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Federal Estate and Gift Taxation of Joint Interests: Planning and Policy Perspectives

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Federal Estate and Gift Taxation of Joint Interests: Planning and Policy Perspectives

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I. INTRODUCTION

Since the enactment of the modern federal estate tax in 1916[1] joint ownership of property has been a continuing problem for estate planners.[2] Although under state law the consequences of joint ownership generally are favorable,[3] the complex federal estate and gift tax rules governing joint interests often produce adverse tax consequences.[4] In the Tax Reform Act of 1976[5] Congress enacted a special provision to deal with the problems of joint ownership between spouses.[6] The efficacy of this special rule for spouses is questionable: commentators have differed both as to its wisdom and proper use.[7] In the Revenue Act of 1978[8] Congress enacted another special provision designed to alleviate the problems of joint ownership between spouses. This provision gives credit for the services of a surviving spouse in a jointly owned farm or other jointly owned business.[9]

This Note will first provide a brief background outlining the

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1. Revenue Act of 1916, § 202(c), 39 Stat. 756, 778. *See* R. PAUL, FEDERAL ESTATE AND GIFT TAXATION 6 (1942); *see also* R. STEPHENS, G. MAXFIELD, & S. LIND, FEDERAL ESTATE AND GIFT TAXATION 4-257 to 4-258 (4th ed. 1978).

2. *See, e.g.*, Cole, *Estate Planning and the Tax Reform Act of 1976* — Inter Vivos *Gifts, Property Ownership and Planning For the Marital Deduction*, 25 KAN. L. REV. 327, 349 (1977); Nordlinger, *Applicability of Federal Estate Taxes to Tenancies By the Entirety Created Prior to the First Federal Estate Tax Law*, 1 GEO. WASH. L. REV. 258 (1933); Riecker, *Joint Tenancy: The Estate Lawyer's Continuing Burden*, 64 MICH. L. REV. 801 (1966); Rosenberg, *Gift Taxes On Estates By The Entireties*, 24 TAXES 965 (1946); Wenig, *Joint Property: Spouses' Expectations and Estate Planners' Assumptions*, 116 TR. & EST. 516 (1977); Note, *Joint Tenancy and Estate Tax Avoidance: A Widening Loophole for Transfers in Contemplation of Death*, 66 YALE L.J. 142 (1956).

3. *See* Part IIA *infra*.

4. *See, e.g.*, Ellis, *Estate and Gift Tax Planning for Termination of Joint Interests*, 31 J. TAX 98, 99 (1969) ("joint interests are among the most hazardous and intricate of all forms of ownership"); Gamble, *Joint Property Interests of Husband and Wife Under the Tax Reform Act of 1976*, 55 MICH. ST. B. J. 930, 932-33 n.6 (1976) ("joint property rules remain a maze of bewildering complexity"); Note, *Internal Revenue Code § 2040: Allocation of Contribution Problems*, 5 U. S.F. L. REV. 166, 176 (1970) ("complicated and unsettled").

5. Pub. L. No. 94-455, 90 Stat. 1520.

6. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2002(c)(3), 90 Stat. 1856 (codified at I.R.C. §§ 2040(b), 2515(c)).

7. *Compare* M. FELLOWS, SUPPLEMENT ON TAX REFORM ACT OF 1976 at 81 (1977) *and* D. KAHN & E. COLSON, FEDERAL TAXATION OF ESTATES, GIFTS, AND TRUSTS (2d ed. 1975) (§ 2040(b) should be repealed immediately) *with* Wenig, *The New Fractional Interest Rule For Spouses*, 1977-2 TAX. MNGM'T (BNA) (EST., GIFTS & TR. J. 4, 6, 10 (March-April 1977)) (§ 2040(b) requires advisers to look more kindly on clients' desires to hold marital property jointly). *See also*, R. STEPHENS, G. MAYFIELD, & S. LIND, *supra* note 1, at 4-257.

8. Pub. L. No. 95-600, 92 Stat. 2763.

9. Revenue Act of 1978, Pub. L. No. 95-600, § 511(a), 92 Stat. 2763, 2881-82 (codified at I.R.C. § 2040(c)). Congress also made certain technical corrections in I.R.C. § 2040(b), Revenue Act of 1978, Pub. L. No. 95-600, § 702(k)(2), 92 Stat. 2763, 2933-34 (codified at I.R.C. § 2040(d), (e)), and in I.R.C. § 2515, Revenue Act of 1978, Pub. L. No. 95-600, § 702(k)(1)(A), 92 Stat. 2763, 2932 (codified at I.R.C. § 2515A).

incidents of joint tenancy which make it an attractive form of co-ownership under state law. This background section also will place joint ownership in the overall perspective of federal estate and gift taxation by pointing out the impossibility of achieving certain basic federal estate planning objectives in an estate composed primarily of jointly held assets. The Note will then analyze the specific provisions of the Internal Revenue Code governing federal estate and gift taxation of joint interests. This analysis will: first, focus on some of the legal problems generated by the present provisions and demonstrate the unnecessary uncertainty and complexity fostered by the current scheme of federal estate and gift taxation of joint interests; second, examine the estate planning alternatives available under the present provisions and assess the consistency of these provisions with the overall system of estate and gift taxation enacted by the Tax Reform Act of 1976; third, point out a solution to the problems of federal estate and gift taxation of joint ownership between non-spouses overlooked in the Tax Reform Act of 1976; and last, demonstrate that the problems of federal estate and gift taxation of inter-spousal joint ownership are inherent in the current scheme of federal estate and gift taxation of married couples and that these problems illustrate the need for comprehensive reform in this area of the estate and gift tax law.

II. BACKGROUND

A. *Joint Ownership Under State Law*

There are three common-law forms[10] of co-ownership of real and personal property: tenacy in common, joint tenancy, and tenancy by the entirety.[11] In a tenancy in common a theoretically unlimited number of cotenants are each entitled to co-equal possession and enjoyment of the entire property. Each cotenant may alienate, de-

10. "Community property" is another form of co-ownership existing in eight states. Spouses in community property states may also hold property as joint tenants. CCH, ESTATE PLANNING GUIDE 68 (1977).

This Note will not deal with joint ownership between spouses in community property states. For a general comparison of the tax consequences of marital co-ownership in community property versus common-law states, see Note, *The Comparative Impact of Selected Provisions of the Tax Reform Act on Transfers of Community Property and Common Law Property,* 1978 U. ILL. L. F. 443.

11. *See* Campfield, *Estate Planning For Joint Tenancies,* 1974 DUKE L.J. 669, 682-83 (1974) and authorities cited therein; Worthy, *Problems of Jointly Owned Property,* 22 TAX LAW. 601, 601-05 (1969). For other general discussions of the state-law incidents of joint ownership, see Banks, *Unraveling Undesirable Joint Tenancies With Minimum Gift Tax Burden,* 34 J. TAX. 36, 36, 37 n.1 (1971); Thomas, *Tax Consequences of Tenancies,* 22 PRAC. LAW 57, 58-59 (June, 1976); Rudick, *Federal Tax Problems Relating to Property Owned in Joint Tenancy and Tenancy By the Entirety,* 4 TAX L. REV. 3, 4-5 (1948).

mise, encumber, give away during life, bequeath, or devise his individual interest without consent of the other cotenants and without changing the relationship of the other cotenants *inter se* or in relation to the transferee.[12] A joint tenancy has essentially the same features as a tenancy in common except that upon the death of one of the joint tenants his interest in the property ends and the surviving joint tenant or tenants automatically succeed to the deceased joint tenant's interest. Joint interests thus cannot be transferred by descent, bequest, or devise. If a joint tenant transfers his interest during life, the transferee becomes a tenant in common in relation to the remaining original joint tenants, who remain joint tenants *inter se*. A reconveyance of the transferred interest by the transferee to the transferor will not restore the original joint tenancy relationship unless the formal requirements for creation of a joint tenancy are present.[13] A tenancy by the entirety is a special form of joint tenancy that can exist only between husband and wife in which neither spouse may transfer his or her interest without the consent of the other.[14]

Joint ownership has a number of advantages under state law that make it an attractive and very popular form of co-ownership.[15] The principal advantage is that the automatic survivorship feature of joint ownership avoids the delay, uncertainty, and expense of probate.[16] Moreover, a large number of states accord preferential estate and inheritance tax treatment to joint interests.[17] Finally, joint ownership is extremely popular among married couples because it provides security for dependent spouses and apparently

12. Campfield, *supra* note 11, at 682-83; Worthy, *supra* note 11, at 601-02.

13. *See* Campfield, *supra* note 11, at 683; Worthy, *supra* note 11, at 602-04. This Note will not discuss the formal requirements for creation of joint tenancies nor other important incidents of joint ownership such as limitations on the rights of creditors to reach such property. For such general discussions, see the authorities cited in Campfield, *supra* note 11, at 671-73 n.3, 683-85 nn.35-52.

14. Campfield, *supra* note 11, at 684-85. Twenty-two states recognize tenancies by the entirety. Some of these states, however, do not recognize tenancies by the entirety in personal property. *See* R. POWELL, 4A POWELL ON REAL PROPERTY ¶ 622 nn.7 & 10 (1976). This Note will not attempt to discuss in detail purely state-law aspects of tenancies by the entirety. It is important to note, however, that in some states the husband is entitled to all of the income from tenancy by the entirety property. *See* Worthy, *supra* note 11, at 605. Transfers of tenancy by the entirety property in these states may have different gift-tax consequences than transfers of tenancy by the entirety property in states in which each spouse is entitled to one-half of the income. *See* Treas. Reg. § 25.2515-2(c)(1972).

15. For discussions of the relative advantages and disadvantages of joint ownership, see Campfield, *supra* note 11, at 671-73 n.3 and authorities cited therein; Worthy, *supra* note 11, at 605-09; Wenig, *supra* note 2, at 520, 560-61.

16. *See* note 15 *supra*.

17. For a state-by-state breakdown, see Note, *Estate Tax Section 2040: Homemaker's Contribution to Jointly Owned Property*, 29 TAX LAW. 623, 635-36 nn.80-85 (1976).

reflects and reinforces a feeling of marital partnership and unity.[18] United States Treasury Department statistics based on estate tax returns filed during calendar year 1973 demonstrate the widespread use of joint ownership. These statistics indicate that of the total wealth held by individuals owning more than $60,000 in assets, nearly twenty-one percent is held in some form of joint ownership.[19]

B. *Joint Ownership and Basic Objectives in Planning for the Federal Estate Tax*

One commentator has termed joint ownership the "bane of estate planners."[20] Because of the common practice of many unadvised or ill-advised married couples of acquiring property in joint ownership, the estate planner is often confronted with the *fait accompli* of an estate, potentially subject to the federal estate tax, that is composed primarily of jointly held property.[21] Generally, the estate planner facing this situation will advise severance of the joint interests for two reasons. First, inclusion of the jointly held property in the gross estate may result in adverse federal estate tax consequences.[22] Second, and more importantly, the automatic survivorship feature of joint ownership may thwart a very important objective in estate tax planning under the current system—"estate equalization" between husband and wife.[23]

Proper explanation of the concept of estate equalization requires a brief summary of certain basic features of the current federal estate and gift tax laws.[24] The federal estate and gift tax provisions impose an excise tax on cumulative *inter vivos* and testamentary taxable transfers of property.[25] The rate structure of the tax is

18. Campfield, *supra* note 11, at 671-72 n.3c; Note, *supra* note 17, at 623.

19. U.S. DEP'T OF THE TREASURY, SUPPLEMENTAL STATISTICS OF INCOME 1972 — PERSONAL WEALTH ESTIMATED FROM ESTATE TAX RETURNS 61 (1976) (Table G). This estimation included in the calculation the entire value of jointly owned property except the portion attributable to consideration furnished by surviving joint tenants. *Id.* (text). *See* Part IV A *infra* for a discussion of the consideration-furnished concept. For other authorities providing background on the extent of joint ownership, see Note, *supra* note 17, at 623 nn.1-6.

20. Cole, *Estate Planning and the Tax Reform Act of 1976 —* Inter Vivos *Gifts, Property Ownership and Planning for the Marital Deduction,* 25 KAN. L. REV. 327, 349 (1977).

21. *See, e.g.,* Queenan, *Division of Jointly Owned Property for Estate Planning Purposes,* 56 MASS. L.Q. 289, 289 (1971).

22. *See id.*; *see generally* Part IV A *infra.*

23. *See, e.g.,* Campfield, *supra* note 11, at 688. *See also* Green and Harrleson, *Tax Reform Act of 1976: New Horizons in Estate and Gift Taxation,* 48 MISS. L.J. 461, 477-80 (1977).

24. For a concise discussion of the changes made in the estate and gift tax provisions by the Tax Reform Act of 1976, see Cole, *supra* note 20, at 327-37.

25. Not all transfers are taxable. *See, e.g.,* I.R.C. § 2503(b) ($3,000 per donee annual exclusion); *see generally* I.R.C. § 2503 *and* Treas. Reg. § 25.2503, T.D. 7238 (1972).

progressive; the marginal rate increases progressively from a low of eighteen percent on taxable amounts under $10,000 to a high of seventy percent on taxable amounts in excess of $5,000,000.[26] Each individual is allowed a "unified credit" against the tax imposed.[27] Beginning in 1981, this unified credit will be $47,000 and will allow each individual to transfer at least $175,625 free of transfer tax.[28] Each individual is allowed a gift-tax marital deduction for lifetime transfers to a spouse; this deduction is computed as follows: A one-hundred percent deduction is allowed for cumulative taxable transfers not exceeding $100,000; no deduction is allowed for cumulative taxable transfers in excess of $100,000 but not exceeding $200,000; a fifty percent deduction is allowed for cumulative taxable transfers in excess of $200,000.[29] An estate-tax marital deduction is also available for testamentary transfers to a surviving spouse.[30] The maximum estate-tax marital deduction is equal to $250,000 or one-half of the adjusted gross estate,[31] whichever is greater, reduced by the amount by which the total gift-tax marital deductions allowed exceed the amount that would have been allowed had the gift-tax marital deductions allowed been limited to one-half of the cumulative *inter vivos* taxable transfers to the spouse.[32] From the foregoing summary, it is apparent that *inter vivos* or testamentary transfers of appropriate amounts of property between spouses can produce substantial tax savings. By transferring at death to the surviving spouse only that portion of the estate that can pass tax-free under the estate-tax marital deduction, and by transferring the remainder to other beneficiaries, a donor spouse may in effect have his or her estate taxed in halves. The donor spouse thus gains the benefit of lower progressive rates and the use of the donee spouse's $47,000 unified credit.

By comparison, in an estate consisting solely of jointly held assets, upon the death of the first spouse the survivorship feature of joint ownership will cause the entire property to vest automatically in the surviving spouse. The portion of the property in excess of the maximum estate-tax marital deduction will be taxed upon the death of the first spouse. The entire property, including the

26. I.R.C. §§ 2001, 2501-02.

27. I.R.C. §§ 2010, 2505.

28. The unified credit increases progressively from $38,000 in 1979, to $42,000 in 1980, to $47,000 in 1981. *Id.* $175,625 is the "exemption equivalent" of the $47,000 unified credit. *See generally,* Cole, *supra* note 20, at 330-31.

29. I.R.C. § 2523.

30. I.R.C. § 2056.

31. *See* I.R.C. § 2056(c)(2)(A).

32. I.R.C. § 2056(c)(1).

portion previously taxed in the first spouse's estate, will be taxed at a higher progressive rate upon the subsequent death of the surviving spouse.[33] Although this "double tax" on half of the property may be mitigated by the section 2013[34] credit for federal estate taxes paid on property previously required to be included in a decedent's gross estate, this credit declines progressively to zero over the ten-year period subsequent to the first decedent's death.[35] The existence of the section 2013 credit also does not alter the fact that the property is taxed at higher rates at the death of the second spouse. Inflation may further compound the problem.

