POINTS TO REMEMBER

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THREE STRIKES AND YOU'RE OUT!

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Estate of Magnin v. Commissioner, 184 F.3d 1074 (9th Cir. 1999), is the latest in a trilogy of cases taking exception to the Federal Circuit's decision in *Gradow v. U.S.*, 897 F.2d 516 (Fed. Cir. 1990), on the issue of what constitutes adequate and full consideration under Internal Revenue Code section 2036(a) for a transfer with a retained life estate.

Gradow arose in the context of a widow's community property election. The husband's will forced his spouse to make an election, either to take under his will or, to take her share of community property. If she elected to take under the will, she was forced to place her remainder interest in her share of the community property in trust, along with her husband's share, in return for a life estate in the entire trust. She elected to take under the will, thereby trading a fee simple interest in half of the community property for a life estate in a trust holding both halves of such property. At her death, her executors excluded the trust from her estate, on the theory that the actuarial value of the life estate in her husband's portion was adequate and full consideration for the remainder interest in her portion which she surrendered. (The taxpayer argued that the actuarial value of the life interest was somewhat in excess of the actuarial value of the remainder; the government did not concede this issue.)

In a very brief opinion, affirming the decision of the Court of Claims, the Federal Circuit Court ruled that within the meaning of section 2036(a) adequate and full consideration must be measured by the *property* which would otherwise have been included in the wife's taxable estate. Under section 2036 that would be the entire value of her community property interest, and not just the actuarial value of her remainder interest in such property. Thus, the remainder was taxed at its value as of the *date of death*, and the taxpayer, under section 2043, was given as an offset the value of the income interest received as of the *date of the transaction*. The Court of Claims had been faced with the problem of interpreting the phrase in section 2036(a) which provides, "The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth) by trust or otherwise . . . " The court concluded that the parenthetical phrase concerning adequate and full consideration modified the word "*property*" and thus required that the consideration equal the value of a fee simple interest.

Gradow and *Pittman*, 878 F. Supp. 833 (WDNC 1994), which followed it, were roundly criticized for failing to give proper consideration to the economics of the transaction. Professor Pennell concluded, "Taxpayers should fare better in these kinds of cases, but only if taxpayers make, and courts apply, the proper economic analysis."[1]

In 1996 the Third Circuit applied economic analysis and found for the taxpayer. In *Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309 (3d Cir. 1996), the decedent owned closely held stock. She transferred a remainder interest in the stock for an annuity that actuarially equaled (or slightly exceeded), the value of the remainder interest. The court applied a two-pronged approach. First, unlike the *Gradow court*, the Third Circuit interpreted the parenthetical phrase in section 2036(a) as modifying "*interest therein*," not "*property*," and, therefore, not requiring the consideration to equal the value of a fee simple interest. Second, the court correctly concluded that , assuming the actuarial tables proved to be correct in practice as well as theory, the diminution to the value of the estate of the party transferring the remainder interest would be offset by a corresponding increase due to the compounded earnings from the life interest received.[2]

In *Wheeler v. U.S.*,116 F3d 749 (5th Cir. 1997), Elmore K. Melton, Jr. sold his remainder interest in his

[1] Jeffrey N. Pennell, *Cases Addressing Sale of Remainder Wrongly Decided*, Estate Planning Journal, Vol. 22, Number 5, September/October 1995.

[2] As an example: Assume a person age 55, with a 25 year life expectancy, holds a life interest and a remainder in $1 million. Assume, also, that the AFR is 7.2% and the fund is invested purely for income, and produces income equal to 7.2%. Assume, also, that the person spends an amount equal to the income. In 25 years the income will have been dissipated and the remainder, now equal to $1 million, will be taxable in the person's estate. Assume, on the other hand that the person sold the remainder for its actuarial value of $238,530. In that case, the individual will have enjoyed the same income of 7.2% per year and will have dissipated it, but, will also have had an additional $238,530 to invest. That additional sum, invested at 7.2% over 25 years would have grown to $1,356,478 (pre-income tax.) The taxable estate may, therefore, actually increase due to the sale of the remainder.

ranch to his two sons in exchange for a note bearing interest at 7% and calling for periodic payments of both principal and interest. The court approved of the statement in *Gradow* that "it is not unreasonable to require that, at a minimum, the sale accomplish an equilibrium for estate tax purposes." However, the court then followed *D'Ambrosio* and acknowledged that the sale of a remainder interest for its actuarial value does not deplete the estate once the potential growth factor is applied to the proceeds of the sale.

