptions to understate the value of the transferred remainder interest.\textsuperscript{178} Both a qualified annuity interest and a qualified unitrust interest guarantee that the taxpayer receives an established payout.\textsuperscript{177} The actuarial tables value the taxpayer's retained qualified interest by reference to the established payout,\textsuperscript{178} and not by reference to the income generated by the property. As a result, the underlying property cannot be invested to shift to the remainderman some of the income that the actuarial tables imputed to the taxpayer in order to value the retained interest. Nor can the investment of the underlying property be manipulated so as to cause the taxpayer's gross estate to include less than the amount projected by the actuarial tables. Therefore, the opportunity to manipulate the investment of the underlying property so that the actuarial tables overstate the value of the retained interest and understate the value of the remainder interest is foreclosed.\textsuperscript{179} As long as the taxpayer receives consideration equal to the actuarial value of the remainder interest, the gross estate is not depleted.

A qualified annuity interest is never affected by the investment performance of the underlying property or by changes in the value of the underlying property because it consists of fixed, annual payments. The actual payout for a qualified annuity interest may be determined at the time the interest is created. The actuarial tables do not need, then, to impute a payout based on the table rate. Instead, the actuarial tables use the actual payout as the income stream.\textsuperscript{180} The actuarial tables, using the table rate as the discount factor, value the annuity interest by discounting the actual payout.\textsuperscript{181}

\begin{itemize}
\item \textsuperscript{176} I.R.C. § 2702(b)(2); Treas. Reg. § 25.2702-3(c)(1)(i).
\item \textsuperscript{177} See, e.g., Boyle, supra note 8, 24 Ga. L. Rev. at 34.
\item \textsuperscript{178} I.R.C. §§ 2702(b)(1), (2). Payment of the fixed amount must be assured because a right of withdrawal is insufficient. Treas. Reg. §§ 25.2702-3(b)(1), (c)(1).
\item \textsuperscript{179} See, e.g., Boyle, supra note 8, 24 Ga. L. Rev. at 34.
\item \textsuperscript{180} Id.
\item \textsuperscript{181} Id.
\end{itemize}

The actuarial tables provide a factor for valuing an annuity interest paying a constant
For example, assume that Parent transfers $500,000 to a ten-year trust, retaining an annuity of $40,000 a year with the remainder over to Child. Assuming a table rate of ten percent, the actuarial value of Parent's annuity is $245,783, which equals the present value, discounted at ten percent, of the ten annual $40,000 payments that Parent will receive during the term of the trust.\textsuperscript{182} The actuarial value of the remainder interest is $254,217, which equals the present value of the right to receive a principal sum of $659,375 in ten years.\textsuperscript{188} Although Child may receive more or less than $659,375, depending upon the investment performance of the underlying property, any deviation only represents a variance in the post-gift appreciation of the remainder. There is no way to shift to Child some of the annuity income retained by Parent.

A qualified unitrust interest pays the taxpayer a portion of the underlying trust corpus. As a result, the payout to the taxpayer is affected to a certain extent by both the income generated by, and fluctuations in the value of, the underlying property. The underlying property may not be invested in such a manner that the portion of the trust corpus retained by the taxpayer is shifted to the remainderman. Because the taxpayer always receives a fixed percentage of the annual value of the underlying property, investing amount throughout its term. The Service has to publish formulae for discounting annuities when the payment varies.\textsuperscript{184} Table B, Notice 89-60, 1989-1 C.B. 700, 708; Notice 89-24, 1989-1 C.B. 680.\textsuperscript{186} Id. The actuarial tables calculate the amount that is paid to Child upon termination of the trust by assuming that the property appreciates at the table rate of interest, ten percent, and that Child receives the amount originally transferred to the trust plus the appreciation, less the amount necessary to fund the annuity. Whenever the annual return exceeds the annuity payment, as here, some of the appreciation is attributed to the remainder interest. Thus, the remainder interest appreciates at a rate equal to the annual appreciation imputed by the tables, less the annual annuity payment. Following the actuarial tables, Child receives $659,375. This figure is calculated as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Appreciation</th>
<th>Annuity</th>
<th>Value of Corpus</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>50,000</td>
<td>40,000</td>
<td>510,000</td>
</tr>
<tr>
<td>2</td>
<td>51,000</td>
<td>40,000</td>
<td>521,000</td>
</tr>
<tr>
<td>3</td>
<td>52,100</td>
<td>40,000</td>
<td>533,100</td>
</tr>
<tr>
<td>4</td>
<td>53,310</td>
<td>40,000</td>
<td>546,410</td>
</tr>
<tr>
<td>5</td>
<td>54,641</td>
<td>40,000</td>
<td>561,051</td>
</tr>
<tr>
<td>6</td>
<td>56,105</td>
<td>40,000</td>
<td>577,156</td>
</tr>
<tr>
<td>7</td>
<td>57,716</td>
<td>40,000</td>
<td>594,872</td>
</tr>
<tr>
<td>8</td>
<td>59,487</td>
<td>40,000</td>
<td>614,359</td>
</tr>
<tr>
<td>9</td>
<td>61,438</td>
<td>40,000</td>
<td>635,795</td>
</tr>
<tr>
<td>10</td>
<td>63,580</td>
<td>40,000</td>
<td>659,375</td>
</tr>
</tbody>
</table>
the property to maximize the return to the remainderman also maximizes the return to the taxpayer. Likewise, an attempt to minimize the return to the taxpayer minimizes the return to the remainderman. There is no way to shift appreciation from the taxpayer to the remainderman.