Although the preceding discussion has focused on achieving estate equalization through use of testamentary transfers between spouses, the importance of *inter vivos* transfers between spouses cannot be ignored. If the spouse who dies first has no assets to transfer at death, the surviving spouse loses the possibility of tax savings through estate equalization with the deceased spouse,[36] and the latter's $47,000 unified credit is wasted. Under the gift-tax marital deduction, after a 100 percent deduction for cumulative *inter vivos* transfers not in excess of $100,000, cumulative transfers to a spouse in excess of $100,000 are fully taxable up to $200,000 and one-half taxable in excess of $200,000. As a result, after $100,000 of cumulative *inter vivos* transfers to a spouse, the donor spouse's $47,000 unified credit begins to be reduced. After the unified credit is depleted all subsequent taxable transfers result in present gift tax liability.[37] Thus, the gift tax provisions inhibit *inter vivos* estate equalization transfers in amounts greater than $100,000.[38] Whether estate equalization will occur, therefore, may often depend upon the happenstance of the donor spouse predeceasing the donee spouse. This result illustrates a fundamental defect in the estate and gift tax law because it allows important differences in tax consequences between similarly situated taxpayers to depend entirely on chance.[39]

33. This analysis assumes that the surviving spouse does not consume the property or remarry. Because the estate and gift taxes are unified, *see generally* Cole, *supra* note 20, this result is not altered if the surviving spouse disposes of the property by gift.

34. I.R.C. § 2013.

35. I.R.C. § 2013(a).

36. There is the possibility of remarriage for purposes of both *inter vivos* and testamentary estate equalization. *See* I.R.C. §§ 2056, 2523.

37. *See* text accompanying note 29 *supra*.

38. *See* ALI, FEDERAL ESTATE AND GIFT TAXATION — RECOMMENDATIONS OF THE AMERICAN LAW INSTITUTE, at 144-46 (1968). *See also* Green and Harrleson, *supra* note 23, at 476-77; Wenig, *supra* note 2 at 518. Non-tax reasons, such as the possibility of divorce, may also make *inter vivos* estate equalization impractical or undesirable.

39. *See* ALI RECOMMENDATIONS, *supra* note 38, at 78, 208-09 (goals of estate and gift tax laws).

Even if Congress were to permit 100 percent tax-free *inter vivos* transfers between spouses, however, estate equalization could not be accomplished by transfers of property by a donor spouse into joint ownership with a donee spouse because upon the death of the first spouse the automatic survivorship feature of the joint tenancy would still cause the entire property to pass to the surviving spouse. The entire property thus would be subject to a second transfer tax upon the surviving spouse's subsequent death.[40] This problem, and the problem of arbitrary tax consequences occuring when estate equalization is prevented by a "donee" spouse predeceasing a "donor" spouse, could be solved by treating married couples as a unit for purposes of transfer taxation of property at death. The "gift-splitting" provisions of section 2513[41] currently treat spouses for purposes of taxation of *inter vivos* transfers in this manner.[42]

From the foregoing discussion of the conflict between joint ownership and estate equalization it is clear that joint ownership under present law can have serious adverse federal tax consequences. Much of the literature discussing joint ownership has therefore emphasized the need to terminate joint tenancies.[43] Joint property, however, will not necessarily[44] produce adverse federal estate and gift tax consequences so long as the amount of property transferred to the surviving spouse does not exceed the amount desirable for purposes of estate equalization.[45] In addition, when federal tax consequences are minimal, as in smaller estates, the estate planner must balance the benefits conferred upon joint ownership by state law against the potentially adverse federal tax consequences before recommending wholesale abandonment of joint ownership.[46]

40. *See* notes 33-36 *supra* and accompanying text.

41. I.R.C. § 2513. *See* Cole, *supra* note 20, at 339-40.

42. This would require some method of "carrying over" the unused unified credit of a deceased spouse. *Cf.* ALI RECOMMENDATIONS, *supra* note 38, at 34, 38-39 (election as to time of imposition of tax on qualified marital deduction gift; gift-splitting at death). *See also* U.S. DEP'T OF THE TREASURY, TAX REFORM STUDIES AND PROPOSALS, HOUSE COMM. ON WAYS AND MEANS AND SENATE COMM. ON FINANCE, JOINT PUBLICATION, 91ST CONG. 1ST SESS., PT. 3, at 358 (Comm. Print 1969). Such a radical change in estate and gift tax policy would require a reassessment of the importance of factors, such as the length of marriage, that currently are not taken into consideration by the estate and gift tax laws. *See* Wenig, *supra* note 7, at 10. Also, the proper impact of other factors such as divorce and remarriage that currently do have an effect on estate and gift taxation of spouses would have to be reassessed. *Cf.* ALI RECOMMENDATIONS, *supra* note 38, at 143 (who is a spouse of the transferor). *See also* Cole, *supra* note 20, at 339-40 (risks of gift-splitting).

43. *See, e.g.*, Banks, *Unraveling Undesirable Joint Tenancies With Minimum Gift Tax Burden*, 34 J. TAX. 36 (1971); Campfield, *supra* note 11; Ellis, *Estate and Gift Tax Planning for the Termination of Joint Interests*, 31 J. TAX. 98 (1969).

44. *See* Part III *infra*.

45. *See generally* Queenan, *supra* note 21.

46. *Id.*

III. FEDERAL GIFT TAXATION OF JOINT INTERESTS

A. *Federal "Common Law"*

With certain exceptions,[47] federal gift taxation of the creation and termination of joint interests is governed by the general Internal Revenue Code sections[48] taxing all transfers of property made for less than full and adequate consideration.[49]

(1) Joint Tenancies

Upon the creation of an ordinary joint tenancy[50] in either real or personal property, a gift for federal gift tax purposes[51] occurs to the extent that one of the joint tenants contributes a greater proportion of the consideration for the acquisition of the property than the value of the fractional interest he acquires under applicable state or federal law. Thus, if A conveys, or purchases and causes to be conveyed, property into the joint names of himself and B, and if B acquires irrevocably a one-half interest in the property, A has made a gift to B of one-half of the fair market value of the property on the date of the transfer into the joint names of A and B.[52] If, in the preceeding example, A had furnished seventy-five percent of the consideration and B twenty-five percent, A would be deemed to have made a gift to B of twenty-five percent of the value of the property.[53] In the case of certain joint interests, such as most joint bank accounts,[54] some joint brokerage accounts,[55] and jointly held United States Savings Bonds,[56] the donor joint tenant can reacquire

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47. *See* text accompanying notes 73-80 *infra* and Part III B *infra.*

48. I.R.C. §§ 2501(a)(1), 2512(b), 2511(a). *See* Treas. Reg. § 25.2511-1(g); Treas. Reg. § 25.2511-1(h)(4), (5).

49. *See* R. STEPHENS, G. MAXFIELD, & S. LIND, *supra* note 1, at 10-82.

50. In states in which contingent remainders are inalienable it may be possible to create between non-spouses a joint interest similar to a tenancy by the entirety by forming joint life estates subject to alternative contingent remainders in the joint life tenants. Such a joint interest presumably would be taxable according to the general federal gift tax principles govening tenancies by the entirety, *see* Part III A (2) *infra,* and would not be affected by I.R.C. §§ 2515, 2515(a) the specific statutory sections applicable to joint tenancies between spouses. *See* Part III B *infra. See generally* C. LOWNDES, R. KRAMER, & J. MCCORD, FEDERAL ESTATE AND GIFT TAXES 748 (3d ed. 1974).

51. Donative intent on the part of the transferor is not necessary for imposition of the federal gift tax. In general, the tax is imposed on all transfers of property made for less than "adequate and full consideration in money or money's worth." I.R.C. § 2512; *see* Treas. Reg. § 25.2511-1(g)(1).

52. Treas. Reg. § 25.2511-1(h)(5).

53. R. STEPHENS, G. MAXFIELD, & S. LIND, *supra* note 1, at 10-83.

54. Treas. Reg. § 25.2511-1(h)(4).

55. Rev. Rul. 69-148, 1969-1 C.B. 226.

56. Treas. Reg. § 25.2511-1(h)(4).

the entire property without the consent of or the obligation to account to the donee joint tenant. Thus, no taxable transfer occurs upon the creation of these "revocable" joint interests because the donee joint tenant does not acquire irrevocable rights in the property.[57] A taxable transfer will occur, however, if the donee joint tenant reduces to possession or disposes of the property for his own benefit without obligation to account to the donor joint tenant.[58]

Lifetime termination[59] of joint tenancies also may give rise to gift tax liability.[60] Termination can occur in four basic ways: First, conversion of the joint tenancy into a tenancy in common between the original joint tenants by conveyance through a "strawman" back to the original joint tenants as tenants in common; second, conversion of the joint tenancy to sole ownership by conveyance by one joint tenant of his interest to the other joint tenant; third, conversion of the joint tenancy to sole ownership by an exchange of properties when two or more properties are held in joint ownership; and last, conversion of the joint tenancy into a tenancy in common or to sole ownership by a conveyance by one or both joint tenants of their interests to a third party.[61] In the case of joint interests created by completed transfers for federal gift tax purposes,[62] termination will not give rise to gift tax liability so long as each joint tenant receives in exchange for his interest the fair market value of

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57. CCH, ESTATE PLANNING GUIDE 54-57, 63-67 (1977).

58. *Id.* When both joint tenants contribute to a revocable joint interest, a taxable transfer occurs if one of the joint tenants reduces to possession for his own benefit, without obligation to account to the other joint tenant, a portion of the property in excess of his pro rata contribution. *Id.*

59. The gift tax does not apply to termination of joint interests by death. Treas. Reg. § 25.2511-2(f).

60. Termination of joint interests may also give rise to income tax consequences. For a discussion of the gift tax, estate tax, and income tax consequences of various methods of terminating joint ownership, see Knecht, *Unwinding Joint Ownerships to Achieve Minimum Tax Liability*, 25 J. TAX. 344 (1966); *see also* Campfield, *supra* note 11, at 693-94 n.80. For a discussion of the tax consequences of termination of joint ownership by conveyance of the jointly held property to a charitable remainder trust, see Teitell, *Estate Planning and Philanthropy*, 179 N.Y.L.J. 1 (1978).

Creation of joint interests also has income tax consequences. Any portion of the property upon which a gift tax is paid acquires a stepped-up basis (but not greater than the fair market value of the property at the time of the gift) to the extent of the gift tax paid. I.R.C. § 1015(d)(1). In addition, the income from jointly held property generally is divided equally for income tax purposes between the joint tenants. Rev. Rul. 74-209, 1974-1 C.B. 46. For comprehensive discussions of the income tax consequences of joint ownership, see Rudick, *Federal Tax Problems Relating to Property Owned in Joint Tenancy and Tenancy By The Entirety*, 4 TAX. L. REV. 3, 24-32 (1948); Worthy, *Problems of Jointly Owned Property*, 22 TAX LAW 601, 618-19 (1969).

61. *See generally* Knecht, *supra* note 60.

62. *See* text accompanying notes 50-58 *supra*.

his fractional share of the property.[63] Thus, for example, no gift tax liability would be incurred by conversion of a joint interest to a tenancy in common between the original joint tenants.[64] A taxable transfer would occur, however, to the extent of one-half of the fair market value of the property on the date of termination when one joint tenant gratuitously conveys his interest to the other joint tenant. As pointed out earlier, in the case of "revocable" joint interests, gift tax liability is incurred only if the noncontributing joint tenant disposes of the property for his own benefit without obligation to account to the contributing joint tenant.[65]

(2) Tenancies By The Entirety

The gift tax consequences of creation and lifetime termination of tenancies by the entirety determined according to general federal gift tax principles[66] are the same as the gift-tax consequences resulting from creation and lifetime termination of other joint tenancies except for valuation of the respective interests of the tenants by the entirety.[67] Because tenancies by the entirety generally are not severable by one spouse acting without the consent of the other spouse, the values of the spouses' respective interests in the property depend upon their life expectancies as determined according to actuarial principles.[68] Thus, when a donor spouse having a shorter life expectancy than the donee spouse creates a tenancy by the entirety and furnishes all the consideration for the acquisition of the property, the donor spouse makes a gift of more than one-half of the fair market value of the property.[69] If, in the preceding example, the spouses had furnished equal proportions of the consideration, there would still be a gift from the "older" spouse to the "younger."[70] Similarly, upon termination of a tenancy by the entirety, an equal

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63. *See generally* Knecht, *supra* note 60.

64. Conversion to a tenancy in common between the original joint tenants does not constitute a sale or exchange within the meaning of I.R.C. § 1002. *See* Rev. Rul. 56-437, 1956-2 C.B. 507.

65. *See* text accompanying notes 54-58 *supra*.

66. These general rules have been modified by I.R.C. §§ 2515(c)(3), 2515A. *See* notes 73-80 *infra* and accompanying text. Note also that, with respect to real property, §§ 2515(a)-(c)(1) override the general rules. *See* Part III B (1) *infra*.

67. This analysis assumes that both spouses have equal rights to the income from the property. In some states the husband is entitled to all of the income from the property during existence of the tenancy by the entirety. *See* note 14 *supra*. In these states a special actuarial factor is required in order to value the respective interests of the husband and wife. *See* Treas. Reg. § 25.2515-2(c) (1972).

68. *See* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 10-83, 10-85.

69. Treas. Reg. § 25.2515-2(d) (1972).

70. *Id.*

division of the proceeds[71] results in a gift from the "younger" spouse to the "older."[72]

In the Tax Reform Act of 1976[73] and the Revenue Act of 1978[74] Congress reduced the complexity and adverse gift tax consequences resulting from the requirement of actuarial valuation of interests in tenancies by the entirety. The 1976 Act provided that actuarial computations are not required in valuing the fractional interests of a husband and wife in a tenancy by the entirety in real property if the tenancy was created "either by one spouse alone or by both spouses."[75] The 1978 Act extended this treatment generally[76] to personal property, but retained the requirement that the tenancy be created by one or both spouses.[77] Thus, actuarial calculations are still required in the case of creations of and terminations[78] of tenancies by the entirety acquired by spouses as a gift from a third party.[79] No sound reason appears for treating tenancies by the entirety acquired by gift differently from those created by the spouses themselves. The value of the gift from one spouse to the other upon a termination in which the proceeds are not divided in accordance with the respective life expectancies of the parties is in no way dependent upon how the tenancy was created.[80] Congress should correct this defect in the statute.

71. Conversion to a tenancy in common is equivalent to an equal division of proceeds of a sale of the property. *See* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 10-85.

72. *See* Treas. Reg. § 25.2515-4(d) (1972). *See generally* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 10-85 to 10-86.

73. Pub. L. No. 94-455, 90 Stat. 1520.

74. Pub. L. No. 95-600, 92 Stat. 2763.

75. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2002(c)(3), 90 Stat. 1856 (codified at I.R.C. § 2515(c)); I.R.C. § 2515(a).

I.R.C. § 2515(c) also requires an "election" under I.R.C. § 2515(a) to treat the creation of the tenancy as a taxable transfer. *See* Part III B(1) *infra.* Generally, if no election is made the transfer is treated as "revocable," *see* text accompanying notes 54-58 and 65 *supra* and Part III B(1) *infra;* and upon termination, no gift occurs if the spouses receive the proceeds in proportion to the consideration each furnished upon creation. *See* Part III B(1) *infra.* Thus, if no election under § 2515(a) were made, actuarial computations could still be required even though each spouse furnished half of the consideration. *See* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 10-93. Congress should correct this technical defect in § 2515.