In July 1999, the Ninth Circuit joined the Third Circuit and the Fifth Circuit in finding that a sale of a remainder interest for its actuarial value satisfied the section 2036(a) test of "adequate and full consideration." In *Estate of Magnin v. Commssioner*, a son agreed to transfer to his children, at death, his remainder interest in his voting stock of the family corporation in exchange for his own father's agreement to bequeath him a life interest and voting rights in the father's block of stock. Again, following *D'Ambrosio* and *Wheeler*, the court held that "adequate and full consideration" spoke to a comparison of the relative actuarial values of the life interest received and the remainder interest transferred and not to the fee simple value of the son's stock holdings. The court noted, "No depletion of the decedent's gross estate occurs when the adequacy of the consideration is measured by the value of the remainder interest. The consideration for the remainder interest usually appreciates so that at the time of a decedent's death, its value is in most cases roughly commensurate to the value of the property absent the transfer." The court remanded the case to the Tax Court to determine the relative values of the interests exchanged.

From the government's point of view, applying actuarial factors presents a considerable risk. In *D'Ambrosio* and *Magnin*, the corpus of the fund which supplied the income to the taxpayer consisted of closely held stock which could, conceivably, have produced no income. In *Wheeler*, the two sons would have had no ability to pay their obligations on their notes absent the funds they received from their employment in the decedent's closely held corporation. These concerns, however, as acknowledged in the *Wheeler* opinion, have been addressed by Congress in sections 2701 through 2704.[3] Now, the value of the annual income payments must have a basis in economic reality. A more fundamental problem, however, lies with the actual length of the term. The taxpayer fully controls the decision to enter into or not to enter into the transaction. If the taxpayer's true life expectancy is shorter than what is predicted by the actuarial tables, casting the transaction to deliver an interest for life rather than a fixed term of years, presents a tax saving opportunity, and the sale will be consummated on that basis. If the taxpayer's true life expectancy exceeds what is predicted by the actuarial tables, the sale is unlikely to occur.

Magnin also spells out the consequences if the actuarial value of the consideration received does not equal the actuarial value of the remainder interest. Section 2036 requires the inclusion, in the gross estate, of the date of death value of the corpus, if the decedent has transferred the corpus and retained a life estate. Section 2036(a) provides an exception if the interest transferred was for "adequate and full consideration." If the consideration was not "adequate and full," the exception will not apply. In that instance, the taxpayer must look, for relief, to section 2043(a) which provides an offset for amount of consideration received. In *Magnin*, the taxpayer argued that since section 2036 provides for inclusion based on date of death values, either the consideration must be computed at its date of death value or, a proportional approach be adopted. The Ninth Circuit rejected both proposals, finding that section 2043(a) provides for neither. Therefore, if the consideration is not "adequate and full," the property will be included at its date of death value and the offset for consideration will be at date of transaction values. In effect, the taxpayer will suffer the same result as in *Gradow*.

These three defeats in three different circuits suggest that Internal Revenue Service should, for the moment, accept the logic of *D'Ambrosio, Wheeler* and *Magnin* and restrict its attacks to situations where the actuarial values of the remainder interests transferred and the consideration received for such transfers are not of equal value. Practitioners should be aware, however, that in TAM 199935003, dated May 18, 1999, just two months prior to the *Magnin* decision, the IRS held that a sale of a life tenancy to the remainderman of a GRIT was not a sale for adequate consideration because the sales price did not equal the value of the corpus that would have been included in the life tenant's estate under section 2036. The IRS relied on the decision in *U.S. v. Allen*, 293 F. 2d 916 (10th Cir.), *cert. denied*, 368 U.S. 944 (1961), which has been rejected by the *D'Ambrosio, Wheeler* and *Magnin* courts. Note, however, that in the TAM the IRS also raised the alternative argument that the actuarial tables did not apply because death was clearly imminent.

[3] *See*, Martha W. Jordan, *The Present State of Sales of Future Interests*, Journal of Taxation, June, 1998.