A unitrust interest is valued based on the amount of the payout and the term of the interest—either a set term of years or the actuarial life expectancy of the measuring life. Ostensibly, the tables value a unitrust interest solely by reference to the term of the interest and the amount of the payout. In point of fact, the tables are "interest-rate-sensitive". The actuarial tables assume that the underlying property appreciates at a set rate of interest and that the amount paid out to the taxpayer increases to reflect the increased value of the underlying property. The actuarial tables assume that the value of the underlying property increases each year by an amount equal to the interest rate, less the payout amount. The tables calculate the annual payout amount by multiplying the predicted value of the underlying property by the unitrust percentage. To value the unitrust interest, the actuarial tables, using the interest rate as the discount factor, determine the present value of each annual payment as of the time of creation of the trust.

Assume, for example, that Parent transfers $500,000 to a trust, retaining a ten-year qualified unitrust interest that pays Parent eight percent of the annual fair market value of the trust corpus. Assume under section 7520 of the Code the interest rate is ten percent. Consequently, the actuarial value of Parent’s unitrust interest is $265,008 and the actuarial value of the remainder interest

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184 Treas. Reg. § 1.664-4. Although this Regulation refers to the present value calculation of a charitable remainder unitrust interest, the calculation is the same for remainder unitrust interests generally.
185 See, e.g., Boyle, supra note 8, 24 Ga. L. Rev. at 34.
186 Id. at 35.
187 Id. at 37. The set rate of interest is determined by reference to § 7520 of the Code and changes monthly.
188 See, e.g., Boyle, supra note 8, 24 Ga. L. Rev. at 35-38.
189 Id. at 35-36.
190 Id.
191 Id.
192 Table D, Treas Reg. § 1.664-4(e)(6). The applicable rate of interest under § 7520 of the Code changes monthly and, thus, the rate of interest varies from month to month.
is $234,992. The actuarial tables determine these values by first assuming that the trust corpus appreciates at ten percent, according to section 7520 of the Code, and using this assumed appreciation to project the amount that is paid out to the taxpayer. Based on these assumptions, the actuarial tables determine the value of the taxpayer’s retained interest by discounting each projected annual payment at the section 7520 table rate of interest. Because the amount of the unitrust payout adjusts to take into account any variation between the actual value of the trust corpus and the value assumed by the actuarial tables, the actuarial value of the taxpayer’s retained interest and of the remainder interest should remain reasonably accurate regardless of the actual investment performance of the trust corpus. The nature of a unitrust interest and the methodology employed by the actuarial tables to value unitrust interests are self-adjusting to prevent distortion.

**E. Personal Residence**

The second exception to the general rule applies to a transfer of a remainder interest in the taxpayer’s personal residence. To

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188 Table D, Treas. Reg. 1.664-4(e)(6).
189 See, e.g., Boyle, supra note 8, 24 Ga. L. Rev. at 34-38.
190 Id. In this example, the actuarial tables assume the following appreciation and payout to the taxpayer.

