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Taxation -- Gross Estate -- Inter Vivos Transfers -- Retention of Possession or Enjoyment

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Taxation—Gross Estate—Inter Vivos Transfers—Retention of Possession or Enjoyment

The federal estate tax taxes a transfer of property made by a decedent during his life if the decedent "retained for his life . . . or for any period which does not in fact end before his death . . . the possession or enjoyment of, or the right to the income from, the property . . . ."[1] Several recent cases raise the question what is meant by a retention of possession or enjoyment of the transferred property for a period which does not in fact end before the transferor's death. Is it enough that the decedent actually remained in possession of the property until his death, or must his possession or enjoyment have been accompanied by an agreement with the transferee allowing him to do so? As far as the naked language of the statute is concerned, it would seem that section 2036 would be satisfied by the continued possession or enjoyment of the decedent, regardless of whether this was pursuant to an agreement with the transferee. Two recent decisions hold, however, that there must be an agreement.[2]

In *Union Planters Nat'l Bank v. United States*,[3] the decedent in 1958 had conveyed by a recorded warranty deed his undivided interest in the family home to his wife. He continued to live in the home until his accidental death in 1959. The Commissioner made a deficiency assessment, taxing the transfer of the home under section 2036 as a transfer with the retention of a life interest. The plaintiff as executor of the decedent's estate paid the assessment and sued for a refund. The government moved for a summary judgment either on grounds that the facts showed there was an implied agreement that the decedent might continue to live in the home, or on grounds that his continued possession or enjoyment of the residence until his death satisfied the statutory requirements for a tax under section 2036. The taxpayer also moved for a summary judgment, contending that the facts showed the absence of an express or implied agreement between the decedent and his wife and that continued factual possession and enjoyment, not based on an agreement, was

[1] INT. REV. CODE OF 1954, § 2036.

[2] Stephenson v. United States, 238 F. Supp. 660 (W.D. Va. 1965); Union Planters Nat'l Bank v. United States, 238 F. Supp. 883 (W.D. Tenn. 1964).

[3] 238 F. Supp. 883 (W.D. Tenn. 1964).

not sufficient to include the value of the residence in the decedent's gross estate. In overruling both motions for summary judgment, the court held that the decedent's continued residence in the home was neither sufficient to show the existence of an agreement nor to meet the statutory requirement of retention of possession or enjoyment. The court further held that the transfer could not be taxed under section 2036 unless the jury determined from the facts that there was an agreement, even an unenforceable one, giving the decedent the right to continue living in the home. The jury found that there was no such agreement.[4] In a later case, *Stephenson v. United States,*[5] in which the husband purchased a family home in his wife's name and lived in the house with her until his death, the government again moved for summary judgment because of the decedent's factual possession or enjoyment of the home. In overruling the motion, the court held that to incur tax liability under section 2036, lifetime possession in fact must result from an agreement with the transferee.

It is difficult to see any justification for interpreting section 2036 as requiring an agreement in addition to actual possession or enjoyment of the transferred property until the transferor's death. When the statute speaks of the decedent's retaining possession or enjoyment "for his life" and "for any period which does not in fact end before his death," it would appear to be contrasting retention of an interest in the property under an agreement for a life estate with retention in fact of possession or enjoyment of the property.[6] It is, moreover, quite apparent from the *Union Planters Nat'l Bank* and the *Stephenson* cases that actual proof of the existence or absence of an agreement for retention of possession by the decedent of the transferred property places the government at a severe disadvantage. This proof must be sought after the death

[4] Union Planters Nat'l Bank v. United States, FED. EST. & GIFT TAX REP. (65-1 U.S. Tax Cas.) ¶ 12,298 (W.D. Tenn. Dec. 28, 1964).

[5] 238 F. Supp. 660 (W.D. Va. 1965). *Cf.* Peck v. United States, FED. EST. & GIFT TAX REP. (65-2 U.S. Tax Cas.) ¶ 12,333 (M.D. Ga. May 5, 1965).

