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- by Roger A. McEowen*

Overview

The U.S. Court of Appeals for the Second Circuit has ruled that the inclusion of property in a decedent's gross estate over which the decedent retained possession or enjoyment at the time of death by an implied agreement is to be apportioned to the extent the decedent actually exercised possession or enjoyment over the property.¹ As such, the decedent's post-transfer, pre-death conduct concerning the property is critical. The court's opinion also points out that careful drafting of pre-death agreements for the usage or enjoyment of property interests that have been given away can result in tax savings beyond those generated by valuation discounts if combined with appropriate conduct by the transferor.

Facts of *Estate of Stewart*²

Beginning in 1989, the decedent co-owned with her son as joint tenants with rights of survivorship a house in East Hampton, New York. They rented the house out during the summer months, splitting the rental income equally. They lived on the first two floors of a five-story brownstone in Manhattan that the decedent had purchased in 1968. The top three floors were leased to a commercial tenant. The brownstone had appreciated substantially over time and, in late 1999, the decedent's estate planning attorney suggested that she gift a portion of the brownstone to her son as a means of potentially reducing the size of her taxable estate. In May of 2000 the decedent and her son

signed a deed that transferred 49 percent of the decedent's interest in the brownstone to the son with the property to be owned by the parties as tenants in common.³ The transfer was subject to gift tax, and the decedent filed a gift tax return reporting the taxable value of the transfer.

After the transfer, the decedent and her son continued to reside in the lower two floors of the brownstone, and the commercial tenant continued to lease the top three floors. The decedent received the rent payments from the commercial tenant in the brownstone, and the son received the rent payments from the East Hampton property. The son did not write a check to his mother for her share of the East Hampton rent, and the decedent paid most of the expenses associated with the brownstone.⁴

The decedent died in late November of 2000 and her estate included 100 percent of the value of the East Hampton property and 51 percent of the brownstone on the estate's tax return. The IRS issued a notice of deficiency, claiming that the decedent had retained possession or enjoyment of the transferred 49 percent interest in the brownstone and, as a result, the full value of the brownstone should have been reported on the estate's federal estate tax return.

The estate took the position that the fractionalizing of the ownership of the brownstone between the decedent and her son reduced its market value and entitled the estate to a valuation discount. This type of discount, known as a fractional interest discount, is

typically in the range of 10-20 percent. When combined with a discount to reflect the reduced marketability of the property due to the co-ownership, the overall discount can increase substantially. Indeed, in this case, upon the decedent's eventual death, the estate and the IRS stipulated to a 42.5 percent discount if it was ultimately determined that the ownership interest in the brownstone had actually been split.⁵

The estate filed a petition in the Tax Court, claiming that while the decedent had retained the possession or enjoyment over only a part brownstone, she had given up much of the income from the top three floors via a set-off to pay her son and had split the value of the bottom two floors by living with her son. While they didn't split the income and expense associated with the properties each month, they did track their respective net incomes from the properties and intended to reconcile any differences at the end of the year in accordance with their respective percentage ownership in the properties. In addition, it was clear that the son had continued to reside in the brownstone at all times after the date of the transfer of the 49 percent interest in the property to him and the time of his mother's death. Consequently, something less than the full value of the 49 percent transferred interest should be included in the estate.

Retained Interests

A decedent's gross estate contains "the value of all property to the extent of the interest therein of the decedent at the time of his death."⁶ The gross estate also includes "the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer . . . under which he has retained for his life . . . the possession or enjoyment of, or the right to the income from, the property."⁷ The meaning of that phrase was the crux of the case.

Without a doubt, possession or enjoyment of an interest in property can be retained via an agreement, even one that can be implied from the facts of the particular situation.⁸ "Possession or enjoyment" refers to the lifetime use of the property – a retention of the present economic

benefit.⁹ So, the question in the case was whether the decedent had either retained a right to the income from the transferred property or the possession or enjoyment of the property in a manner that required inclusion of the property in the estate.

Tax Court Opinion¹⁰

The Tax Court agreed with the IRS that the full value of 100 percent of the brownstone was included in the decedent's estate by virtue of I.R.C. §2036(a)(1). The Tax Court reasoned that the decedent had retained the economic benefit from the brownstone by virtue of receiving the rent from the commercial tenant, and the lack of any written agreement stating that the decedent and her son would reconcile the income and expenses of the two properties. Instead, the Tax Court determined that an implied agreement existed under which the decedent would retain the economic benefits of the brownstone. The Tax Court, while stating that the decedent satisfied the terms of the agreement, made no effort to determine what the terms of the agreement actually were. In addition, the Tax Court viewed I.R.C. §2036(a)(1) as an "all-or-nothing" statute. Once an agreement (implied or otherwise) is found to exist, the terms of the agreement and the transferor's conduct concerning the property subject to the agreement are immaterial – full inclusion of the property in the estate is required. The estate appealed.

Second Circuit's Opinion

On appeal, the court noted that the decedent had not retained the right to the income from the interest gifted to her son. She had no legally enforceable power to receive the income from the portion of the property she transferred to her son. However, that didn't resolve the entire question. The question remained under I.R.C. §2036(a)(1) whether the decedent had retained the *possession or enjoyment* over the transferred property. If that question was resolved in the positive, the court noted, the applicable Treasury Regulation also required a determination of the *extent* of the retained possession or control.¹¹ Likewise, in Rev. Rul. 79-109,¹² IRS ruled that in the situation where a decedent retained an

interest in only a part of the transferred property, or a corresponding part of the income that the property produces, the amount included in the decedent's gross estate is the portion of the transferred property that is necessary to yield the retained income. That amount could be measured by examining the terms of any agreement, implied or otherwise, concerning the transferor's use of the property.