<table>
<thead>
<tr>
<th>Year</th>
<th>Appreciation</th>
<th>Payout</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>50,000</td>
<td>40,000</td>
<td>510,000</td>
</tr>
<tr>
<td>2</td>
<td>51,000</td>
<td>40,800</td>
<td>520,200</td>
</tr>
<tr>
<td>3</td>
<td>52,020</td>
<td>41,616</td>
<td>530,604</td>
</tr>
<tr>
<td>4</td>
<td>53,060</td>
<td>42,448</td>
<td>541,216</td>
</tr>
<tr>
<td>5</td>
<td>54,127</td>
<td>43,297</td>
<td>552,041</td>
</tr>
<tr>
<td>6</td>
<td>55,204</td>
<td>44,163</td>
<td>563,082</td>
</tr>
<tr>
<td>7</td>
<td>56,308</td>
<td>45,046</td>
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<td>8</td>
<td>57,434</td>
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<tr>
<td>9</td>
<td>58,583</td>
<td>46,866</td>
<td>597,548</td>
</tr>
<tr>
<td>10</td>
<td>59,755</td>
<td>47,804</td>
<td>609,499</td>
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</table>

The present value of the right to receive $609,499 in ten years, using ten percent as the discount factor, is $234,988, which (except for a rounding error of four dollars) is the actuarial value of the remainder interest. Similarly, the present value of the payout stream, if discounted at ten percent, is $265,012, which equals the actuarial value of the taxpayer’s retained interest after taking into account the four dollar rounding error.

191 See, e.g., Boyle, supra note 8, 24 Ga. L. Rev. at 40.
192 Id.
193 I.R.C. § 2702(a)(3)(A)(ii). Strictly construed, the statute exempts any transfer of a
qualify for this exception, the transfer of the remainder interest must be effectuated by a personal residence trust, which includes a qualified personal residence trust. If a taxpayer uses a personal residence trust to transfer a remainder interest in his or her personal residence, the value of the retained interest is its actuarial value.

The special valuation rules value a retained interest in the taxpayer’s personal residence using actuarial methods, even though the taxpayer does not receive a guaranteed payout. A guaranteed payout is not required for a personal residence trust, since the value of the retained interest derives from the use of the personal residence, not from income payments. Because the holder of the retained interest is saved the expense of renting the personal residence, it is misleading to view the taxpayer as not receiving any payments from the retained interest. A more appropriate characterization is to view the taxpayer as receiving deemed payments equal to the annual rental value of the residence, and then expending those payments on rent.

The actuarial tables value a retained interest in a personal residence using the same methodology for valuing an income interest.

remainder interest in the transferee’s personal residence from the scope of § 2702 of the Code without limiting the number of personal residences the transferee may have or the form of the transfer. The Regulations, however, limit the number of personal residences that may qualify for this exemption and place severe restrictions on the terms of the transfer. See Treas. Reg. §§ 25.2702-5(b)(2), (b)(3), (c)(2). These restrictions, as well as the restrictions placed on personal residence trusts and qualified personal residence trusts, are designed to prevent a transferor from using the personal residence exception to circumvent the general rule. Without these restrictions, a taxpayer could transfer a remainder interest in a personal residence, use the actuarial rules to value the remainder interest, and sell the underlying property and invest it so that the transfer would fall under the general rule if accomplished directly.

The primary distinctions between a personal residence trust and a qualified personal residence trust relate to the amount of cash the trust may hold and whether the trust may sell the personal residence that it holds. See infra notes 206-07 and accompanying text. In addition, the transfer of a remainder interest, even if effectuated by a personal residence trust or qualified personal residence trust, does not qualify for the exception if the transferor already has an interest in two personal residence trusts or qualified personal residence trusts. Treas. Reg. § 25.2702-5(a). A personal residence trust and a qualified personal residence trust may hold only one personal residence to be used by the transferor or by the transferor and spouse. See Treas. Reg. §§ 25.2702-5(b)(1), (c)(1). The Regulations place substantial restrictions on how a residence held by a personal residence trust or qualified personal residence trust may be used. Treas. Reg. §§ 25.2702-5(b)(2)(iii), (c)(2)(iii).