76. Actuarial computations are still required when the fair market value of the property, determined as if each spouse had an unqualified right to sever his or her interest, cannot be ascertained without reference to the life expectancy of one or both spouses. Revenue Act of 1978, Pub. L. No. 95-600, § 702(k)(1)(A) (codified at I.R.C. § 2515A).

77. *Id.*

78. In the case of creation by gift from a third party, of course, there are no gift-tax consequences between the spouses. The actuarial valuation requirement, however, does affect the value of the gifts from the third party to each spouse. There appears to be no policy justification for this requirement.

79. *See* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 10-85.

80. *See also* notes 75 and 78 *supra.*

B. Section 2515 Property

(1) Operation of the Section 2515 Exception

Section 2515[81] carves out an exception to the general gift-tax rules governing creation and termination of joint interests.[82] Section 2515(a) provides that the creation by either one spouse or by both spouses[83] of a tenancy by the entirety in real property or a joint tenancy in real property[84] in which only husband and wife are joint tenants[85] is deemed not to be a transfer for federal gift-tax purposes unless the donor so elects.[86] Section 2515(a) also applies to additions in value to the joint interest by improvements thereto or reductions in indebtedness thereon.[87] Prior to 1977, an election to treat the creation of an interspousal joint interest as a gift had no effect on the tax consequences of subsequent additions in value. The Tax Reform Act of 1976, however, amended section 2515 to provide that an election to treat the creation of a section 2515 joint interest as a gift applies to all subsequent additions in value.[88]

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81. I.R.C. § 2515.

82. The joint interests here referred to are the type that are "irrevocable." *See* text accompanying notes 50-53 *supra.*

83. Section 2515 does not apply to a joint interest received by spouses as a gift from a third party. R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 10-86.

84. For background on the determination whether property is real property or personal property for purposes of I.R.C. § 2515(a), see Rev. Rul. 77-423, 1977-46 I.R.B. at 14.

85. I.R.C. § 2515(d); Treas. Reg. § 25.2515-1(a) (1972).

86. *See generally* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 10-86 to 10-89. The election to treat a transfer of § 2515 property as a gift is made by filing a timely gift tax return. *Id.* at 10-89. A return may be filed even though no gift tax is due for purposes of taking advantage of the annual exclusion. *Id.* Such a "tax-free" election may be an advantage upon lifetime termination of the § 2515 joint interest. *See* text accompanying notes 90-96 *infra.*

87. R. STEPHENS, G. MAXFIELD & S. Lind, *supra* note 1, at 10-89. Appreciation in value of the property does not constitute an "addition." *See id.*, at 10-90 to 10-91.

88. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2002(c)(2), 90 Stat. 1855 (codified at I.R.C. § 2515(c)(2)). I.R.C. § 2515(c)(2) contains one important technical problem: it is not clear from the wording of the statute whether an initial election by one spouse applies to subsequent additions in value made by the other spouse. *See* Wenig, *supra* note 7, at 7. Moreover, § 2515(c)(2) does not alleviate the problems in determining each spouse's contribution to a § 2515 joint interest arising upon lifetime termination, *see* notes 90-96 *infra* and accompanying text, because it apparently permits "gift elections" for subsequent additions in value when the initial creation of the joint interest was not treated as a gift.

The Internal Revenue Act of 1978 created another interesting technical problem with § 2515 property. In order to come within the special exception in subsection (b) of I.R.C. § 2040, an election under § 2515(a) is required upon the creation of an interspousal joint interest in real property. The Revenue Act of 1978, Pub. L. No. 95-600, § 702(k)(2), 92 Stat. 2763, 2933-34, added § 2040(d) as a temporary measure to allow qualification of pre-1977 joint interests without severance and recreation. Section 2040(d) accomplishes this result by allowing a donor spouse to elect during 1977, 1978, or 1979 to pay a gift tax on the appreciation attributable to that portion of the property which was a gift at the time of creation of the joint interest. If the spouses made no § 2515 election upon creation, then the donor must pay gift tax on one-half of the fair market value of the property at the time of the § 2040(d) election.

Section 2515 does not appreciably complicate the determination of tax consequences upon the creation of a joint interest. If the donor elects to treat the transaction as a gift, the tax consequences are determined under the general gift-tax principles applicable to all joint interests. If the donor makes no election, no gift-tax consequences result from creation of a joint interest in section 2515 property.[89]

Section 2515, however, does complicate determination of the gift-tax consequences resulting from lifetime terminations[90] of interspousal joint interests in realty. If the donor elected to treat creation of and all subsequent additions in value to the section 2515 joint interest as taxable transfers, the gift-tax consequences upon termination are the same as those determined under general gift-tax principles:[91] the legal interests of both spouses under local law are "recognized" so that no gift will occur so long as each spouse receives one-half of the proceeds.[92] If, however, the donor did not elect to treat either the creation of or any subsequent additions in value to the section 2515 property as taxable transfers, section 2515(b) comes into play. Section 2515(b) "disregards" the legal interests of the spouses under local law, and instead recognizes only their respective contributions to the acquisition or improvement of the property. No gift will occur upon termination of a section 2515 joint interest with respect to which the donor has never made a gift election so long as each spouse receives a percentage of the proceeds in proportion to his or her respective contribution to the property.[93] Thus, if a wife provided all the consideration for acquisition and improvement of a section 2515 joint interest, the husband will ac-

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See generally Part IV B *infra*. Although new § 2040(d) makes no reference to § 2515(b), presumably the gift-tax consequences of lifetime termination of a § 2515 joint interest subsequent to a § 2040(d) election would not be determined under § 2515(b). General gift-tax principles would control if the original creation of the joint interest had been treated as a gift.

It is also interesting to note that § 2040(d) attempts to solve the problem of allocating appreciation in the value of the property when both spouses have made non-simultaneous improvements thereto or reductions in indebtedness thereon. *See* notes 90-96 *infra* and accompanying text. Section 2040(d) provides that a substantial improvement of the joint interest shall be treated as the creation of a separate joint interest. § 2040(d)(6). Perhaps regulations will provide that reductions in indebtedness will be treated in a similar manner.

89. R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 10-87 to 10-89.

90. For the rules defining what constitutes termination of a section 2515 joint interest, see Treas. Reg. § 25.2515-1(d)(2)(i), (ii) (1972).

91. R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 10-93. *See* text accompanying notes 50-65 *supra*. The general gift-tax rule requiring actuarial valuation of the interests of husband and wife in a tenancy by the entirety was, for the most part, abolished by the Tax Reform Act of 1978. *See* notes 66-80 *supra* and accompanying text.

92. *See* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 10-93.

93. *Id.* at 10-89 to 10-90.

quire a gift upon termination to the extent that he receives any proceeds. Complications arise when contributions to the property by both spouses do not occur simultaneously and the property appreciates or depreciates in value between the contribution dates. In this situation, the appreciation (or depreciation) in the value of the property occuring between successive contribution dates is attributed to the spouse who furnished the consideration prior to the occurrence of the appreciation. If both spouses furnished consideration prior to the occurence of the appreciation, the appreciation would be attributed to both.[94] For example, assume a husband paid the entire purchase price of $30,000 for the acquisition of real property and took title in the joint names of himself and his wife; the husband did not elect to treat the transfer as a gift. After the property had appreciated in value to $50,000, the wife, also not electing to treat the transfer as a gift, made a $30,000 improvement, which increased the value of the property to $80,000. If the joint interest is later terminated by a sale of the property for $100,000, the husband must receive five-eighths of the proceeds and the wife three-eighths in order to avoid an interspousal gift even though both contributed equally to the property. Although the tax consequences of the preceding example are easily computed, this is not always the case. For example, when both spouses make nonsimultaneous payments on a long-term mortgage, both make nonsimulataneous improvements to the property, and the value of the property fluctuates considerably, it can become virtually impossible to ascertain the relative contributions of the spouses (adjusted for appreciation).[95] The problem becomes more complex when the donor elected to treat some contributions as gifts. This situation requires a further allocation of the proceeds between the "gift contributions" and the "nongift contributions."[96]

Another complicated gift-tax problem arises upon termination by gift from both spouses to a third party of a section 2515 joint interest that was not elected to be treated as a taxable transfer when it was created. Because the spouses may divide the proceeds from the termination of a section 2515 joint interest as they desire, the regulations properly treat the value of the proceeds received by each spouse as the amount reported by that spouse as a gift to the third

94. *Id.* at 10-92.

95. *Id.* The regulations provide that if gradual appreciation and numerous contributions prevent ascertainment of each spouse's respective contribution with reasonable certainty, appreciation can be disregarded. *See* Treas. Reg. § 25.2515-1(c)(2) (1972).

96. Treas. Reg. § 25.2515-4(c) (1972).

party.[97] Thus, if each spouse reported a gift to the third party of one-half the value of the property, the transaction would be treated as a taxable transfer of one hundred and fifty percent of the value of the property. The donee spouse would be considered to have made a gift to the third party of fifty percent of the value of the property. The donor spouse also would be considered to have made a gift to the third party of fifty percent of the value of the property. In addition, under section 2515(b) the donor spouse would have made a gift to the donee spouse of fifty percent of the value of the property.[98] The donor spouse could avoid this result by reporting the entire value of the property as a gift to the third party and having the donee spouse report no gift to the third party.[99]

Another important principle in planning for termination of section 2515 joint interests is that although section 2515 governs the gift-tax consequences of termination of a section 2515 joint interest, it has no effect on section 2035, which requires inclusion in the gross estate of gifts made within three years of death.[100] Thus, when both spouses terminate by gift to a third party a section 2515 joint interest that was not elected upon creation to be treated as a taxable transfer, and the donee spouse dies within three years of the termination, one half of the value of the property will be included in the donee spouse's gross estate under section 2035 as a gift occuring within three years of death. This result occurs even though all of the proceeds were allocated to the donor spouse under Section 2515(b) and the donor spouse thus reported no gift to the third party.[101]

97. Treas. Reg. § 25.2515-1(d)(3) (1972). For purposes of determination of the amount of proceeds received by each spouse, the amount reported as a gift by each is determined without regard to the "gift-splitting" provisions of § 2513. *Id.*

98. *See* Ellis, *Estate and Gift Tax Planning for the Termination of Joint Interests*, 31 J. TAX. 98, 100-01 (1969).

99. *Cf. id.* at 101 (suggesting that the "step transaction" doctrine might prevent this result). *But see* Rev. Rul. 76-348, 1976-2 C.B. 267.

100. Rev. Rul. 76-348, 1976-2 C.B. 267. The rationale of this ruling is based on recognition under I.R.C. § 2035 of the property interests of both spouses under local law. *Id.* at 268. *See also* the authorities cited in the following paragraph.

Although there does not appear to be any authority squarely on point, it seems clear that a § 2515(b) "gift allocation" could not prevent inclusion of any portion of the property in the gross estate under I.R.C. § 2036 (transfers with retained life estate), I.R.C. § 2037 (transfers taking effect at death) and I.R.C. § 2038 (revocable transfers). *See* Rev. Rul. 76-348, *supra*, at 268; *see also* Miller v. United States, 325 F. Supp. 1287 (E.D. Pa. 1971); Estate of Koussevitsky, 5 T.C. 650 (1945); Estate of May, ¶ 78,020 T.C.M. (P-H) (Jan. 18, 1978); Campfield, *supra* note 11, at 706-53:

101. Rev. Rul. 76-348, *supra* note 100. In the example given in text, if the spouses had converted their § 2515 joint interest into a tenancy in common, § 2035 would not apply because both spouses would be considered to have received full and adequate consideration for the relinquishment of their interests in the joint tenancy. *See* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-248 & n.74.

Although this result may at first seem anomalous, when it is considered in conjunction with the results reached by courts construing the interrelationship of sections 2035-38 and section 2040 (the estate tax provision governing the consequences of termination by death of joint interests),[102] and in light of the policy considerations discussed below, it appears a proper and equitable interpretation.

(2) Planning and Policy Considerations

Congress enacted section 2515 in 1954 as a relief measure designed to prevent a large majority of married couples, ignorant of the gift-tax consequences of acquiring homes in joint names, from incurring deliquency penalties.[103] Prior to the Tax Reform Act of 1976, the considerations in deciding whether to elect gift-tax treatment upon the creation of a section 2515 joint interest were relatively simple. Election was desirable only when: the spouses expected the property to appreciate substantially in value and planned to terminate the joint interest during life and to distribute the proceeds other than in proportion to their respective contributions;[104] and when no gift tax liability would be incurred because of the gift-tax marital deduction and $3,000 annual exclusion.[105] In all other situations, an election merely resulted in a payment of tax that otherwise would have been deferred until the death of the donor spouse or might never have been incurred because only that portion of the property attributable to the consideration furnished by the donee spouse would be included in his or her gross estate if the donee spouse predeceased the donor spouse.[106] The Tax Reform Act of 1976, however, injected another consideration into the decision whether to elect gift-tax treatment upon creation of a section 2515 joint interest. In certain circumstances, an election may now be desirable if the spouses anticipate that they will hold the property until one of them dies.[107]

In those situations in which an election of gift-tax treatment is not especially desirable, the ability to avoid gift-tax conse-

102. *See* Part IV A(3) *infra. See also* note 100 *supra.*

103. *See* S. REP. No. 1622, 83d Cong., 2d Sess. 128 (1954).

104. *See* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 10-94 to 10-96. An election in this situation allows the donor to transfer the appreciation without gift-tax consequences. *Id.* For an approach to decision-making under § 2515 based on the time-value of money, see Banks & Due, *Joint Realty and the Gift Tax Election,* 54 TAXES 250 (1976).

105. *See id.* Prior to the Tax Reform Act of 1976, the gift-tax marital deduction was a flat fifty percent. In this situation a mortgage on § 2515 property could be amortized at the rate of $12,000 annually without gift-tax cost. *See* CCH, ESTATE PLANNING GUIDE 60 (1977).

106. *See* Part IV A(1) *infra.*

107. *See* Part IV B *infra.*

quences on an interspousal transfer of real property can be an important planning device to further estate equalization and thus effect substantial estate-tax savings. The typical situation is one in which a husband transfers income-producing realty into the joint names of himself and his wife and does not elect gift-tax treatment. Because under local law each spouse generally is entitled to one-half of the income from joint property, this technique appears to be a device to transfer assets from one spouse to another without the normal gift-tax consequences.[108] Although the Commissioner could argue that the receipt of income by a donee spouse from section 2515 property not elected for gift-tax treatment at its creation constitutes a gift from the donor spouse, no cases or administrative rulings address this point.[109]

Section 2515 introduces a great deal of complexity into the law of federal gift taxation of marital joint interests. The section may represent a substantial "loophole" in gift taxation of interspousal transfers. Moreover, the rationale for the enactment of section 2515 has lost much of its force since the enactment of the one-hundred percent gift-tax marital deduction for the first $100,000 of interspousal transfers.[110] Although reform cannot be considered without reference to its impact on the new elective estate-tax provision governing termination by death of interspousal joint interests,[111] the need for reform is apparent.

IV. Federal Estate Taxation of Joint Interests

Section 2040 of the Internal Revenue Code governs federal estate taxation of joint interests; death of a joint tenant triggers application of the provision. Section 2040(a), the general rule, applies to all joint interests; section 2040(b), added by the Tax Reform Act of 1976,[112] and section 2040(c), added by the Revenue Act of 1978,[113] are special elective provisions applicable only to certain interspousal joint interests. In contrast to the rules governing gift taxation of joint interests, the rules governing estate taxation of joint interests are rather easily and simply stated. The complexities, legal problems, and difficulties in planning fostered by the estate-tax provi-

108. *See, e.g.*, Johnson, *Meeting the Pre- and Post-Death Problems of Jointly Held Property*, 20 N.Y.U. Inst. Fed. Tax. 227, 240-41 (1962) (suggesting this technique).

109. *See* C. Lowndes, R. Kramer & J. McCord, Federal Estate and Gift Taxes §§ 30.8-.10 (3d ed. 1974).

