

NOTES

SECTION 2035: TAXATION OF GIFTS MADE WITHIN THREE YEARS OF DEATH

Not the least of the dramatic, wholesale reform of estate and gift taxation in the Tax Reform Act of 1976¹ involves section 2035.² As amended, section 2035 ties together the estate and gift tax provisions by returning to the gross estate any gifts made by a decedent during the three years preceding his death along with any gift taxes paid on such gifts. The amendment of section 2035 is a response to taxpayers' frequent and successful use of gift giving shortly before death to reduce their estate tax liability.

The use of gift giving to reduce estate tax liability was possible prior to the Tax Reform Act of 1976 because lifetime transfers of wealth possessed a definite advantage over testamentary transfers. Both the gift and estate taxes were structured progressively, but the gift tax rates were low in comparison to estate tax rates.³ By making lifetime transfers a donor could take advantage of these lower gift tax rates in two ways. First, any gift transfer was taxed at the lowest marginal gift tax rate. At the same time, this first dollar reduced the estate, and thereby eliminated a dollar from the highest estate tax bracket.⁴ Thus, a donor could take advantage of lower gift tax rates on the transfer and also reduce his future estate tax liability by reducing his gross estate. Consequently, donors frequently made lifetime transfers to avoid or decrease estate tax liability.

¹ Tax Reform Act of 1976, Pub. L. No. 94-455, §§ 101 *et seq.*, 90 Stat. 1520 (1976). For an excellent discussion of the various political pressures at work in the legislature during consideration of the Act, see Surrey, *Reflections on the Tax Reform Act of 1976*, 25 CLEV. ST. L. REV. 303 (1976).

² I.R.C. § 2035, as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a), 90 Stat. 1848 (1976), provides in full:

(a) INCLUSION OF GIFTS MADE BY DECEDENT.—Except as provided in subsection (b), the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death.

(b) EXCEPTIONS.—Subsection (a) shall not apply to—

(1) any bona fide sale for an adequate and full consideration in money or money's worth, and

(2) any gift excludable in computing taxable gifts by reason of section 2503(b) (relating to \$3,000 annual exclusion for purposes of the gift tax) determined without regard to section 2513(a).

(c) INCLUSION OF GIFT TAX ON CERTAIN GIFTS MADE DURING 3 YEARS BEFORE DECEDENT'S DEATH.—The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse after December 31, 1976, and during the 3-year period ending on the date of the decedent's death.

³ Prior to 1977, estate tax rates began at 3% and reached a maximum rate of 77%. Revenue Act of 1954, § 2001, 68A Stat. 373-74 (1954). The gift tax rates ranged from 2¼% to 57¼%. Revenue Act of 1954, § 2502(a), 68A Stat. 403-04 (1954).

⁴ Donaldson, *Inter Vivos Giving in Estate Planning Under the Tax Reform Act of 1976*, 18 WM. & MARY L. REV. 539, 539-40 (1977). See generally JOINT COMMITTEE ON TAXATION, 94TH CONG., 2D. SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 1, 526, *reprinted in* 1976-3 [vol. 2] C.B. 3, 539 [hereinafter cited as JOINT COMMITTEE REPORT].

In an effort to prevent estate tax avoidance, Congress in the Revenue Act of 1916⁵ enacted the predecessor of section 2035, which provided that the value of a decedent's gross estate was to be determined by including the value at the time of his death of property transferred in contemplation of death during the last three years of the donor's life, except in the case of a bona fide sale. The statute also established a rebuttable presumption that a transfer of property within two years of death was made in contemplation of death.⁶ Provisions to the same effect have remained in the Internal Revenue Code since that time.⁷ This congressional effort to curb estate tax avoidance was aided by a broad judicial interpretation of the statutory phrase "in contemplation of death."⁸

Despite this congressional and judicial effort to curb estate tax avoidance, donative transfers to avoid estate taxes flourished and were relatively successful. Gifts made outside of the period covered by section 2035 were not included in the donor's gross estate, even if made in contemplation of death, and hence were forever free of estate taxation.⁹ Moreover, with a little careful planning, a donor could establish a "life motive" for a gift to rebut the presumption.¹⁰ The Internal Revenue Service was embroiled in considerable litigation concerning the motives of decedent donors, with little success.¹¹ Thus, prior versions of section 2035 did not automatically return transfers made within a few years of death to the gross estate.¹² Because there was a great likelihood that lifetime gifts would escape estate taxation altogether under prior law, it was to the donor's advantage to make as many lifetime transfers as possible.

⁵ Revenue Act of 1916, § 202(b), 39 Stat. 777-78.