The actuarial tables assume that the taxpayer is paid an income stream equal to the annual return earned by the property, which the tables assume equals the table rate of interest. The assumed income stream is then discounted at the table rate of interest to determine the value of the retained interest.\footnote{See supra notes 136-40 and accompanying text.} To the extent that the rental value of the personal residence does not equal the table rate, the income stream assumed by the actuarial table exceeds the deemed payments made to the taxpayer and the actuarial value of the retained interest is greater than the actual value. This difference, however, is not one that the taxpayer may manipulate to favor the remainderman. The difference occurs as a natural function of the rental market whenever the rate of return generated by the rental value of the residence is less than the table rate.\footnote{This difference should not be viewed any differently than differences in valuation resulting from discrepancies between the interest rate in § 7520 of the Code and the prevailing market rate.}

Although the actual value of a remainder interest in a personal residence trust may deviate from its actuarial value, there are several policy reasons for ignoring this difference. First, Congress has indicated an acceptance of a de minimis difference between the market rate and the table rate.\footnote{Section 7520 sets the table rate of interest at 120 percent of the market rate. Because the actuarial assumptions require an after tax return equal to the table rate, the table rate established by § 7520 of the Code may be unrealistically high, and as a result, creates a de minimis depletion of the transferor's gross estate. See, e.g., Boyle, supra note 8, 24 Ga. L. Rev. at 22.} Second, Congress has expressed an intent to sanction transfers of split-interests in personal residences because the opportunity for abuse is so small.\footnote{Congress excepted the transfer of a remainder interest in a personal residence from the rules that require split charitable gifts to be in trust with a guaranteed payout to the non-charitable beneficiary. I.R.C. § 170(f)(3)(B)(i). Congress also excluded transfers of remainder interests in personal residence from former § 2036(c) of the Code by limiting its application to the transfer of an interest in an "enterprise". I.R.C. § 2036(c)(1), repealed by the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101- 508, 104 Stat. 1398-490 (1990).} Third, the difference is caused by forces beyond the taxpayer's control. The taxpayer does not have the opportunity to manipulate the investment of the trust corpus and deplete the gross estate. Lastly, the Treasury Regulations ensure that any difference between the actual value of the remainder interest and its actuarial value will remain de minimis and beyond the taxpayer's command.
nally, if the trust acquires any assets other than the personal resi-

dence as a result of the sale or conversion, unless these assets are

invested in the personal residence, they must be distributed to the
taxpayer.  

F. Adequate and Full Consideration and Section 2702  

A taxpayer who transfers a remainder interest can no longer ma-
nipulate the investment of the property to distort the value of the
remainder interest and to shift property to the remainderman free
of the gift tax as he or she was able to do before the enactment of
section 2702 of the Code. Whenever the relationship between the
taxpayer and the remainderman is such that the taxpayer may be
motivated to shift wealth to the remainderman, section 2702 of the
Code applies and requires the taxpayer to structure the transaction
so that the amount the actuarial tables assume the taxpayer re-
tains and the amount the taxpayer actually receives are
comparable.

The actuarial tables accomplish this by requiring the taxpayer to
choose one of three structures—a qualified annuity interest, a
qualified unitrust interest, or a personal residence trust. A quali-
fied annuity interest guarantees the taxpayer an established pay-
out without regard to the income produced by the underlying
property. A qualified unitrust interest pays the taxpayer an estab-
ishied amount. Although this amount varies with the value of
the underlying property, it is by its nature self-adjusting and, thus,
prevents the taxpayer from shifting wealth to the remainder-
man. A personal residence trust insures that the taxpayer re-
ceives value from the retained interest in the form of enjoyment of
the property. The personal residence trust also insures that any
deviation from the actual value of the retained interest is de
minimis.

If the taxpayer fails to structure the transaction to conform to
one of these three arrangements, section 2702 of the Code requires
the taxpayer to treat the transfer as equivalent to a transfer of the

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Treas. Reg. § 25.2702-5(c)(7)(ii). The Regulations prohibit using the trust to shift as-
sets to the remainderman. Thus, trust assets may not be distributed to anyone other than
the taxpayer during the term of the retained interest. Treas. Reg. § 25.2702-5(c)(4).