[6] Congress apparently used the language, "for any period which does not in fact end before his death," to cover a transfer similar to one which went untaxed in Nichols v. Coolidge, 274 U.S. 531 (1927). Mrs. Coolidge had deeded her two residences to her children on the understanding that she would continue to live in the residences until her death, which she did. The Court held this was not a transfer intended to take effect in possession or enjoyment at her death because she had not reserved a legal interest in the residences at the time of the transfer.

of the transferor from interested witnesses who normally stand in such an intimate family relationship to the decedent that their dealings with the decedent would have been confidential.[7] How can it be determined, for example, what understanding actually existed between the decedent and his wife about the decedent's continued occupancy of the family residence? Obviously, section 2036 was worded in broad and inclusive terms in order to prevent tax avoidance. It would seem to encourage tax avoidance if the courts ignore the language of section 2036 and read into the statute a requirement of an agreement with the transferee in addition to possession or enjoyment in fact until his death.

The only basis in the statutory language for requiring an agreement that the transferor be allowed to continue in possession of the transferred property during his life, in addition to possession in fact of the property until his death, is the word "retained." The statute says that the decedent must have "retained" possession or enjoyment of the transferred property for a period not in fact ending before his death. Does this necessarily imply the existence of some agreement for the continued possession of the transferred property, or can the requirement of retention be satisfied by possession in fact? The dictionary definition of "retain" is "to hold or continue to hold in possession or use."[8] Certainly one could keep possession of property without any agreement for continued possession. A wrongdoer who seized property against the true owner's will might "retain" possession of the property, even though this retention was quite independent of any agreement with the true owner and was in fact in complete defiance of the true owner's wishes. It is certainly a strained interpretation of section 2036 to say that the statute's use of the word "retained" implies a requirement of an agreement for continued possession. Moreover, there seems to be little justification for straining if this defeats the policy of the statute, as it appears to do. Presumably, Congress provided that there should be a tax where a person transfers property and retains possession or enjoyment of the transferred property for a

[7] In both cases the evidence establishing that there was not an express or implied agreement concerned private conversations between the decedent and his wife at the time of the transfer. In *Stephenson*, Mrs. Stephenson quoted her husband as saying at the time he gave her the home, "It's yours to do with as you choose, you can even put me out if you wish." 238 F. Supp. at 662, n.2.

[8] WEBSTER, THIRD NEW INTERNATIONAL DICTIONARY (1965).

period not in fact ending before his death in order to prevent tax avoidance by means of apparent outright transfers coupled with secret agreements for retention of possession. The test which the statute appears to lay down for a tax is the objective fact of continued possession for the actual duration of the transferor's life, rather than his subjective state of mind or some unknown agreement with a transferee.[9]

It is difficult in these cases to discern the relevance of an unenforceable agreement. An enforceable agreement that the transferor shall have possession of the transferred property until his death would be tantamount to a reservation of a life estate. It is also difficult to see how an unenforceable agreement adds anything to retention in fact, since it has no legal status. An unenforceable agreement might indicate an intention to retain possession of the transferred property during the transferor's life, but, if the critical characteristic of a taxable transfer under section 2036 is the objective operation of the transfer,[10] the subjective state of mind of the transferor would seem to have no significance.

Prior to the *Union Planters Nat'l Bank* case there were decisions hinting that some sort of agreement for continued possession or enjoyment was necessary for a tax under section 2036,[11] but there does not seem to have been any case which squarely held that the agreement was a *sine qua non* of the tax where the decedent's possession and enjoyment had continued from the time of the transfer until his death.