The court noted that because the brownstone was used in part as residential property and partly as income-producing commercial property it was necessary to examine the facts and circumstances surrounding the residential and commercial uses to determine the existence of any implied agreement. Importantly, the court stated that the terms of any implied agreement did not involve the residential portion of the son's 49 percent interest, just the 49 percent transferred interest that involved the non-residential portion. On that point, the court noted that the decedent neither had exclusive possession of the residential portion of the 49 percent interest nor did she exclude the son from the 49 percent interest.¹³ But, the Tax Court had made no specific findings relating to the decedent's enjoyment of the residential portion of the property – simply believing that co-tenancy was enough to support an implied agreement to use the transferred property. The appellate court, however, noted that was improper – the decedent's residential use of the property did not indicate an implied agreement resulting in an implied agreement to retain substantial economic benefits of the residential portion of the 49 percent interest that she transferred to her son. But, the court noted, it was proper for the Tax Court to find that the decedent had retained substantial economic benefit of the commercial portion of the 49 percent interest transferred to her son. She continued to receive the rental income and the son's explanation of a plan to "settle up" at year's end was not credible.

So, the Tax Court's finding of an implied agreement was upheld, but the appellate court reasoned that the Tax Court should have analyzed the terms of the agreement via the conduct of the parties. There was absolutely no

doubt, the appellate court noted, that the son had the possession and enjoyment of the residential portion of the 49 percent interest that his mother transferred to him. The decedent did not retain any substantial economic benefit for her life of that portion of the 49 percent interest. Similarly, the appellate court believed that it was unlikely that the decedent retained all of the substantial economic benefit from the portion of the 49 percent interest attributable to the commercial lease.

Thus, the court remanded the case to the Tax Court for an analysis of the implied agreement, a consideration of all of the facts and circumstances surrounding the transfer and use of the property, and a determination of the apportionment of the 49 percent interest in accordance with those findings. In determining the apportionment, the appellate court instructed the Tax Court to follow the IRS guidelines set forth in Rev. Rul. 79-109.¹⁴ In addition, the appellate court instructed the Tax Court, on remand, to reexamine the handling of the income and expenses on both the brownstone property *and* the East Hampton property. The appellate court specifically noted that the decedent's payment of expenses on the brownstone must be considered as a factor in determining the decedent's level of retained economic enjoyment of the property, and that how the parties distributed the income and expense from the East Hampton property might be relevant for determining the extent of the decedent's retained interest in the residential portion of the brownstone that she had transferred to her son.

Planning Points

The *Stewart* opinion¹⁵ is refreshing inasmuch as it holds the IRS to its own position staked out in the regulations¹⁶ and in a Revenue Ruling.¹⁷ The opinion also points out the need for careful drafting of instruments that could potentially involve an I.R.C. §2036(a)(1) argument by the IRS. For documents drafted properly, valuation discounts can be achieved along with non-inclusion in the decedent's eventual estate of the portion of property over which the decedent did not retain either an income interest or possession

or enjoyment. In addition, the opinion points out that *how the transferor acts* with respect to transferred property matters. That means that practitioners must not only draft transfer agreements properly, they must also counsel clients with respect to economic activities and relationships concerning the property after it is transferred so as to achieve maximum tax benefit.

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¹ Estate of Stewart, *et al.* v. Comr., No. 07-5370, 2010 U.S. App. LEXIS 16427 (2nd Cir. Aug. 9, 2010)

² *Id.*

³ The decedent had been diagnosed with pancreatic cancer in December of 1999 and began chemotherapy treatments in January of 2000.

⁴ Past practice had been that the decedent paid all of the expenses associated with the brownstone.

⁵ This likely explains why the IRS pushed for inclusion of the full value of the brownstone in the decedent's estate. Inclusion of 100 percent of the date-of-death value of the brownstone in the decedent's estate would have negated any fractional interest and/or lack of marketability discount.

⁶ I.R.C. §2033.

⁷ I.R.C. §2036(a).

⁸ See Treas. Reg. §20.2036-1(c); Estate of Maxwell v. Comr., 3 F.3d 591 (2d Cir. 1993).

⁹ See, e.g., United States v. Byrum, 408 U.S. 125

¹⁰ Estate of Stewart, *et al.* v. Comr., T.C. Memo. 2006-225.

¹¹ Treas. Reg. §20.2036-1(c)(1)(i).

¹² 1979-1 C.B. 297.

¹³ The court noted that in cases where a transferor's use of the property by occupancy after the transfer arises from a familial relationship with the transferee, the transferee's use and enjoyment of the transferred interest is not diminished. See Estate of Guchess v. Comr., 46 T.C. 554 (1966).

¹⁴ 1979-1 C.B. 297.

¹⁵ 2010 U.S. App. LEXIS 16427 (2nd Cir. Aug. 9, 2010).

¹⁶ Treas. Reg. §20.2036-1(c)(1)(i).

¹⁷ 1979-1 C.B. 297.