See, e.g., Boyle, supra note 8, 24 Ga. L. Rev. at 40.

Id.
entire property. The effect of this section is to limit sales of remainder interests at fair market value to nonabusive situations or subject the value of the retained interest to the gift tax. As a result, section 2702 of the Code insures that consideration equal to the gift tax value of the remainder interest always fully replenishes the taxpayer's gross estate.

Even though section 2702 of the Code states that its valuation rules are to apply solely for purposes of determining whether the transfer of a remainder interest results in a gift, the valuation rules are equally applicable to section 2036(a) of the Code and should be so applied. If a transfer may deplete the gross estate for gift tax purposes, it has equal potential to deplete the gross estate for estate tax purposes. Similarly, a transfer that cannot deplete the gross estate for gift tax purposes, also cannot deplete the gross estate for estate tax purposes. A taxpayer who sells a remainder interest for its gift tax value has received sufficient consideration to prevent depletion of the gross estate. This principle holds true in either of two scenarios. In the first scenario, the taxpayer survives the retained interest and is therefore concerned only with the application of the gift tax. In the second, the taxpayer dies prior to the expiration of the retained interest and must therefore consider both the gift tax and the estate tax. Consequently, consideration equal to the gift tax value of a remainder interest is adequate and full consideration for purposes of both the gift tax and the estate tax under section 2036(a) of the Code. This is true regardless of whether the gift tax value of the remainder interest is its actuarial value or the value of the underlying property.

VII. THE BONA FIDE SALE: THE ADDITIONAL REQUIREMENT FOR ESTATE TAX PURPOSES

Although adequate and full consideration should be given the
same meaning for both the gift tax and estate tax, the sale of a remainder interest for adequate consideration may escape the gift tax and yet be subject to the estate tax. Unlike the gift tax, which exempts all transfers for adequate and full consideration from the tax, section 2036(a) of the Code only excuses those transfers for adequate and full consideration that qualify as bona fide sales. The bona fide sale requirement is consistent with the intent of section 2036(a) of the Code to tax inter vivos transfers that are testamentary in nature. If property is transferred in a transaction that is donative in character and the taxpayer retains the benefits of the property until death, the property is included in the taxpayer's gross estate even though adequate consideration was received for the remainder interest. While it may be the case that the consideration received in a non-arm's length transfer is sufficient to prevent depletion of the taxpayer's gross estate, the donative character of the transaction combined with the taxpayer's retention of an interest in the property is nevertheless sufficient to make the transfer testamentary in nature. Therefore, the most appropriate result is to include the property in the taxpayer's gross

circumvent the transfer tax law, the taxpayer will take advantage of it. The approach of § 2702 of the Code is necessary for purposes of the gift tax because the gift tax applies at the time of the sale of the remainder interest, and unless the opportunity to circumvent the tax is foreclosed at this time, taxpayers will be able to circumvent the gift tax system and the government will have no recourse except in those instances where the transaction also falls within the scope of the estate tax.

For purposes of § 2036(a) of the Code, however, hindsight is available. The question of whether or not § 2036(a) of the Code applies may be answered at the taxpayer's death. As of this date, it is possible to look back and determine whether the investment of the underlying property was manipulated so that the remainder interest was undervalued. If the taxpayer is able to prove that there was no manipulation and that the taxpayer received income equivalent to that imputed by the actuarial tables, the sale should be considered to have been made for adequate consideration for purposes of § 2036(a) of the Code. This is so even though the transfer was subject to the gift tax, because § 2702 of the Code established the value of the remainder interest as the value of the underlying asset. Consequently, the valuation rules of § 2702 of the Code provide a safe harbor definition of adequate consideration for purposes of § 2036(a) of the Code, rather than the absolute definition they establish for purposes of the gift tax. Taxpayers, however, are unlikely to structure sales of remainder interests so that they fall into the general rule of § 2702 of the Code, due to the onus of paying double tax on the retained interest.

\textsuperscript{114} I.R.C. § 2512.

\textsuperscript{115} I.R.C. § 2036(a).

estate.