There have been decisions in which an agreement has been used as a makeweight along with continued possession or enjoyment to impose a tax liability. This was the case in *Estate of McNichol v. Commissioner*[12] where the decedent transferred by warranty deed all of his income-producing property to his children and continued to

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[9] See note 10 *infra.*

[10] Sections 2036 to 2038 which tax incomplete inter vivos transfers grew out of and amplify the wording of section 202(B) of the Revenue Act of 1916 that taxed transfers "intended to take effect in possession or enjoyment at or after . . ." the death of the transferor. Mr. Justice Holmes in Shukert v. Allen, 273 U.S. 545 (1927), established an objective test for transfers taking effect at death. In Estate of Speigel v. Commissioner, 335 U.S. 701 (1949) *rehearing denied* 336 U.S. 915 (1949), the subjective intent of a transferor was held immaterial in determining whether a transfer took effect at death. See LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES §§ 6.1-6.3 (2d ed. 1962).

[11] See cases cited notes 12-19 *infra.*

[12] 265 F.2d 667 (3d Cir. 1959), *affirming* 29 T.C. 1179 (1958).

receive all of the rents from the property under an oral agreement with his children until his death. The taxpayers argued that the transfer was not taxable because the oral agreement was unenforceable under the Pennsylvania Statute of Frauds and, therefore, did not give the decedent a "right to the income." The Tax Court[13] rejected this argument and held that the receipt of the income was a retention of possession and enjoyment, declaring that the statute posed alternative tests for inclusion—either the right to income or the factual retention of possession and enjoyment, regardless of the decedent's retention of any right to the property. In affirming the Tax Court's decision, the Third Circuit[14] placed more reliance on the presence of the agreement, holding that retaining even an unenforceable right to the income is taxable as retention of possession and enjoyment. The court limited its decision to the facts of the case and declined to say whether it would have upheld the tax if there had been no evidence of an agreement. In *Harter v. United States*[15] the decedent in 1935 had conveyed income-producing property to his wife by a warranty deed that was not recorded until 1950 when he was in his final illness. Up until the time of his death he had received all of the rents from the property, and from 1941 to 1947 he had reported the rents as income and had taken deductions for depreciation of improvements to the property on his separate income tax returns. The court held the transfer to be taxable, basing its decision on the factual retention of a life interest and an inferred agreement between the decedent and his wife that he would control the property. Neither of these decisions decided directly that an agreement is indispensable for a tax under section 2036.

In other cases, agreements have been the deciding factor in determining whether the decedent was the settlor of a trust under which he had a life interest. This was one of the issues in *State St. Trust Co. v. United States*[16] where the decedent had originally created a trust for his children, reserving the power to terminate it. He terminated the trust in favor of the children upon their agreement to use the funds to establish a second trust, the one in issue in the case. The court found the decedent to be the settlor

[13] 29 T.C. 1179 (1958).
[14] 265 F.2d 667 (3d Cir. 1959).
[15] 55-1 U.S. Tax Cas. 55,397 (N.D. Okla. 1954).
[16] 263 F.2d 635 (1st Cir. 1959).

of the second trust on the theory that he was the substantial creator of the trust. The question of who is the settlor of a trust also comes up in cases involving cross or reciprocal trusts in which agreements have been relevant in determining whether one trust was created as consideration for the other trust.[17] Agreements were significant in these cases in determining whether the decedent was the transferor, not in establishing whether he had retained a taxable life interest in the transferred property.

In cases where the decedent overtly transfers possession and enjoyment which he later receives back from the transferee, agreements have been necessary to prove that the decedent never completely divested himself of the transferred property. In *Estate of Skinner v. United States*[18] the decedent created an irrevocable trust that gave the trustees a discretionary power to pay the income to the decedent or to others. Tax liability was imposed after it was established that the decedent had received all of the income of the trust during her life as a result of a prearrangement with the trustees. In *Burrill v. Shaughnessy*[19] the court refused to uphold a tax when the government failed to sustain its allegation that the decedent-settlor had been appointed a contingent life estate in a trust as a result of a prearrangement with the donee of the power. This, however, was not a case of continued possession or enjoyment. The decedent had created an irrevocable trust giving his wife the income for her life and a limited power to appoint to him by will, which she exercised several months after he had transferred the property into the trust.