110. *See* notes 28-29 *supra* and accompanying text.

111. *See* Part IV B *infra*.

112. Pub. L. No. 94-455, § 2002(c), 90 Stat. 1520, 1855 (codified at I.R.C. § 2040(b)).

113. Pub. L. No. 95-600, § 511(a), 92 Stat. 2763, 2881-82 (codified at I.R.C. § 2040(c)).

sions, however, are as great or greater than those arising under the gift-tax provisions.

A. *Section 2040(a) — The General Rule*

(1) Basic Operation

Section 2040(a) provides that the gross estate shall include: First, the entire value of all property held jointly by the decedent and any other person, except any portion that the decedent's executor can attribute to contibutions to the acquisition or improvement of the property made by the surviving joint owner or owners with funds or property that were never acquired from the decedent for less than adequate and full consideration in money or money's worth; and second, the value of the decedent's fractional share of all jointly held property acquired by the decedent and the other joint owner or owners from third parties by gift, bequest, devise, or inheritance.[114] Thus, for example, when A and B acquire property as joint tenants, A paying $80,000 of the purchase price and B paying $20,000, if A later dies after the property has appreciated in value to $200,000, $160,000 will be included in A's gross estate. If A and B had acquired the property by gift from a third party, only one-half of the value of the property would be included in the gross estate of either A or B.[115]

Section 2040(a) applies to all joint interests, including joint bank accounts, jointly held government bonds, and other jointly held instruments.[116] The operation of section 2040(a) is not affected by whether the joint interest in question is "revocable" or "irrevocable" for gift-tax purposes,[117] or whether, in the case of section 2515 property, an election was made upon creation of the section 2515 joint interest to treat the transfer as taxable.[118] The gift-tax consequences upon creation of a joint interest are thus irrelevant for purposes of section 2040(a).[119] Gift-tax consequences may nevertheless reduce the estate tax payable, however, because if a gift tax was paid or payable upon creation of the joint interest, the estate

114. D. KAHN & E. COLSON, FEDERAL TAXATION OF ESTATES, GIFTS, AND TRUSTS 80 (2d ed. 1975); *see also* Treas. Reg. § 20.2040-1(a); R. STEPHENS, G. MAXFIELD, & S. LIND, *supra* note 1, at 4-233 to 4-234.

115. Treas. Reg. § 20.2040-1(c); R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-239 to 4-240.

116. Treas. Reg. § 20.2040-1(b); D. KAHN & F. COLSON, *supra* note 114 at 86-87. *See also* Rev. Rul. 68-269, 1968-1 C.B. 399.

117. *See* Part III A *supra.*

118. *See* Part III B(1) *supra.*

119. R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-237.

will be entitled to either a credit for gift tax paid or a subtraction for gift tax payable in the estate tax computation, depending upon when the joint interest was created.[120] Some commentators have referred to this combined scheme of gift tax and subsequent estate tax as "double taxation,"[121] and its constitutionality has been challenged on this ground.[122] It has long been settled, however, that the imposition of a gift tax upon creation of a joint interest and subsequent taxation of the entire property in the estate of the donor joint tenant does not constitute double taxation in the constitutional sense.[123] It is also clear that the present scheme of estate and gift taxation of joint interests does not constitute double taxation in any practical sense except to the extent that the credit for prior gift taxes does not equal the full amount of gift tax paid. For some joint interests created prior to January 1, 1977, the effective date of the Tax Reform Act of 1976, the gift-tax credit is inadequate and some double taxation may occur.[124] The Tax Reform Act of 1976 corrected this problem by providing in the estate tax computation a full subtraction for gift taxes payable on gifts made subsequent to December 31, 1976.[125] Of course, if the donee joint tenant predeceases the donor joint tenant, although none of the value of the joint interest will be included in his gross estate (assuming he furnished none of the consideration), the gift tax paid or payable by the donor joint tenant is lost because the survivorship feature of the joint interest causes the property to revert to the donor's sole ownership. The property will then be subject to another gift tax or estate tax upon subsequent transfer.[126] This problem, however, is not the fault of the federal tax law but results because of the automatic survivorship feature of the joint interest.

The real effect of section 2040(a) is to outlaw a "completed gift" of a fractional share in a joint interest when the donor remains a joint tenant with the donee until the former's death. This is easily illustrated by reference to the federal estate and gift tax treatment

120. *Id.*

121. *See* Thomas, *The Tax Consequences of Tenancies,* 22 PRAC. LAW 57, 64 (June 1, 1976); Worthy, *Problems of Jointly Owned Property,* 22 TAX LAW. 601, 615 (1969).

122. *See* R. PAUL, FEDERAL ESTATE AND GIFT TAXATION 395-403 (1942); *see also* Rosenberg, *Gift Taxes on Estates by the Entireties,* 24 TAXES 965 (1946); Note, *Taxation—Joint Tenancy—Tenancy by the Entirety—Federal Taxation Aspects,* 27 N.D. L. REV. 407 (1951).

123. R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-257 to 4-258.

124. *See* Schwartz, *Joint Tenancy and the Federal Tax Law,* 101 TR. & EST. 1151, 1153, 1188 (1962).

125. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a)(1), 90 Stat. 1520 (codified at I.R.C. § 2001(b)(2)).

126. *See, e.g.,* Rosenberg, *supra* note 122, at 965.

of tenancies in common.[127] The gift-tax consequences of creation of a tenancy in common are very similar to those of creation of a joint tenancy. If A pays the entire consideration for the acquisition of property and acquires title in the names of himself and B as tenants in common, A has made a gift to B of one-half the fair market value of the property on the date of the transfer. Upon the subsequent death of A or B, however, only one-half the value of the property is included in the gross estate of either.[128] Of course, under the "unified system" of estate and gift taxation enacted by the Tax Reform Act of 1976, the value of A's gift to B is included in the ultimate calculation of the tax upon A's cumulative *inter vivos* and testamentary transfers. Any appreciation, however, in the value of B's interest in the property occuring between the date of the gift and the date of A's death is not included.[129] With a joint tenancy, on the other hand the full fair market value of the property on the date of A's death would be included in his gross estate and thus enter into the calculation of total transfer tax liability. Section 2040(a), therefore, prevents a donor joint tenant from making a completed gift of the fractional share in the joint interest acquired by the donee joint tenant because it prevents the donor joint tenant from removing from transfer taxation subsequent appreciation in the value of the fractional interest transferred.

(2) Establishing Survivor's Contribution

The decedent's executor has the burden of proving what portion of the value of a joint interest is attributable to consideration furnished by a surviving joint owner or owners and as such is thus excludable from the decedent joint owner's gross estate.[130] Because the general rule of section 2040(a) could otherwise easily be circumvented, the statute specifically provides that the survivor's contribution must never have been acquired from the decedent by gift.[131] This rule introduces a "tracing" requirement that can significantly compound the executor's problems in meeting the burden of proof.[132]

127. The characteristics of a tenancy in common under state law are essentially the same as those of joint ownership except that in a tenancy in common there is no survivorship feature. *See* notes 10-13 *supra* and accompanying text.

128. CCH, ESTATE PLANNING GUIDE 67-68 (1977).

129. *See* Cole, *supra* note 20, at 338-39.

130. Treas. Reg. § 20.2040-1(a)(2); R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-245.

131. I.R.C. § 2040(a) (1st proviso); Treas. Reg. §§ 20.2040-1(a)(2), (c)(4).

132. R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-240; Riecker, *Joint Tenancy: The Estate Lawyer's Continuing Burden,* 64 MICH. L. REV. 801, 810 (1966). For example, the use of joint bank accounts creates special problems because the executor must not

Joint ownership is most often employed in marital and other family situations; the non-arm's-length nature of making contributions to joint interests increases the difficulty of proof. Inadequate or nonexistent record-keeping by taxpayers frequently results in inclusion in the decedent joint owner's gross estate of a greater portion of the value of the joint interest than is actually attributable to the decedent's contribution.[133] In response to these problems some courts have allowed an "equitable approximation" of the respective contributions to the property. Other courts, however, have adopted stringent standards of proof.[134]

In addition to difficult factual problems in determining the relative contibutions of the decedent and survivors to a joint interest, section 2040(a) creates technical and legal problems in establishing survivors' contributions. As in the case of lifetime terminations of section 2515 joint interests,[135] when contributions in the form of improvements or reductions in indebtedness are made nonsimultaneously by both the decedent and the survivor or survivors and the property fluctuates in value between the contribution dates, allocation of the respective contributions between the decedent and survivors becomes complicated, if not impossible.[136]

Several legal issues have surfaced concerning whether a surviving joint tenant acquires certain types of contributions from the decedent by gift within the meaning of section 2040(a). The regulations take the position that income from property acquired by gift from the decedent is not itself acquired by a gift within the contemplation of section 2040(a) and therefore may constitute a valid contribution by a surviving joint tenant.[137] Somewhat inconsistently, however, the regulations also provide that appreciation in value of property acquired by gift from the decedent and later contributed to the acquisition cost of a joint interest does not constitute a valid contribution.[138] The courts have rejected this latter position at least

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only trace the funds to a source other than decedent, but must also prove that the survivor did not withdraw the contributions. R. STEPHENS, G. MAXFIELD & S. LIND, *supra*, at 4-246.

133. *See, e.g.*, Giacopuzzi v. Commissioner, 29 T.C.M. (CCH) 1777 (1970). *See also* cases cited in 1 A. CASNER, SUPPLEMENT TO ESTATE PLANNING 1008-10 (1978); R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-245 to 4-247 nn. 54-65; Riecker, *supra* note 132, at 811 nn. 29-36.

134. *See* note 133 *supra*.

135. *See* Part III B(1) *supra*.

136. *See* notes 93-95 *supra* and accompanying text. For discussions of this problem as it relates to § 2040, see R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-243 to 4-245; Note, *Internal Revenue Code § 2040: Allocation of Contribution Problems*, 5 U.S.F. L. REV. 166 (1970).

137. Treas. Reg. § 20.2040-1(c)(5).

138. Treas. Reg. § 20.2040-1(c)(4). For an opinion that the distinction between income

in part. *Swartz v. United States*[139] and *First National Bank v. United States*[140] both held that the portion of proceeds from sale of gift property representing appreciation in value of the property occurring subsequent to the date of the gift from the decedent does constitute a valid contribution for purposes of section 2040(a). *Endicott Trust Co. v. United States,*[141] however, refused to recognize appreciation in value of gift property as a valid contribution when the donee and decedent jointly held the gift property, sold it, and reinvested the proceeds in the joint interest in question. From an economic standpoint, *Endicott* seems indistinguishable from *Swartz* and *First National Bank.*[142] Acceptance of the taxpayer's argument in *Endicott,* however, would certainly tempt the estate planner to advise a sale and repurchase of appreciated joint property in contemplation of the donor joint tenant's death.[143] It would also suggest a bolder argument, in direct conflict with the "incomplete gift" principle of section 2040(a),[144] that even unrealized appreciation in the value of property held jointly by the decedent and survivor constitutes a valid contribution. Another problem in establishing contribution of a surviving joint owner is the proper treatment of reductions by the decedent joint owner in the indebtedness upon the joint interest. In *Bremer v. Luff*[145] it was held that when the survivor was jointly and severally liable with the decedent upon the mortgage, the survivor would be deemed to have contributed equally to the purchase of the property even though the decedent in fact paid off the mortgage. Legal scholars have criticized this result.[146] There appear to be no clearly correct answers to the legal problems presented by the section 2040(a) "consideration-furnished" rule.[147] This Note submits that these problems demonstrate the inherent unsoundness of the rule.

Difficult problems also occur in establishing a survivor's contribution to joint property acquired with funds derived from jointly

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and appreciation lacks substance, see Dean, *Federal Tax Consequences of Joint Ownership,* 53 GEO. L.J. 863, 867 (1965).

139. 182 F. Supp. 540 (D. Mass. 1960).

140. 223 F. Supp. 963 (W.D. Mo. 1963).

141. 305 F. Supp. 943 (N.D.N.Y. 1969).

142. *Cf.* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-243 nn. 45-46 (propriety of *Endicott* questionable).

143. *See id.* at 4-243.

144. *See* notes 127-29 *supra* and accompanying text.

145. 7 F. Supp. 148 (N.D.N.Y. 1933).

146. *See* Note, *Assumption of Joint Mortgage As Avoidance of Federal Estate Tax on Tenancy by Entirety,* 44 YALE L.J. 687 (1935). *See also* CASNER, *supra* note 133, at 1003; R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-247.

147. *See generally* Dean, *supra* note 138, at 864-67; Reicker, *supra* note 132, at 812-15.

conducted income-producing activity. Such problems can be particularly troublesome in the husband-wife relationship because of the absence of arm's length dealing. These problems are considered in Part IV C as an introduction to new section 2040(c), which was enacted to deal with them.

(3) Interaction of Section 2040(a) With Sections 2035, 2036, and 2038

Because section 2040 applies only to property held jointly at the death of one of the joint tenants, termination of joint interests prior to death can be utilized to avoid inclusion of the entire value of jointly held property in the gross estate of a donor joint tenant.[148] If none of the other estate-tax provisions[149] requiring inclusion of the property in the gross estate apply, the gift-tax rules discussed in Part III of this Note govern the tax consequences of termination of a joint interest.[150] In certain situations, such as conversion of the joint interest to a tenancy in common when creation of the joint interest was a completed gift for gift-tax purposes, no gift-tax consequences occur upon lifetime termination.[151] As will become apparent from the following discussion, substantial tax savings can result from lifetime termination of joint interests.

After several losing battles in the courts, the Commissioner, in 1969, acquiesced in a series of cases[152] holding that when a joint interest is terminated in contemplation of death[153] section 2040 does not apply, and that section 2035 requires inclusion in the donor joint tenant's gross estate of only the value of the decedent's fractional interest under local law transferred for less than full and adequate consideration.[154] The rationale of these cases is that, under section 2035, local property law, not section 2040, should determine the value of the interest transferred.[155] The commentators have uniformly and correctly criticized this result as permitting an easy

148. *See generally* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-248 to 4-250; D. KAHN & E. COLSON, *supra* note 114, at 83-86; Campfield, *supra* note 11, at 706-15; Rudick, *Federal Tax Problems Relating to Property Owned in Joint Tenancy and Tenancy by the Entirety*, 4 TAX L. REV. 3, 11-13 (1948).

149. *E.g.*, I.R.C. §§ 2035-38.

150. *See* note 148 *supra*.

151. *See* notes 59-65 *supra* and accompanying text.

152. *See* Campfield, *supra* note 11, at 706-11.

153. I.R.C. § 2035 now requires inclusion in the gross estate of all property transferred within three years of death for less than full consideration.

154. 1969-2 C.B. xxiii; *see also* Rev. Rul. 69-577, 1969-2 C.B. 173.