A. Bona Fide Sales and Arm's Length Transactions

Not all transfers for adequate consideration are exempted from the estate tax. Only bona fide sales may be exempted. Inherent in the concept of a bona fide sale is an arm's length exchange. In such an exchange, both parties seek to receive value equal to that which they surrender. Because value is a relative concept, however, it cannot always be ascertained with certainty and the same property may have different value to different people.

The gift tax recognizes the peculiar nature of value. An arm's length bona fide sale or exchange that is free from donative intent is considered to be made for adequate consideration for purposes of the gift tax.

An arm's length, bona fide sale or exchange that is free from donative intent is also a bona fide sale for adequate consideration for purposes of section 2036(a) of the Code. In Estate of Friedman v. Commissioner, Mr. and Mrs. Friedman owned certain real property as tenants by the entireties. Mr. Friedman died, leaving a will that devised the real property to a trust with the income to Mrs. Friedman for life and the remainder to his children from a previous marriage. Because Mr. Friedman did not own a devisable interest in the real estate, his will put Mrs. Friedman to an election. She could transfer the property to the trust and accept the benefits under the will or she could keep the property outright, receiving her husband's interest in the property by operation of law. Mrs. Friedman elected not to take under her husband's will. Her stepchildren hired legal counsel and challenged Mrs. Friedman's election. To forestall litigation, Mrs. Friedman and the stepchildren negotiated a settlement in which the stepchildren re-

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117 "The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." Treas. Reg. § 25.2512-1.
120 Id. at 714.
121 Id. at 715.
122 Id.
124 Id. at 716.
linquished any claims they might have had to Mr. Friedman's estate and Mrs. Friedman transferred one-half of the real estate to the stepchildren in a trust, retaining a life estate for herself. The issue raised in Friedman was whether the property transferred to the stepchildren in the trust was pulled back into Mrs. Friedman's gross estate as a transfer in contemplation of death or excluded because the transfer was for adequate and full consideration. Because the settlement was arm's length and made in the belief that it was "advantageous economically," the transfer of the remainder interest to the stepchildren was for adequate and full consideration for purposes of both the gift tax and the estate tax. The court did not even find it necessary to inquire into the relative values of the properties exchanged.

United States v. Past appears to find in the alternative, and rejects the conclusion of Friedman. The court in Past holds that for purposes of section 2036(a) of the Code, a transfer pursuant to a property settlement is not, as a matter of law, made for adequate and full consideration. Instead, the relative values of the properties exchanged must be compared to determine whether adequate and full consideration is received. An analysis of the facts in Past, however, demonstrates that the exchange was not bona fide and free from donative intent. As a result, Past is distinguishable from Friedman and stands for the proposition that if donative intent is present, the exchange is not arm's length and, therefore, not presumptively for full and adequate consideration.

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In *Past*, a husband and wife divided their community property as part of a divorce settlement. Because the wife was an alcoholic, the husband insisted that the majority of the property transferred to the wife be held in a trust, with income to the wife for life and the remainder to the couple's children. The issue was whether the portion of the trust contributed by the wife was included in her gross estate by section 2036(a) of the Code or excluded because the transfer to the trust was for adequate consideration. Despite the fact that the transfers were pursuant to a property settlement, the court found that the transaction was not free from donative intent. Although the division of the property may have been at arm's length as between the spouses, the transfer of the remainder interest to the children was in the nature of a gift.

### B. Bona Fide Sales and Widow's Election Wills

Although the *Gradow* court misconstrued the definition of adequate and full consideration, the court's conclusion that Mrs. Gradow's community share was pulled back into her gross estate by section 2036(a) of the Code was correct. The court's reasoning, however, was in error. Regardless of whether Mrs. Gradow received adequate and full consideration, section 2036(a) of the Code requires that the value of her community share be pulled back into underlying property. *Gradow v. United States*, 11 Cl. Ct. 808, 811 (1987), aff'd, 897 F.2d 516 (Fed. Cir. 1990). *Past* did not really support this conclusion because *Past* misconstrued § 2036(a) of the Code, just as the *Gradow* court did. After determining that donative intent was present, the *Past* court, relying on *Estate of Gregory*, held that the relative values of the properties exchanged had to be compared to determine whether adequate consideration was received. *Past*, 347 F.2d at 12, citing *Estate of Gregory v. Commissioner*, 39 T.C. 1012, 1012 (1963). The court in *Past* compared the relative values of the properties exchanged and concluded that the consideration was insufficient. 347 F.2d at 13-14. The relative values of the properties exchanged, however, were irrelevant. As soon as the court decided that donative intent was present, the exchange could not qualify as an arm's length, bona fide transaction and § 2036(a) of the Code applied.