None of the previous cases hold that an agreement for retention of possession or enjoyment is a prerequisite for a tax under section 2036 when the decedent retained possession or enjoyment of property he transferred during his life for a period not in fact ending with his death. They were either cases where agreements were necessary to determine whether the decedent was in fact the transferor of the property, as in the *State St. Trust Co.* case, or cases where, in instances of interrupted possession or enjoyment, agreements were

[17] Estate of Guenzel v. Commissioner, 258 F.2d 248 (8th Cir. 1958); McLain v. Jarecki, 232 F.2d 211 (7th Cir. 1956); Newberry's Estate v. Commissioner, 201 F.2d 874 (3d Cir. 1953).

[18] 316 F.2d 517 (3d Cir. 1963). *Cf.* Estate of T. M. Flynn, 13 P-H Tax Ct. Mem. 1380 (1944); Estate of J. H. Scheide, 16 P-H Tax Ct. Mem. 1087 (1947).

[19] 71 F. Supp. 99 (N.D.N.Y. 1947).

invoked to determine whether the decedent had completely divested himself of the property at the time of the transfer, as in the *Skinner* case. There were also cases in which agreements were used as a makeweight in finding a tax liability, as in *McNichol,* but no cases squarely holding that no tax would be imposed on continued possession or enjoyment in the absence of an agreement.

The Treasury contends that if the decedent transferred his home to his wife or to his children, the full value of the home should be included in his gross estate in any of the three following situations: (1) if by state law he had a legally enforceable right to live in the home as long as it belonged to his wife, or (2) if he was discharging a legal obligation to support his wife or children, or (3) if he continued to reside in the residence until his death.[20]

In light of the literal wording of section 2036 and the apparent policy behind the statute to prevent tax avoidance, it is submitted that the Treasury's position is sound and should be followed.

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Torts—Implied Warranty in Real Estate—Privity Requirement

The principle of caveat emptor[1] in real property sales is beginning to show cracks in what previously was its impregnable structure. In 1936 Professor Williston said, "There are no implied warranties in sales of real estate."[2] Although this is still the rule in a vast majority of the jurisdictions in the United States,[3] the reasoning behind it seems to be weakening.

The first inroad into the principle involved houses to be con-

[20] Speech by Chief Counsel Sept. 19, 1964, as reported in 4 RESEARCH INSTITUTE TAX COORDINATOR 47008C (1965).

[1] The North Carolina view is that caveat emptor will be followed in the sale of real property provided no fraud is involved. Smathers v. Gilmer, 126 N.C. 757, 759, 36 S.E. 153, 154 (1900). For a further discussion of the North Carolina view see 42 N.C.L. REV. 946, 951 (1964). See generally Bearman, *Caveat Emptor in Sales of Realty,* 14 VAND. L. REV. 541 (1961); Dunham, *Vendor's Obligation as to Fitness of Land for a Particular Purpose,* 37 MINN. L. REV. 108 (1953); Hamilton, *The Ancient Maxim Caveat Emptor,* 40 YALE L.J. 1133 (1931); Comment, 5 DE PAUL L. REV. 263 (1956); Note, 4 W. RES. L. REV. 357 (1953).

[2] 4 WILLISTON, CONTRACTS § 926, at 2602 (rev. ed. 1936).

[3] *E.g.,* Narup v. Higgins, 51 Ill. App. 2d 102, 200 N.E.2d 922 (1964); Coutrakon v. Adams, 39 Ill. App. 2d 290, 188 N.E.2d 780 (1963); Shapiro v. Kornicks, 103 Ohio App. 49, 124 N.E.2d 175 (1955); Steiber v. Palumbo, 219 Ore. 479, 347 P.2d 978 (1959). See 55 AM. JUR. *Vendor and Purchaser* § 368 (1946); Annot., 78 A.L.R.2d 446 (1961).