155. R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-249 to 4-250 (a literal reading of § 2035).

avoidance of section 2040.[156] The following example[157] illustrates this point. A and B are joint owners of stock. A provided the entire purchase price for acquisition of the stock. The transfer of the stock into the joint names of A and B was a completed gift for gift-tax purposes. In this situation, section 2040(a) provides for inclusion of the entire value of the stock in A's gross estate and inclusion of none of the value of the stock in B's gross estate. If on the day before A's death, A and B transfer the stock by gift to X, only one-half the value of the stock would be included in A's gross estate. If B then died within three years of the transfer to X, however, one-half the value of the stock would also be included under section 2035 in his gross estate. The potentially adverse tax consequences to B in the preceding example can be avoided if A alone transfers his interest in the stock to X. The potential tax savings of this termination-in-contemplation-of-death technique can thus be quite substantial.[158] One further point with respect to section 2035 and termination of joint tenancies must be noted: A termination in anticipation of the death of the donor joint tenant is not effective to save taxes when the creation of the joint interest occurs within three years of the donor joint tenant's death. In this situation section 2035 would require inclusion of the entire value of the property in the donor tenant's gross estate by virtue of the transfer occurring at the creation of the joint interest.[159]

Termination of joint interests by methods that subject the property to inclusion in the gross estate under sections 2036 and 2038 receive treatment similar to that of section 2035 terminations. When two joint tenants own the property, only one-half of its value is included in the gross estate of either. If, in the preceding example, A and B had transferred their stock to an irrevocable trust reserving a life estate for their joint lives, upon the death of either, only one-half of the value of the stock would be includible in the gross estate

156. *E.g.*, D. KAHN & E. COLSON, *supra* note 114, at 86; R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-250; Campfield, *supra* note 11, at 712-15; Note, *Joint Tenancy and Estate Tax Avoidance: A Widening Loophole For Transfers in Contemplation of Death*, 66 YALE L.J. 142 (1956).

157. Termination cannot be considered without regard to the gift-tax consequences, *see* Part III *supra*, and the income-tax consequences, *see* Part IV A (4) *infra*.

158. *See generally* note 148 *supra*. If in the example given in the text, A and B had converted the joint interest to a tenancy in common, there would be no gift-tax consequences; section 2035 would be inapplicable because the receipt by A and B of equal interests in the tenancy in common in exchange for their relinquishment of their joint interests would constitute full consideration; and only half the value of the stock would be includible in the gross estate of either A or B. *See* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 11, at 4-248 & n. 74.

159. *See* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-248.

under section 2036.[160] One slight difficulty, however, exists with respect to section 2038.[161] The estate planner must take care that the joint interest is clearly severed. The Commissioner has contended with some success that a transfer of jointly held property to a revocable trust should be disregarded as a sham and section 2040 applied.[162] The tax-saving potential of section 2036 and 2038 terminations is generally equivalent to that available by straight terminations or section 2035 terminations.[163]

One other intriguing nuance in the operation of section 2040(a), although not involving sections 2036 and 2038, and not necessarily involving section 2035, merits discussion at this point. Section 2040(a) apparently could be used to return property to a donor without incurring transfer tax upon the return transfer. In *Estate of Koussevitsky*[164] a husband had given property to a wife. Shortly before her death, the wife transferred the property into the joint names of herself and her husband. The Commissioner argued that, under sections 2040 and 2035, the wife's gross estate should include the entire value of the property. The Commissioner conceded that section 2040 would have required the inclusion of the property's entire value in the gross estate of the husband had he died first. The court therefore decided against the Commissioner on the section 2040 issue on grounds of consistency in application of the statute. The court then agreed that the property could be included in the wife's estate under section 2035, but found that the joint interest was not created in contemplation of death.[165] Presently, the wife's gross estate would include the property in the *Koussevitsky* situation because section 2035 now requires inclusion of all gifts made within three years of death.[166] The *Koussevitsky* principle, however, could easily be extended to a situation in which section 2035 would be inapplicable because the creation of the joint interest was not a gift. For example, if in *Koussevitsky* the husband had contributed to the creation of the joint interest property equal in value to that contributed by the wife, no gift by the wife to the husband would have occurred upon creation of the joint interest. There do not appear to be any cases litigated on this point nor any recommendations by tax planners to utilize this method. The potential for tax

160. *Id.* at 4-249 to 4-250.

161. I.R.C. § 2038 (inclusion of revocable transfers).

162. *See* Campfield, *supra* note 11, at 728-32.

163. *See generally* CCH, ESTATE PLANNING GUIDE 50-52 (1977).

164. 5 T.C. 650 (1945). These references are to I.R.C. §§ 2035, 2040. These sections correspond to §§ 811(c) and 811(e) of the Internal Revenue Code of 1939.

165. *See* Campfield, *supra* note 11, at 710 n.147; Rudick, *supra* note 148, at 11.

166. I.R.C. § 2035.

avoidance with this technique, however, is substantial; a court might refuse to allow this sort of manipulation on the rationale that the transactions in question are shams.[167] Again, this Note submits that these problems demonstrate the inherent unsoundness in the general rule of section 2040(a).

(4) Jointly Held Property and Stepped-Up Basis

Section 1014[168] provides for a step-up in basis to the fair market value on the date of the decedent's death, or alternate valuation date, for property included in the decedent's gross estate.[169] The Tax Reform Act of 1976, however, provided that a decedent's basis is to be carried over to his estate or beneficiaries with a fresh start step-up adjustment to the fair market value of the property on December 31, 1976.[170] The Revenue Act of 1978 postponed the effective date of the carryover basis provisions until 1980 and it now appears uncertain whether stepped-up or carryover basis will be in effect after 1980.[171] To the extent that future law allows a fresh start adjustment to the value of the property on December 31, 1976, basis considerations will for some time continue to be important in estate planning for jointly held interests.

It may sometimes be advantageous to the surviving joint tenants to have jointly held property included in the decedent's gross estate in order to obtain a step-up in basis even with the resulting increase in estate taxes.[172] Section 2040(a) requires inclusion in the gross estate of the entire value of a joint interest except any portion the executor proves is attributable to contributions of the surviving joint tenants. The portion of the property required to be included in the decedent joint owner's gross estate receives the step-up in basis.[173] The survivor does not, however, have an election to receive the step-up in basis by failing to prove contribution in the estate proceeding. To establish the step-up in basis for income-tax purposes, the survivor has the burden of proving what portion of the property section 2040(a) required to be included in the decedent's

167. *See, e.g.*, Horner's Estate v. Comm'r, 130 F.2d 649 (3d Cir. 1942) (dealing with joint property and a revocable trust).

168. I.R.C. §§ 1014(a), (b)(9).

169. *See* CASNER, SUPPLEMENT OF ESTATE PLANNING 994 (1978).

170. *Id.* at 995. The adjustments are slightly more complex than represented by the text. *See* I.R.C. § 1023.

171. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763.

172. CASNER, *supra* note 169, at 994.

173. This basis increase is reduced by depreciation and depletion deductions allowed to the survivor for income tax purposes prior to the decedent's death. Treas. Reg. § 1.1014-(6).

gross estate.[174] The survivor may obtain the equivalent of an election, however, by manipulation of the contribution test of section 2040(a).[175] The effectiveness of this technique is dependent upon a correct prediction of which joint owner will die first; but, to the extent that joint ownership is desirable in the overall estate plan, this method may achieve some tax savings.[176]

(5) Planning For Joint Ownership and the Overall Estate Plan

Although joint ownership affords significant advantages under state law,[177] the presence of too much jointly held property in an estate can produce adverse federal estate-tax consequences through "overfunding" of the estate-tax marital deduction and loss of the possibility of lifetime estate equalization. To the extent that joint ownership is desirable in the estate plan, however, the contribution-furnished rule of section 2040(a) affords a possibility of tax savings. In a situation in which potential joint owners have independent means so that the contribution-furnished rule can be manipulated,[178] the joint owners might take a calculated risk that the joint owner with the longer life expectancy will survive.[179] By allowing the "younger" joint owner to provide the entire consideration for all joint property, no portion of the property would be subjected to estate taxation upon the death of the "older" joint owner. The estate planner could not, of course, utilize this technique without regard to the gift-tax consequences of creation of joint interests. When utilized in conjunction with the gift-tax rules treating creation of certain types of joint interests, such as joint bank accounts and section 2515 property, as nontaxable transfers this technique may afford significant tax savings.[180]

(6) A Policy Critique of Section 2040(a)

Section 2040(a) has remained substantially unchanged since enactment of the first modern federal estate tax in 1916.[181] Until enactment of the federal gift tax in 1932, the contribution-furnished

174. Richard v. Madden, 52 T.C. 845 (1969), *aff'd per curiam*, 440 F.2d 784 (7th Cir. 1971).

175. *See* Part IV A (1), (2) *supra*.

176. *See* Part II B *infra*.

177. *See* Part II *supra*.

178. *See generally* Part IV A(3) *supra*.

179. Such a prediction could be based not only on age, but also on sex, health, occupation, family history, etc.

180. The estate planner must also evaluate this technique in light of the basis consideration outlined in Part IV A (4) *supra*.

181. *See* note 1 *supra*.

test of section 2040(a) perhaps made sense as a revenue protecting measure.[182] With the advent of the gift tax, however, the justification for treating joint interests differently from tenancies in common disappeared.[183] From an economic viewpoint, a joint interest does not differ from a tenancy in common in which the cotenants have made wills devising the property to each other. The joint owners may unilaterally sever the joint interest and destroy the survivorship relationship; the tenants in common may unilaterally revoke their wills. The possessory incidents of the two forms of ownership are virtually indistinguishable.[184] The only types of joint interests to which the application of the contribution-furnished test makes sense are those joint interests, such as joint bank accounts, in which under local law the donee acquires no irrevocable rights in the property.[185] With these "revocable" joint interests, the entire transfer occurs, if at all, at the death of the donor and should be taxed at that time. With respect to all other types of joint interests, as explained earlier in the discussion of section 2040(a), the contribution-furnished rule, compared to the federal estate and gift tax treatment of tenancies in common, discriminates against joint interests by preventing a donor from making a completed gift of a fractional joint interest and thus removing subsequent appreciation in the value of that fractional interest from transfer taxation.[186]

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182. R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-257. The "estate depletion" theory was the basis for enactment of the federal gift tax. 2 R. PAUL, FEDERAL ESTATE AND GIFT TAXATION 962-64 (1942). The gift tax also prevents income tax avoidance to some extent by taxing gratuitous transfers of property. *See* ALI RECOMMENDATIONS, *supra* note 38, at 71.

183. *Cf.* Note, *Joint Tenancy and Estate Tax Avoidance: A Widening Loophole For Transfers In Contemplation of Death,* 66 YALE L.J. 142 (1956) (suggesting a "substantial control" theory). For the federal estate and gift tax treatment of tenancies in common, see notes 127-29 *supra* and accompanying text.

184. *See* Part II A *supra.* This argument is also supported by the fact that under general principles of federal gift-tax law, because each joint owner may unilaterally sever his interest, actuarial calculations are not required in order to value the interest received by a joint tenant upon creation of the joint interest. Creation of joint interests and creation of tenancies in common are thus generally treated identically for federal gift-tax purposes. *See* Part III A *supra* and notes 127-29 *supra* and accompanying text. The situation with respect to a tenancy by the entirety is essentially the same as that of the "irrevocable" joint tenancy because both husband and wife acquire irrevocably vested rights under local law upon creation of the joint interest. The only difference between a regular joint tenancy and a tenancy by the entirety lies in valuation of the respective interests of the spouses. The actuarially younger spouse has a more valuable interest. *See* Part III A (2) *supra. See also* Rosenberg, *Gift Taxes on Estates By The Entireties,* 24 TAXES 965 (1946) (discussing cases sustaining imposition of gift-tax upon creation of tenancies by the entirety).

185. The contribution-furnished rationale also would apply to § 2515 property. As stated earlier, however, the rationale for continuing the § 2515 option is highly questionable. *See* Part III B(2) *supra.*

186. *See* Part IV A(1) *supra.*

Since 1947 reform proposals recommending integration of the estate and gift taxes have advocated abolition of the contribution-furnished test except in the case of "revocable" joint interests.[187] These proposals have recommended that joint interests be taxed in the same fashion as tenancies in common.[188] In view of the complexity, potential for manipulation, and discriminatory treatment of joint interests fostered by the contribution-furnished test, and in view of the widespread extent of joint ownership,[189] it is surprising that Congress did not correct these problems when it integrated the estate and gift taxes in the Tax Reform Act of 1976.[190] Instead Congress enacted a special provision, applicable only to interspousal joint interests, that allows spouses to elect to have joint interests either taxed like tenancies in common or taxed under the old contribution-furnished rules.[191] Without question, Congress should abolish the contribution-furnished rule for joint interests of non-spouses. This Note defers a conclusion on whether spouses should be allowed to elect this treatment until after discussion of the complexities fostered by this new option.

B. *Section 2040(b) — "Fractional Interest" Rule For Spouses*

(1) Basic Operation of the Rule

Section 2040(b) provides that in the case of any qualified joint interest, one-half the value of the property will be included in the gross estate of the first spouse to die, regardless of which spouse furnished the consideration for the property.[192] A joint interest is qualified and the rule of section 2040(b) is mandatory if the joint interest meets the following four requirements: First, one or both spouses must have created the joint interest after December 31,

187. ADVISORY COMM. TO THE TREASURY DEP'T, FEDERAL ESTATE AND GIFT TAXATION: A PROPOSAL FOR INTEGRATION AND CORRELATION WITH THE INCOME TAX (1947); ALI RECOMMENDATIONS, *supra* note 38; HOUSE COMM. ON WAYS AND MEANS AND SENATE COMM. ON FINANCE, JOINT PUBLICATION, 91st CONG., 1ST SESS., PT. 3 TAX REFORM STUDIES AND PROPOSALS, U.S. TREASURY DEP'T (Comm. Print 1969).

188. *See* Platt, *Integration and Correlation — The Treasury Proposal,* 3 TAX. L. REV. 59, 61 (1947).

189. *See* note 19 *supra* and accompanying text.

190. This failure on the part of Congress has not gone unnoticed by commentators discussing the Tax Reform Act of 1976. *See, e.g.,* Gaubatz, *The Unfinished Task of Estate and Gift Tax Reform,* 63 IOWA L. REV. 85, 101-02 (1977); *cf.* Cole, *supra* note 20, at 349 (problem "eased" but potential for litigation with IRS still present). *But see* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-257 (applauds limiting changes to interspousal joint interests until effects seen).

191. I.R.C. § 2040(b).

192. I.R.C. § 2040(b)(1). *See generally* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-250.

1976;[193] second, only the decedent and the decedent's spouse may be joint owners;[194] third, in the case of personal property, the creation of the joint interest must have been, in whole or in part, a completed gift for federal gift-tax purposes;[195] and last, in the case of real property, the joint tenants must have made an election under section 2515 to treat the creation of the joint interest as a gift.[196] The Revenue Act of 1978 provides a temporary elective procedure, available through 1979, for bringing otherwise qualified pre-1977 joint interests within the rule of section 2040(b).[197] This procedure does not require severance and recreation of the joint interest.[198] In order to make the election, the donor spouse must report a gift of the property in an amount equal to the appreciation attributable to the portion of the property that was a gift upon the creation of the joint interest.[199] For real property, if the donor spouse made no section 2515 election upon creation, the amount of the gift will equal one-half the fair market value of the property.[200] After 1979, severance and re-creation will again be required in order to bring pre-1977 joint interests within the rule of section 2040(b).[201] The amount of the gift occuring upon post-1979 re-creation, however, must still be determined according to the temporary rules for qualification without severance.[202]

Although section 2040(b) is mandatory if all the requirements for a qualified joint interest are met, the provision is, in effect,

193. I.R.C. § 2040(b)(2)(A); Tax Reform Act of 1976, Pub. L. No. 94-455, § 2002(c)(1), (d)(3), 90 Stat. 1520, 1856.

194. I.R.C. § 2040(b)(2)(C).

195. I.R.C. § 2040(b)(2)(B)(i).

196. I.R.C. § 2040(b)(2)(B)(ii). Recall that an initial election under § 2515 now carries over to subsequent additions in value to the property. *See* note 88 *supra* and accompanying text.

197. Revenue Act of 1978, Pub. L. No. 95-600, § 702(k)(2), 92 Stat. 2763, 2933-34 (codified at I.R.C. § 2040(d), (e)).

198. The donor spouse makes the election by filing a timely gift-tax return for any calendar quarter in 1977, 1978, or 1979. The election may not be made after the death of the donor spouse. I.R.C. § 2040(d)(1), (2).