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her gross estate because the exchange involved donative intent and was not a bona fide sale.

Transfers pursuant to widow's election wills exemplify transfers that (regardless of the consideration received) are testamentary in nature and, therefore, subject to section 2036(a) of the Code. The Gradow court distinguished the hypothetical sale of a remainder interest from the transfer pursuant to a widow's election will by stating that the former was not testamentary in nature while the latter transfer was. The exchange under a widow's election will is not exempt from section 2036(a) of the Code simply because at the moment of the first spouse's death, the value of a life estate in the deceased spouse's property happens to equal or exceed the value of the remainder interest transferred by the widow. Regardless of the value given or received by the widow, there is no element of a bona fide sale in the widow's election to take under her husband's will. As the Gradow court recognized, the net result is to provide for the widow's economic future and to pass the property to the next generation. The exchange is merely a device to accomplish the estate planning goals of a husband and wife. There is no attempt to equalize the values exchanged.

First, although the surviving spouse has the opportunity to compare values, the deceased spouse agrees at the time that he writes his will to exchange a life estate in his property for his widow's remainder interest in her community share. At the time that he agrees to the exchange, the deceased spouse is unaware of the value of the property he will receive relative to the value of the property he will relinquish. Second, quite often the spouses have reciprocal wills and only fate determines which spouse will be transferring a remainder interest in exchange for a life estate in the deceased spouse's community share. Third, although it is arguable that the surviving spouse will not make the election unless it is economically favorable to her, the spouses frequently agree that this is the best plan to carry out their estate planning wishes.

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See Ralph G. Miller, Jr. & Philip P. Martin, Jr., Voluntary Widow's Election: Nationwide Planning for the Million Dollar Estate, 1 Cal. W. L. Rev. 63, 72 (1985); Morrison, supra note 8, 44 Tex. L. Rev. at 223.

1141 See, e.g., Johanson, supra note 30, 47 Tex. L. Rev. at 1286.

In Estate of Gregory v. Commissioner, Mrs. Gregory even signed the election to take
exempted from section 2036(a) of the Code.

VIII. Conclusion

For purposes of both the gift tax and the estate tax, adequate and full consideration requires the seller of a remainder interest to receive sufficient consideration to prevent depletion of the gross estate. If the gross estate is depleted, the sale of a remainder interest has both gift tax consequences and, if the seller holds the retained interest until death, estate tax consequences.

In an arm's length transaction, consideration equal to the actuarial value of the remainder interest prevents depletion of the gross estate. When the remainder interest is sold to a family member, the seller may be motivated to shift wealth to the remainderman tax-free. Section 2702 of the Code prevents this result by redefining adequate consideration for purposes of the gift tax to equal the value of the underlying property in those situations where the taxpayer has the ability to circumvent the gift tax. Because the seller is similarly motivated to shift wealth without the imposition of the estate tax whenever the remainderman is a family member, the only way to ensure that the seller's gross estate is not depleted is to require the seller to receive consideration equal to the gift tax value of the remainder interest. That value equals the actuarial value of the remainder interest in those situations where the actuarial assumptions must be respected. Where the opportunity and motivation to defeat the actuarial assumptions are present, the gift tax value of the remainder interest equals the value of the underlying property.

Although the requirement of adequate and full consideration has the same meaning for purposes of both the gift tax and the estate tax, section 2036(a) of the Code has an additional requirement that the sale of the remainder interest be bona fide in order to avoid the estate tax. A sale of a remainder interest, even though made for adequate consideration, results in inclusion of the underlying property in the seller's gross estate unless the sale is bona fide. A bona fide sale is a bargained-for exchange, devoid of donative interest. Both the seller and the buyer must be seeking to receive value equal to that which they have relinquished. The requirement of a bona fide sale honors the purpose of section 2036(a) of the Code, which is to include in a taxpayer's gross estate lifetime
transfers of a donative nature, where the taxpayer retained an interest in the property until death.