199. I.R.C. § 2040(d)(3), (4). The election may be made even if the amount of the gift thus determined is less than the $3,000 annual exclusion. I.R.C. § 2040(d)(2).

200. I.R.C. §§ 2040(d)(4), (5). This is also the case when a gift of personal property was not reported and the statute of limitations on assessment has expired. *Id.* For further discussion of § 2040(d), see note 88 *supra*.

201. I.R.C. § 2040(e).

202. *Id.* If this were not the rule, § 2040(b) could be elected with slight or no gift-tax consequences: when the pre-1977 creation of a joint interest was a completed gift, generally, no gift will occur upon termination so long as the proceeds are divided equally between the joint owners, *see generally* Part III *supra;* by varying slightly from a 50-50 proportion the contributions to re-creation, spouses could qualify under § 2040(b) by a very small gift upon re-creation.

elective for both real property and most personal property.[203] For real property the situation is fairly simple: if the donor spouse elects under section 2515 to treat the creation of the joint interest as a gift and the property meets the other requirements of section 2040(b)(2), upon the death of either spouse the fractional interest rule will apply; if no section 2515 election is made the general rule of section 2040(a) will apply.[204]

The situation is somewhat more complicated in the case of personal property. First, certain types of joint interests in personalty cannot qualify at all for fractional interest treatment because of the requirement that a gift occur upon creation of the joint interest.[205] For example, joint bank accounts generally cannot qualify because no gift for federal gift-tax purposes occurs upon creation since under local law the donee usually acquires no irrevocably vested rights in the account.[206] These types of joint interests will continue to be governed by the contribution-furnished rule.[207] For joint interests in personalty that can qualify for fractional interest treatment, the estate planner can avoid the mandatory rule of section 2040(b) and invoke the contribution-furnished rule of section 2040(a) by careful manipulation of the requirement that a gift occur upon creation of the joint interest. A simple example illustrates this procedure.[208] In 1979 H creates a joint interest with his own funds between himself and his wife, W, in stock having a fair market value of $100,000. Upon creation of this joint interest, a gift from H to W of $50,000 occurs and thus section 2040(b) applies: under section 2040(b), the gross estate of the first spouse to die will include one-half the value of the stock.[209] If, in the preceding example, H had contributed only $50,000 of the purchase price of the stock and W had contributed the other $50,000 from funds previously acquired by gift from H, no gift would occur upon creation of the joint interest. The

203. *See generally* M. FELLOWS, SUPPLEMENT ON TAX REFORM ACT OF 1976 (1977) to D. KAHN & E. COLSON, FEDERAL TAXATION OF ESTATES, GIFTS, AND TRUSTS (2d ed. 1975); R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-250 to 4-257.

204. *See* text accompanying notes 192-96 *supra*.

205. I.R.C. § 2040(b)(2)(B)(i).

206. *See* notes 54-58 *supra* and accompanying text.

207. CASNER, ESTATE PLANNING UNDER T.R.A. 1976 24-25 (1977).

208. For this and other examples, see M. FELLOWS, *supra* note 203, at 59-62.

209. If the $50,000 gift to W was a taxable gift, $50,000 will be included in H's total transfer tax computation under § 2001(b)(1)(B), but subsequent appreciation in W's fractional share of the stock occurring subsequent to the gift will not be subject to transfer tax. If, however, H dies within 3 years of the creation of the joint interest, the full fair market value on the date of H's death of W's fractional share of the stock will be included in H's gross estate under § 2035.

contribution-furnished rule of Section 2040(a) would apply:[210] if H predeceased W, his gross estate would include the entire value of the stock; if W predeceased H, her gross estate would include none of the value of the stock.[211]

(2) Planning and Policy Considerations

The basic advantage of the fractional interest rule of section 2040(b) over the consideration-furnished rule of section 2040(a) is that the former allows a donor to exclude from transfer taxation appreciation in the value of the fractional interest transferred, while the latter requires inclusion of the entire value of the property in the donor's gross estate.[212] On the other hand, if the donee predeceases the donor, the fractional interest rule requires inclusion of one-half the value of the property in the donee's gross estate, whereas the consideration-furnished rule requires none of the value of the property to be included.[213] In addition the fractional interest rule requires that the creation of the joint interest be treated as a gift, while in the case of a joint interest in real property between spouses, no such requirement exists.[214] Similarly when the estate planner contemplates the qualification of a pre-1977 joint interest, he or she must consider the gift-tax consequences.[215] Basis considerations also are important in any decision to elect fractional interest treatment. Under the consideration-furnished rule, the entire property obtains a step-up in basis if the donor spouse dies first; if the donee spouse dies first, however, no step-up in basis occurs. In contrast, the frac-

210. This example assumes that the transactions would not be subject to attack by the IRS as sham or as collapsible under the step-transaction doctrine.

211. An interesting question presented by the second example is whether the $50,000 acquired from H previous to the creation of the joint interest (assuming the transfer was a post-1976 taxable gift, not falling within the annual exclusion or marital deduction) would also be includible in H's total transfer tax calculation under § 2001(b)(1)(B) as an adjusted taxable gift. Adjusted taxable gifts are those "other than gifts which are includible in the gross estate of the decedent." I.R.C. § 2001(b). Section 2040(a) here requires inclusion of the property *represented by* the $50,000 prior gift to W; yet, the creation of the joint interest was not a gift from H to W. If H had created the joint interest entirely with his own funds (prior to the effective date of § 2040(b)), the gift to W upon creation would be includible in H's gross estate under § 2040(a) and thus not includible as an adjusted taxable gift. The fact that the transaction giving rise to the gift is not the same one that requires inclusion in the gross estate, compare I.R.C. §§ 2035-40, should not cause the gift to be included twice in the calculation. Even literally, the $50,000 is a "gift . . . includible in the gross estate of the decedent." Any other interpretation would result in double taxation merely because of the inherent unsoundness of § 2040(a) in the overall scheme of the unified system. *See also* notes 164-67 *supra* and accompanying text.

212. *See* text accompanying notes 183-86 *supra*.

213. *See* note 192 *supra* and accompanying text.

214. *See* notes 195-96 *supra* and accompanying text.

215. *See* notes 197-202 *supra* and accompanying text.

tional interest rule ensures that half the property will obtain a step-up in basis on the death of the first spouse.[216]

If the fractional interest rule were available on an elective basis for nonspouses, the foregoing considerations would provide an option to speculate on which joint owner would die first. Although this may sometimes be important in planning for joint ownership between spouses, the primary consideration in the husband-wife situation is the effect of joint interests upon the basic goal of estate equalization.[217] The discussion below will illustrate some of the considerations relevant to the decision whether to elect fractional interest treatment. The discussion considers three basic situations: First, when estate equalization is not contemplated; second, when only deathtime equalization is contemplated; and last, when lifetime equalization is contemplated or has already occured. For purposes of simplicity, this discussion will ignore basis considerations.[218]

Situation 1

When a husband and wife do not desire ultimate tax savings through estate equalization, and instead simply wish to pass as much property with as little tax cost as possible to the survivor, joint ownership may be the most desirable method.[219] When the spouses contribute unequally to the acquisition of the joint property, qualification under the fractional interest rule may be advantageous. If, by using the $3,000 annual exclusion and contributions of the "poorer" spouse the couple accumulates a joint estate consisting solely of qualified joint interests with a value not in excess of $850,000, and neither spouse makes lifetime gifts to third parties, no tax will be imposed upon the vesting at death of all the joint property in the survivor. If the couple must utilize the $100,000 gift-tax marital deduction[220] to help qualify the joint property for fractional interest treatment, the tax imposed at the death of the donor spouse is only $15,800.[221] If a second $100,000 transfer to the donee spouse is necessary in order to qualify all the joint property, the tax imposed at the death of the donor rises to $32,300. If, however, the donor spouse had not made this second $100,000 transfer, with the result that $200,000[222] of the joint property would not qualify for

216. *See generally* Part IV A (4) *supra*.
217. *See generally* Part II *supra*.
218. Deductions and credits other than the marital deduction and unified credit are also ignored.
219. *See* Part II B *supra*.
220. *See* text accompanying note 29 *supra*.
221. Wenig, *supra* note 7, at 9.
222. This situation assumes no appreciation in value of the property.

fractional interest treatment, a tax of $45,050 would be imposed at the death of the donor spouse even though the second $100,000 transfer to the donee spouse was a taxable gift.[223] This curious result is caused by the interaction of the gift-tax and estate-tax marital deductions, which estate planners must always take into account when planning for interspousal joint interests.[224]

The foregoing examples illustrate to a limited extent the interaction of the fractional interest rule with the marital deductions and the unified credit. The examples do not, however, take into account the important intangible factor of appreciation. As interspousal gifts necessary to qualify joint property approach the $350,000 mark, the point at which the unified gift-tax credit is exhausted and tax will become currently due on subsequent transfers not falling within the $3,000 exclusion,[225] the estate planner must weigh the advantage of excluding from transfer taxation subsequent appreciation in value of the donee's fractional interest against the gift-tax consequences of qualification.[226] It also is likely that around the $350,000 interspousal transfer mark, the ultimate value of the joint property upon the death of the first spouse, given inflation, will exceed $850,000. At this point another intangible factor, the possiblity that the donee spouse may predecease the donor spouse, must be taken into account because $425,000 (one-half of the $850,000

223. Comparison of tax imposed when $200,000 of joint property does not qualify under fractional interest rule:

	$200,000 in marital gifts	$100,000 in marital gifts
Total Value of Joint Property	$850,000	$850,000
Amount Included In Donor Spouses' Gross Estate	425,000	525,000
Minus Marital Deduction	(250,000)	(212,500)*
Taxable Estate	175,000	312,500
Adjusted Taxable Gifts	100,000	—
Taxable Amount	275,000	312,500

	$200,000 in marital gifts	$100,000 in marital gifts
Tentative Tax	79,309	92,050
Minus Unified Credit	(47,000)	(47,000)
Tax Imposed	$32,300	$ 45,050

* reduced because of $100,000 gift-tax marital deduction, *see* § 2056 (c) (1) (B).

224. For a discussion of the interaction of the gift-tax and estate-tax marital deductions and the unified credit, see Cole, *supra* note 20, at 341-44.

225. *See* text accompanying notes 28-29 *supra.*

226. The illustration given in note 233 *infra* demonstrates the importance of inflation in this calculus.

joint estate) is the maximum amount that will be returned to the donor tax-free upon the donee spouse's death.[227] Despite the complexities in planning for the fractional interest rule, in many situations it will allow spouses to hold significant amounts of property in joint ownership without the disadvantages existing under prior law. This result is, of course, inimical to the tax-saving objective of estate equalization, but many couples are willing to pay the price.[228]

Situation 2

In contrast to situation one, this example presents one spouse who owns substantially all of the assets. Although this spouse is not interested in lifetime estate equalization because of the resulting loss of control, equalization at death is contemplated through use of a maximum estate-tax marital deduction. The primary difference between this example and situation one is that joint interests will make up only a relatively small portion of the estate.[229] Thus, in this situation the effect of qualification of joint interests under the fractional interest rule on the donee spouse's estate will not be a factor. A primary consideration in this instance is the effect of fractional interest qualification on the estate-tax marital deduction. Unless the formula for determining the estate-tax marital deduction takes into account the fact that qualification removes a portion of the property from the donor's adjusted gross estate (the figure upon which the estate-tax marital deduction is computed in an estate larger than $500,000), rather than being equalized upon the donor spouse's death, the estates may become lopsided and produce a greater total transfer tax.[230]

The benefit of removing subsequent appreciation from the

227. This assumes full use of the unified credit and estate tax marital deduction on the theory that the donee spouse would never have made any gifts to the donor or third parties.

When substantial appreciation is anticipated and the donee spouse's life expectancy is somewhat greater than the donor's, the calculated risk of qualification may be warranted. *See* Sacks, *An Estate Planning Tool — Severance and Recreation of Joint Tenancies,* 24 PRAC. LAW 71, 73-76 (1978); *cf.* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-257 (wonders whether game is worth the candle if wrong spouse dies first); Cole, *supra* note 20, at 350-51 (doubtful whether benefits to be obtained are attractive enough to encourage widespread use). The decision is somewhat analogous to that presented by the § 2515 election. *See* Part III B *supra.* For an approach to decision-making under that section based on inflation and the time-value of money, see Banks & Due, *Joint Realty and the Gift Tax Election,* 54 TAXES 250 (1976).

228. *See generally* Wenig, *supra* note 2.

229. Typically in this situation, the couple will only hold the family residence and a small amount of personal property jointly. Only a small percentage of the donor spouse's assets will be held jointly with the donee spouse because of the loss of control attendant upon joint ownership.

230. *See* M. FELLOWS, *supra* note 203, at 76-80 (Illustration h).

donor's gross estate is not of much value when the spouses contemplate deathtime equalization because the donor wishes half of his estate to be taxed at his death, with the other half being taxed at his spouse's death. Moreover, to the extent that taxable transfers to the donee spouse are incurred to qualify property for fractional interest treatment, total transfer taxes will be increased.[231] If, however, the donor spouse wishes to provide security for the donee spouse by the use of a certain amount of joint property, or wishes to sacrifice ultimate tax savings by overqualifying the estate-tax marital deduction to provide the donee spouse with more assets for enjoyment during his or her lifetime,[232] qualified joint interests may be useful for transferring subsequent appreciation to the donee spouse without tax costs. To the extent, however, that taxable transfers would be incurred in order to qualify joint interests in an estate subject to high marginal rates of taxation, subsequent appreciation in the value of the fractional interest transferred would have to be quite substantial in order to offset the adverse tax consequences of section 2040(b) qualification.[233] Section 2040(b) is thus of only marginal utility to spouses in situation two.

Situation 3

In a situation in which lifetime equalization of estates is contemplated or has already occurred, the presence of any significant amount of jointly held property will frustrate the equalization objec-

231. Such transfers would come into the total transfer tax computation as adjusted taxable gifts. *See* I.R.C. § 2001(b)(1)(B). *See* M. FELLOWS, *supra* note 203, at 75-76, 80 (recommending complete avoidance of the fractional interest rule).

232. The adverse effects of this plan are mitigated somewhat by the deferral of tax between the donor spouse's death and the donee spouse's death. Moreover, the donee may consume part of the property or remove substantial portions of it from taxation by use of the $3,000 per donee annual exclusion (or the spouse may remarry). *See also* note 233 *infra*.

233. The following illustration is taken from M. FELLOWS, *supra* note 203. It and the additional calculations provided below it indicate the importance of appreciation in the operation of the fractional interest rule in the context of estate equalization.

Illustration:

In 1990, H independently owns an estate of $900,000. He and his wife, W, own a home, which has a value of $100,000, in joint tenancy with right of survivorship. This home was purchased in 1981 for $80,000 cash. H provided 90 per cent of the consideration for the home, and W provided the remaining 10 per cent of the consideration. W owns no other property. Table A demonstrates the effect of a [§] 2515 election and the effect of [§] 2040(b) on the total transfer taxes owned by the couple if they were to die in the near future. Despite the [§] 2515 election, assume that the gift tax marital deduction, [§] 2523, along with the annual exclusion, [§] 2503(b), results in no taxable gift at the time the joint tenancy was created and that [§] 2515 was elected. Assume further that no other gifts were made by either spouse and that H takes advantage of the maximum estate tax marital deduction. ([§§] 2053 and 2054 deductions are ignored).

tive. The automatic survivorship feature of the joint interest will cause it to pass to the surviving spouse rather than into a marital

	H predeceases W	
	Table A: § 2040(b)	Table B: § 2040(a)
(a) H's estate taxes		
Property in adjusted gross estate not including home	$ 900,000	$ 900,000
Home	50,000	90,000
Total adjusted gross estate	950,000	990,000
Minus Marital Deduction*	(462,000)	(495,000)
Taxable Estate	488,000	495,000
Adjusted taxable gifts	0	0
Tentative Tax Base	488,000	495,000
Tentative Tax	151,720	154,100
Minus Gift Tax Payable	0	0
Tax calculated under § 2001	151,720	154,100
Minus Unified Credit	(47,000)	(47,000)
Estate Tax Due	104,720	107,100

* § 2056: 50% of the Adjusted Gross Estate reduced because of lifetime marital deduction gift.

(b) W's estate taxes		
Property in Adjusted Gross Estate not including home	$ 412,000	$ 405,000
Home	100,000	100,000
Taxable estate	512,000	505,000
Adjusted Taxable gifts	0	0
Tentatixe tax base	512,000	505,000
Tentative Tax	160,240	157,650
Minus Gift Taxes Payable	(0)	(0)
Tax calculated under § 2001	160,240	157,650
Minus Unified Credit	(47,000)	(47,000)
Estate Tax Due	113,240	110,650

In the above example the total estate taxes are $210 greater if § 2040(b) is elected and H predeceases W. Although the effect would not be very great here, having less tax due at H's death and more due at W's subsequent death produces a valuable deferral of tax. The total estate taxes are the same whether or not § 2040(b) is elected if W dies first. (The calculation for W predeceasing H is omitted). M.FELLOWS, *supra* note 203, at 76-80 (Illustration h) (citations omitted).

If, in the preceding example, the home had appreciated in value to $160,000 instead of only $100,000 the total estate taxes if H predeceases W are the same whether or not § 2040(b) is elected. The calculations are provided below:

deduction trust or directly to the ultimate beneficiaries.[234] Because the estate-tax marital deduction is equal to at least one-half of the adjusted gross estate, and because joint interests will make up a very small portion of the estate, qualification is unnecessary. The joint property can pass to the survivor tax-free under the estate-tax marital deduction. Moreover, if a taxable transfer occurs in qualifying a joint interest, higher total transfer taxes will be incurred because the gift upon qualification will enter the total transfer tax computation as an adjusted taxable gift.[235] Thus, to the extent that a couple with equal estates deems joint property desirable, qualification under the fractional interest rule generally should be avoided.

In enacting section 2040(b), Congress intended to reduce the complexity of estate and gift taxation of joint interests.[236] It is clear,

	Table A: § 2040(b)	Table B: § 2040(a)
	(H predeceases W)	
(a) H's estate taxes		
Property in Adjusted Gross Estate not including home	$ 900,000	$ 900,000
Home	80,000	144,000
Total adjusted gross estate	980,000	1,044,000
Minus Marital Deduction (§ 2056)	477,000	522,000
Taxable estate	503,000	522,000
Adjusted taxable gifts	(0)	(0)
Tentative tax base	503,000	522,000
Tentative Tax	156,910	163,940
Minus Gift tax payable	(0)	(0)
Tax calculated under § 2001	156,910	163,940
Minus Unified Credit	(47,000)	(47,000)
Estate Tax Due	109,910	116,940
(b) W's estate taxes		
Property in Adjusted Gross Estate not including home	$ 397,000	$ 378,000
Home	160,000	160,000
Taxable Estate	557,000	538,000
Adjusted taxable gifts	0	0
Tentative Tax Base	557,000	538,000
Tentative Tax	176,890	169,860
Minus gift taxes payable	(0)	(0)
Tax calculated under § 2001	176,890	169,860
Minus Unified Credit	(47,000)	(47,000)
Estate Tax Due	129,890	122,860

In either instance, 2040(a) or 2040(b), the total transfer tax is $239,800.

234. *See* Part II B *supra*.

235. *See* M. FELLOWS, *supra* note 203, at 70-76.

236. H.R. REP. No. 94-1380, 94th Cong., 2d Sess. 19 (1976) ("present application of the provisions relating to jointly owned property are unnecessarily complex").

however, that although section 2040(b), when it applies, eliminates the complexities in determining which spouse furnished the consideration for joint property,[237] section 2040(b) increases the overall complexity of taxation of joint interests.[238] As the examples provided above illustrate, section 2040(b) makes planning for joint interests more difficult; it can be a trap for the unwary.[239] The provision does, however, remove discriminatory tax treatment of joint ownership for those married couples who wish to utilize it. Couples who do not desire estate equalization and wish to hold the bulk of their property in joint ownership can benefit greatly from the fractional interest rule. When spouses contemplate equalization at death, these benefits diminish and become virtually non-existent when the couple desires full *inter vivos* and testamentary equalization. The elective character of section 2040(b) thus mitigates the inherent problems of joint ownership in the current scheme of federal estate and gift taxation of spouses. This election should be available to account for the differing objectives of married couples.[240] Whether the overall benefit achieved by section 2040(b) is outweighed by the increased complexity it introduces is questionable. Congress should reform the estate and gift tax code as it relates to interspousal transfers and estate equalization.[241]

C. *Section 2040(c) — Optional Rule Giving Credit for Surviving Spouse's Services in a Jointly Held Farm or Business*

Establishing the contributions of a surviving spouse, particularly a wife, to marital joint interests for purposes of section 2040(a) is complicated by the non-arm's-length nature of the transactions giving rise to those contributions. Congress recognized this in enacting the fractional interest rule of section 2040(b) in the Tax Reform Act of 1976. After noting the existing problems in this regard, the House Report on section 2040(b) states that "[t]he effect of includ-

237. *See, e.g.*, Cheifetz, *Joint Tenancy: New Law Simplifies Estate Tax Consequences of This Type of Ownership*, 18 TAX ACCOUNT. 270 (1977) (use of joint tenancy enhanced by elimination of the tracing requirement).

238. To this effect, see M. FELLOWS, *supra* note 203, at 55 (increases complexity); R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-257 (further proliferation and complication); Gamble, *Joint Property Interests of Husband and Wife Under the Tax Reform Act of 1976*, 55 MICH. S.B.J. 930 (1976) (further complication of the rules).

239. *See, e.g.*, Salo, *Joint Ownership of Assets in Georgia — The Fiduciary Lawyers' Labyrinth*, 14 GA. S.B.J. 14 (1977) (advising the utmost of caution).

240. Even though joint ownership may frustrate the goal of estate equalization, many couples, for psychological reasons, nevertheless desire to hold a certain amount of property — the family home, etc. — in joint ownership.

241. *See* Part II B *supra*. *Cf.* Wenig, *supra* note 7, at 519-20 (suggesting that Congress merely allow tax-free transfers by one spouse into the joint names of both spouses).

ing only one-half the value of the property in the gross estate in these situations is to implicitly recognize the services furnished by a spouse toward accumulation of the jointly owned property."[242] The fractional interest rule as earlier demonstrated, has no relation to services performed by a spouse, and will result in no benefit whatsoever unless the qualified property appreciates in value.[243]

In a further effort to grapple with this problem, Congress, in the Revenue Act of 1978, enacted still another elective provision designed to give credit for the services of a surviving spouse in a jointly owned farm or other business. The provision allows an exclusion of a portion of the value of the joint interests used in the trade or business based upon the number of years of material participation of the surviving spouse.[244] This section analyzes the problems of establishing contributions of a surviving spouse to marital joint interests and assesses the effectiveness of new section 2040(c) in dealing with those problems.

(1) Prior Law

a. Contributions of Property

It is clear that if a wife[245] contributes her separate funds or property[246] to the acquisition or improvement of jointly held property, and proves this after the husband's death,[247] the wife's contributions constitute "consideration in money or money's worth" for purposes of section 2040(a).[248] The contribution must, however, be traceable directly to the joint interest in question.[249] For example, if a wife contributes her separate funds for the support of the family,

242. H.R. REP., *supra* note 236, at 20.

243. *See generally* Part IV B *supra*.

244. Revenue Act of 1978, Pub. L. No. 95-600, § 511(a), 92 Stat. 2763, 2881-82 (codified at I.R.C. § 2040(c)).

245. This section will refer to the surviving spouse as the wife. This is not done to perpetuate sexual stereotypes, but because in all the cases referred to herein the surviving spouse attempting to prove contribution was in fact the wife. In addition, with respect to certain legal issues discussed in this section, such as whether a wife's domestic services can constitute consideration for purposes of § 2040(a), gender is relevant.

246. The funds or property must be shown not to have been acquired from the husband for less than full and adequate consideration. A wife's relinquishment of dower, or other marital rights in the husband's estate does not constitute consideration. I.R.C. § 2043(b). Release of rights to maintenance and support, however, does qualify. Rev. Rul. 68-379, 1968-2 C.B. 414. *See also* Note, *Valuation of the Right to Support for Purposes of the Federal Tax System*, 72 COLUM. L. REV. 132 (1972).

247. *See generally* Part IV A (2) *supra*.

248. R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 1, at 4-247.

249. *See* Estate of Leoni, 17 T.C.M. (P-H) 678 (1948) (widow established joint ownership of original fund, part of the proceeds of which were used to acquire the properties in question).

and the husband later transfers property into joint ownership with the wife to recompense her for previous outlays, the wife's prior expenditures do not constitute consideration for acquisition of the joint interest. To benefit under section 2040(a), the wife must demonstrate that her expenditures were loans to the husband that he became legally obligated to repay and did in fact repay by the transfer of property into joint ownership.[250] The harsh results produced by this rule are illustrated by *McGrew's Estate v. Commissioner.*[251] In *McGrew* certain judgments had been rendered against the husband at a time when he was ill. The wife discharged these judgments using, in part, her separate property. Later, the husband transferred funds to a joint bank account for the purpose of reimbursing the wife for the expenditure of her separate property. In affirming the Board of Tax Appeals' holding that the entire balance of the joint account was includible in the husband's gross estate, the court found that the wife had failed to sustain the burden of showing that she had made the expenditures with the expectation of repayment.[252]

Because it is unrealistic to require couples like the McGrews to keep the kind of records necessary to sustain such a burden, the American Law Institute in 1968 recommended that Congress permit one hundred percent tax-free interspousal transfers.[253] Nevertheless, establishing a surviving spouse's contributions to the acquisition or improvement of joint interests is still a problem in the current scheme of federal estate and gift taxation of spouses.

b. Contributions of Services

The performance of domestic services by a wife does not constitute consideration for purposes of section 2040(a).[254] The wife's legal obligation to render such services, even though not directly enforceable, renders them invalid as consideration.[255] The services of a wife rendered to her husband outside the domestic situation, however,

250. Fox v. Rothensies, 115 F.2d 42 (3d Cir. 1940) (under state law there was no presumption of a loan in this circumstance).

251. 135 F.2d 158 (6th Cir. 1943).

252. *Id.* at 162.

253. ALI RECOMMENDATIONS, *supra* note 38, at 32-33. "[T]he imposition of a transfer tax on the movement of property from spouse to spouse . . . forces them into an unnatural recordkeeping . . . if the law is to be complied with . . . [a] 100% marital deduction . . . would . . . bring to full fruition from a tax standpoint the often expressed attitude of husband and wife that the property is 'ours' without regard to the technical legal ownership requirements."

254. Note, *Estate Tax Section 2040: Homemaker's Contribution To Jointly Owned Property*, 29 TAX LAW. 623 (1976).

255. *Id.* at 628.

can constitute consideration.[256] The wife may render these services as an employee,[257] or under a profit-sharing[258] or partnership agreement.[259] The husband and wife must be able to contract for such services under local law;[260] such an agreement must, in fact, exist between them, either express or implied.[261] Services rendered by a spouse gratuitously cannot constitute consideration for purposes of section 2040(a).[262]

The wife must, of course, show that she contributed her compensation for services rendered, and in what amount, to the acquisition of the joint interests in question.[263] When the wife is an employee of the husband this "tracing" requirement becomes quite stringent.[264] In the profit-sharing agreement and partnership situations, however, the courts are sometimes willing to assume that the contribution of the wife equalled that of the husband and to allow exclusion of one-half of the jointly owned property shown to have been acquired with profits from the joint enterprise.[265] In order to receive this favorable treatment, the estate need not prove exactly equal contributions of property or services to the joint enterprise.[266] Formal agreements are not necessary; nor is it conclusive how the couple reported the joint income for income-tax purposes.[267] Even when the spouses show a clear agreement to share profits, however, the profits must be traceable into the joint property.[268] It also must not appear that the joint property is primarily attributable to capital furnished by the husband.[269] Two cases illustrate this point. In

256. R. STEPHENS, G. MAXFIELD, & S. LIND, *supra* note 1, at 4-247.

257. Estate of Ehret v. Comm'r, 35 T.C.M. (CCH) 1432 (1976).

258. Berkowitz v. Comm'r, 108 F.2d 319 (3d Cir. 1939).

259. Singer v. Shaughnessy, 198 F.2d 178 (2d Cir. 1952).

260. *See, e.g.*, Estate of Waterman, 9 T.C.M. (P-H) 841 (1940) (state statute invalidating contracts for services between spouses had no effect on husband-wife joint venture).

261. Estate of Trafton, 27 T.C. 610, 615 (1956); Estate of Fletcher, 44 B.T.A. 429, 434 (1941).

262. Bushman v. United States, 8 F. Supp. 694 (Ct. Cl. 1934).

263. *E.g.*, Estate of Drazen, 48 T.C. 1 (1967).

264. *Id. Compare* Estate of Ehret v. Comm'r, 35 T.C.M. (CCH) 1432 (1976) (commissioner's determination deemed generous) *with* Estate of Carpousis v. Comm'r, 43 T.C.M. (P-H) 1064 (1974) (*Cohan* equitable approximation rule applied).

265. *Compare* Estate of Ensley v. Comm'r, 36 T.C.M. (CCH) 1627 (1977) *with* Estate of Otte v. Comm'r, 41 T.C.M. (P-H) 317 (1972).

266. Singer v. Shaughnessy, 198 F.2d 178 (2d Cir. 1952); Estate of Otte v. Comm'r, 4 T.C.M. (P-H) 317 (1972).

267. United States v. Neel, 235 F.2d 395 (10th Cir. 1956); Singer v. Shaughnessy, 198 F.2d 178 (2d Cir. 1952).

268. Estate of Drazen, 48 T.C. 1 (1967).

269. *See* Estate of Ensley v. Comm'r, 36 T.C.M. (CCH) 1627 (1977). *See* notes 274-77 *infra* and accompanying text.

Singer v. Shaughnessy[270] at the time of the couple's marriage the husband was a salesman for a book publishing company and also owned a small publishing business of his own. Although the wife contributed no original capital to the business, from the time of the marriage until the husband's death she took an active part in running it. For some years after the marriage, the husband continued to work as a salesman, devoting only his spare time to the business. He later gave up his other work in order to devote all his time to the business. The wife participated in the business for eighteen years until the husband's death. Shortly before the husband's death, the couple executed a formal partnership agreement reciting that the wife had served as the husband's employee until that point and that he then desired to sell her a half-interest in the business, which they would then operate as partners. The wife paid a portion of the sale price in cash and executed notes for the remainder. In an income-tax return filed for the husband after his death, the wife included all of the profits from the business up to the date of the formal agreement, and one-half thereafter. In the original estate tax return the wife included the entire value of certain jointly owned property. Later, however, the wife filed an amended estate-tax return including only half of the value of the jointly owned property on the theory that she had been an equal partner in the business since her marriage and that the jointly owned property was purchased with profits from the business.[271] In the wife's suit in district court after the Commissioner's denial of her claim for a refund, a jury found that an equal partnership existed between the husband and wife from the time of their marriage and that the joint property in question was purchased with profits from the business.[272] On appeal, the Second Circuit noted that the formal agreement mitigated against a finding of partnership, but found that there was substantial evidence to support the jury's verdict. Citing income tax cases dealing with the bona fides of family partnerships, the court stated that the wife appeared "to have been the more dominant one in guiding the business." Concluding that the husband and wife "conducted the business together and shared the net profits as equal partners would have done," the court upheld inclusion of only half the joint property in the husband's gross estate.[273]

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270. 198 F.2d 178 (2d Cir. 1952).

271. *Id.* at 179.

272. *Id.* at 180.

273. *Id.* at 181. The following cases reach the same result: United States v. Neel, 235 F.2d 395 (10th Cir. 1956); Rogan v. Ferry, 154 F.2d 974 (9th Cir. 1946); Rogan v. Klammerdiner, 140 F.2d 569 (7th Cir. 1944); Berkowitz v. Comm'r, 108 F.2d 319 (3d Cir. 1939); Richard-

In *Estate of Ensley*[274] the wife brought no separate property into the marriage. Although it was not clear from the trial record what the husband's net worth was at the time of the marriage in 1953, $200,000 would be a fair estimate.[275] At this time the husband's principal assets were an amusement park and a restaurant. From the time of their marriage until the husband's death in 1972, the couple engaged in various businesses. At the husband's death, the couple had accumulated jointly owned property with a net fair market value in excess of $800,000, most of which was used in the family businesses.[276] The court found that the husband and wife had an agreement to share profits equally and that the wife's services in the businesses, especially the most successful one, were "at least equal in value" to those of the husband.[277] In the Tax Court, the wife argued for exclusion from the husband's gross estate of half of the jointly owned property, basing her claim of contribution to the acquisition of the properties in question on her services rendered in the joint businesses. The Commissioner argued for full inclusion of the joint property in the husband's gross estate on the ground that the wife had failed to trace any contributions to specific items of joint property, and that the source of the contributions for the joint properties was traceable to the husband's original capital.[278] The court agreed with the Commissioner, noting that the wife had failed to present evidence establishing the value of her services in relation to the husband's capital and service contributions or to trace the profits from the businesses to specific joint properties. The businesses did not show significant profits on the couple's income tax returns until after the joint properties were largely paid for. The court concluded that no basis existed, in view of the wife's

son v. Helvering, 80 F.2d 548 (D.C. Cir. 1935); Estate of Otte v. Comm'r, 41 T.C.M. (P-H) 317 (1972); Estate of Trafton, 27 T.C. 610 (1956); Estate of Giuliani, 11 T.C.M. (CCH) 673 (1952); Estate of Fletcher, 44 B.T.A. 429 (1941); Estate of Waterman, 9 T.C.M. (P-H) 841 (1940).

274. 36 T.C.M. (CCH) 1627 (1977).

275. *See id.* at 1627-28.

276. *Id.* at 1628-30.

277. *Id.* at 1631. Indeed, it appeared from the record that, although major management decisions were made jointly by the husband and wife, the wife's efforts were largely responsible for the success of their most prosperous enterprise. The wife, however, never drew a salary or entered into any formal agreement with the husband. *Id.* at 1628. During their nineteen-year partnership, the couple engaged in various real estate transactions and made improvements to various properties. Although the record was somewhat sketchy in this regard, it appeared that the principal collateral used in these transactions stemmed from the property brought into the marriage by the husband. In addition, according to the couple's joint income tax returns, the businesses were relatively unprofitable until about two years prior to the husband's death, at which time much of the indebtedness on the joint property had already been discharged. *Id.* at 1632-33.

278. *Id.* at 1631.

burden of proof, for allowing an exclusion of fifty percent of the joint property from the gross estate.[279] The court did, however, allow an exclusion of $18,300 in the value of the jointly held property as representing half the indebtedness on the property discharged during 1970 and 1971. During these years, it found the wife owned $25,000 in profits from the businesses that could have been used for this purpose.[280]

The *Ensley* case thus illustrates how the contribution-furnished test of section 2040(a) and the absence of a formal business arrangement between spouses can result in adverse tax consequences.[281] Had the husband and wife in *Ensley* entered into a formal partnership agreement at the time of their marriage, the husband's gross estate would have included only half the value of their assets as his partnership interest.[282] This situation, at least in part, motivated Congress to enact the fractional interest rule of section 2040(b) in the Tax Reform Act of 1976.[283] New section 2040(c), enacted by the Revenue Act of 1978, represents a more realistic effort to deal with the problem.

(2) Section 2040(c)

Section 2040(c) provides an elective rule for excluding from the gross estate a portion of the value of jointly held property used in a farm[284] or in any other trade or business. The value of this portion is based on "material participation" by the surviving spouse in the business. In order to qualify as section 2040(c) property the decedent, the surviving spouse, or both must have created the joint interest, and only the spouses may be joint owners.[285] Only real

279. *Id.* at 1632. The court also rejected the wife's argument that the appreciation in value of certain of the properties was attributable to her fractional interest in the properties and therefore should be excluded from the gross estate. *See* Part IV A (2) *supra*. The court did not explain how the reductions in indebtedness upon the joint properties were accomplished. It would seem that some funds generated by the joint businesses must have been used to discharge these mortgages.

280. 36 T.C.M. (CCH) at 1633.

281. *See also* Bushman v. United States, 8 F. Supp. 694 (Ct. Cl. 1934); Estate of Silvester v. Comm'r, 36 T.C.M. (CCH) 1815 (1977); Estate of Drazen, 48 T.C. 1 (1967); Estate of Heidt, 8 T.C. 969 (1947); Estate of Awrey, 5 T.C. 222 (1945).

282. *See* Hocky, *Wife's Services May Avoid Inclusion of Jointly Held Property in Husband's Estate,* 34 J. TAX. 174, 174-75 (1971) (analyzing some of the cases, discussing the importance of local law, and drawing some planning conclusions). *See also* Ellis, *Estate and Gift Tax Planning for the Termination of Joint Interests,* 31 J. TAX. 98, 102 (1969) (joint tenancy as partnership).

283. *See generally* H.R. REP., *supra* note 236.

284. I.R.C. § 2040(c)(1), (4), (9). The definition of farm in I.R.C. § 2032A(e)(4), (5) is incorporated by § 2040(c) (4).

285. I.R.C. § 2040(c)(3).

property and tangible personal property *used in* the farm or other business can qualify.[286]

The value of an eligible joint interest required to be included in the decedent spouse's gross estate by virtue of section 2040(c) is the fair market value of the property on the appropriate valuation date reduced by the adjusted consideration furnished by the surviving spouse and the section 2040(c) value of the property.[287] The term adjusted consideration is defined as the consideration furnished by a spouse determined as under section 2040(a), but not including any consideration in the form of profits of the business of which the section 2040(c) property is a part, plus the amount that the section 2040(a) consideration would have earned over the period it was invested in the farm or business if it had been earning six percent simple interest.[288] Section 2040(c) value is defined as the excess of the fair market value of the property on the appropriate valuation date over the adjusted consideration furnished by both spouses multiplied by two percent for each year up to a maximum of twenty-five years that the surviving spouse materially participated in the farm or business.[289]

Section 2040(c) has certain limitations. The amount included in the decedent spouse's gross estate under section 2040(c) must equal at least fifty percent of the fair market value of the property.[290] Total reductions in the value of the decedent spouse's gross estate resulting from application of section 2040(c) may not exceed $500,000.[291] Furthermore, the executor must make the election to have section 2040(c) apply within the time period, including extensions, for filing the estate-tax return.[292]

A simple example will illustrate the operation of section 2040(c). H and W purchase Blackacre, a farm, in 1980 for $100,000, taking title as joint tenants. W provides $90,000 of the purchase price and H $10,000. The couple makes no election under section 2515 to treat the creation of the joint interest as a gift, nor do they elect to qualify the property for section 2040(b). H materially participates in the farming operations for twenty years until W's death in

286. I.R.C. § 2040(c)(4).

287. I.R.C. §§ 2040(c)(1), (8).

288. I.R.C. § 2040(c)(6).

289. I.R.C. §§ 2040(c)(5), (8). Material participation is to be determined in a manner similar to that used for purposes of I.R.C. § 1402(a)(1) (net earnings from self-employment). *See* notes 301-07 *infra* and accompanying text.

290. I.R.C. §§ 2040(c)(2)(A), (8).

291. I.R.C. § 2040(c)(2)(B).

292. I.R.C. § 2040(c)(9). The period is nine months after the date of the decedent's death. I.R.C. § 6075(a).

2000, at which time the farm has a fair market value of $300,000. The adjusted consideration furnished by W is $198,000;[293] the adjusted consideration furnished by H is $22,000.[294] The adjusted consideration furnished by both spouses therefore is $220,000. The percentage rate is forty percent.[295] The section 2040(c) value of the property therefore is $32,000.[296] The section 2040(c) value plus H's adjusted consideration equal $54,000, and thus the value of Blackacre includible in W's gross estate is $246,000. By comparison, under section 2040(a), W's gross estate would include $270,000.[297] If W had elected under section 2515 to treat the creation of the joint interest as a gift, her gross estate would include only $150,000 under section 2040(b).[298]

In order to assess the effectiveness of section 2040(c) in dealing with the problems of contributions by surviving spouses to joint interests, it is necessary to examine some of the technical aspects of section 2040(c) in greater detail. To receive the benefit provided by section 2040(c), the estate must show that the surviving spouse materially participated in the farm or business.[299] Material participation for purposes of section 2040(c) must be determined "in a manner similar to" that used for purposes of section 1402(a)(1), which relates to net earnings from self-employment.[300] The proviso that material participation be determined "in a manner similar to" that used for section 1402(a)(1) allows for some variation in the requirement to suit the purposes of section 2040(c);[301] however, the legislative history of section 2040(c) clearly contemplates that participation in both management and operation of the business is required.[302] Recently proposed regulations under section 2032A,[303] which provides a special use valuation for farms and certain other closely-held business interests and which also has a material participation requirement determined by reference to section 1402(a), sup-

293. $90,000 *plus* $90,000 *times* 6% *times* 20 years *equals* $198,000. I.R.C. § 2040(c)(6).

294. $10,000 *plus* $10,000 *times* 6% *times* 20 years *equals* $22,000.

295. 2% *times* 20 years *equals* 40%. I.R.C. § 2040(c)(5)(B).

296. $300,000 *minus* $220,000 *equals* $80,000 *times* 40% *equals* $32,000. I.R.C. § 2040(c)(5).

297. *See* Part IV A (1) *supra.*

298. *See* Part IV B (1) *supra.*

299. I.R.C. § 2040(c)(5)(B).

300. I.R.C. § 2040(c)(7).

301. For a discussion of the regulations under § 1402(a) as they relate to § 2032A, which also has a material participation requirement determined by reference to § 1402(a), see Note, *Material Participation And the Valuation of Farm Land For Estate Tax Purposes Under The Tax Reform Act of 1976,* 66 KY. L.J. 848 (1977-78).

302. S. REP. on H.R. 6715 at 215.

303. I.R.C. § 2032A. Proposed Treas. Reg. § 20.2032A-3, *reprinted in* [1979] II FED. TAXES EST. & GIFT (P-H) ¶ 135,609.

port this view.[304] Thus the activities of a surviving spouse required to meet the material participation requirement of section 2040(c), if accompanied by a profit-sharing or partnership agreement, would support exclusion of one-half of all joint property acquired with profits from the business.[305] Section 2040(c), therefore, will be of benefit only in the *Ensley* situation in which it is impossible to trace profits to specific joint properties,[306] or in a case in which husband and wife cannot contract with respect to services under local law.[307] The *Ensley* case also illustrates another situation upon which section 2040(c) will have no effect. In *Ensley* a portion of the property in question was not used in the couple's business.[308] Section 2040(c) would have no application to this situation.[309] Section 2040(c) will also not cover the situation in which a wife, either alone or in conjunction with the husband, manages the couple's investments, leaving the husband free for other activities.[310] The Treasury has adopted a restrictive interpretation of the "trade or business" requirement under section 2032A and can be expected to do likewise under section 2040(c).[311] Finally, the section 2040(c) requirement

304. These proposed Regulations state:

> *In general.* Actual employment on a substantially full-time basis (35 hours a week or more) or to any lesser extent necessary personally to manage fully the farm or business . . . constitutes material participation.
>
> *Factors considered.* No single factor is determinative of the presence of material participation, but physical work and participation in management decisions are the principal factors to be considered.

Proposed Treas. Reg. §§ 20.2032A-3(d)(1), (2).

305. *See* Part IV C(1)(b) *supra.* The activities of a wife as a mere clerical employee of her husband would not appear to meet the material participation requirement since participation in management decisions is contemplated by § 2040(c). *See* text accompanying notes 300-04 *supra.*

306. *See* text accompanying notes 274-82 *supra.*

307. *See* S. REP., *supra* note 302, at 214-15.

308. *See* text accompanying notes 274-82 *supra.*

309. Joint bank accounts are frequently the depositories of profits from husband-wife businesses. *See, e.g.,* Estate of Drazen, 48 T.C. 1 (1967).

310. *See, e.g.,* Richardson v. Helvering, 80 F.2d 548 (D.C. Cir. 1935).

311. Proposed Treas. Reg. § 20.2032A-3(b), *reprinted in* [1979] II FED. TAXES EST. & GIFT (P-H) ¶ 135,609. According to the Proposed Regulations under 2032A:

> The term "trade or business" applies only to a business such as manufacturing, mercantile, or service enterprise, or to the raising of agricultural or horticultural commodities, as distinguished from management of the investment assets. No trade or business is present even though an office and regular hours are maintained for management of income producing assets, as the term "business" is not as broad under section 2032A as under Section 162.

Id. An interesting possibility is whether an election under § 2040(c) could be made when the surviving spouse did not participate in the business. This could be an advantage when the survivor had contributed valid consideration to the acquisition of the property and the property subsequently declined in value. On its face, § 2040(c) does not prevent this result; the legislative history is of little help in resolving the problem, *see generally,* S. REP., *supra* note 302.

that the executor must elect 2040(c) within the time period for filing the estate-tax return may present the executor with a difficult decision. When there is clear material participation, as there was in *Ensley*, a profit-sharing agreement will not be difficult to show; whether profits can be traced to the court's satisfaction, however, is a more difficult question.[312] The executor may have to weigh the benefits of a fifty percent exclusion against the chances of a failure of proof such as that in *Ensley*.

Section 2040(c) is a provision of limited applicability and offers only limited benefits to the taxpayer. Nevertheless, it will provide some relief in situations such as that encountered in *Ensley*.[313] Clearly, it is no substitute for a formal business arrangement between spouses. Moreover, section 2040(c) makes no attempt to solve the problems of contributions of property by surviving spouses to joint interests. In sum, the problems in this area of the law remain substantial.

V. Conclusion

The federal estate and gift tax provisions governing taxation of joint interests remain highly complex and, in many areas, based upon questionable and uncertain policy. The current rules make planning difficult because chance often dictates the result. Yet, in many instances, they offer significant potential for manipulation and tax-avoidance. Section 2040(a) is an anachronism in the context of the unified estate and gift tax system. Section 2040(b), although mitigating "federal tax discrimination" against a popular form of co-ownership between spouses, introduces further complexity into the law. Section 2040(c) provides limited relief for the interspousal transfer problem, but only with respect to transfers of services. The problems encountered in working with the estate and gift tax provisions governing joint interests and the inherent conflict between joint ownership and federal estate tax-planning objectives demonstrate the need for comprehensive reform in the area of estate and gift taxation of spouses. Given the widespread extent of joint ownership, it would seem that an important goal of taxation in this area should be to produce a simple system that treats similarly situated taxpayers equally.

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312. *See* note 281 *supra*.

313. A substantial exclusion would occur in *Ensley* because the wife materially participated for nineteen years and the property apparently appreciated from around $200,000 to over $800,000. In this situation § 2040(c) would exclude approximately $140,000. *See* notes 274-82, 284-96 *supra*.