⁶ *Id.*

⁷ Revenue Act of 1918, § 402(c), 40 Stat. 1097 (1919); Revenue Act of 1921, § 402(c), 42 Stat. 278 (1921); Revenue Act of 1924, § 302(c), 43 Stat. 304 (1924); Revenue Act of 1936, § 805, 49 Stat. 1744 (1936); Revenue Act of 1939, § 811(c), 53-1 Stat. 121 (1939); Internal Revenue Code Amendments, § 7, 63 Stat. 894 (1949); Revenue Act of 1950, § 501(a), 64 Stat. 962 (1950); Revenue Act of 1954, § 2035, 68A Stat. 381-82 (1954).

⁸ As Justice Hughes stated in *United States v. Wells*, 283 U.S. 102 (1931), [t]he words "in contemplation of death" mean that the thought of death is the impelling cause of the transfer, and while the belief in the imminence of death may afford convincing evidence, the statute is not to be limited, and its purpose thwarted, by a rule of construction which in place of contemplation of death makes the final criterion to be an apprehension that death is "near at hand."

Id. at 118. See *Detroit Bank & Trust Co. v. United States*, 467 F.2d 964, 968 (6th Cir. 1972); *Estate of Chotin v. United States*, 201 Ct. Cl. 882, 882 (1973); *Estate of Dinell v. Commissioner*, 58 T.C. 73, 78-79 (1972).

⁹ Revenue Act of 1950, § 501(a), 64 Stat. 962 (1950) (continued in Revenue Act of 1954, § 2035(b), 68A Stat. 382 (1954)).

¹⁰ Some courts have held that avoidance of tax liability was itself a "life motive." *Allen v. Trust Co. of Georgia*, 326 U.S. 630, 635 (1946); *Estate of Rosebault v. Commissioner*, 12 T.C. 1, 4 (1949). Generally, however, a transfer made for the purpose of avoiding death taxes, or made as a testamentary substitute, has been viewed as made in contemplation of death. See, e.g., *Rickenberg v. Commissioner*, 177 F.2d 114, 118 (9th Cir. 1949); *Gould v. Granquist*, 59-1 U.S. Tax Cases ¶ 11,857 (D. Ore. 1958). See also *Estate of Hill v. Commissioner*, 229 F.2d 237, 240 (2d cir. 1956) (a transfer in avoidance of death taxes which were, in fact, non-existent was held to have been made in contemplation of death).

¹¹ JOINT COMMITTEE REPORT, *supra* note 4, at 527, 1976-3 [vol. 2] C.B. at 539. *Ingram, The Estate, Gift, Generation-Skipping, and Related Income Tax Provisions of the Tax Reform Act of 1976 and Some Estate Planning Observations*, 1976 UTAH L. REV. 647, 741 (1976).

¹² See *Donaldson*, *supra* note 4, at 542.

It was also to the donor's advantage to make frequent lifetime gifts even if the presumption of section 2035 stood and the value of the gift was returned to the gross estate. Prior versions of section 2035 returned the value of the gift to the gross estate, but not an amount equal to the gift taxes paid as a result of the transfer. Moreover, if the value of the gift was returned to the gross estate, the amount of the gift tax was available as a credit against subsequent estate taxes.¹³ Hence, the net taxable estate was effectively reduced by the amount of gift taxes paid or owing¹⁴ during the donor's life.¹⁵

The reduction of the gross estate by an amount equal to any gift taxes paid, coupled with the strong possibility that the gift itself would escape estate taxation, made lifetime gift giving beneficial to the taxpayer. As a practical matter, however, lifetime gift giving was available only to wealthier taxpayers who could afford to part with property before death. Taxpayers with more modest estates generally had to retain their property until death to insure their own financial security.¹⁶ Congress was concerned with the vertical inequity in the tax system which resulted from the fact that the timing of a transfer was the essential factor that determined its tax consequences—and choice of timing was available only to the very wealthy.¹⁷ To the extent that a discrepancy in the tax effect of this provision worked to the advantage of the wealthy, it undermined the progressivity of the overall tax system,¹⁸ since one third of the net progressivity in the United States tax system is the result of the estate and gift taxes alone.¹⁹

In order to increase the progressivity of the tax system by eliminating some of the provisions of the transfer tax that had favored the wealthy, Congress undertook major alterations in the estate and gift tax systems in the Tax Reform Act of 1976.²⁰ Among the Act's changes was an amendment of section 2035.

In general, amended section 2035 increases a gross estate by an amount equal to the value of all property or any interest in property that the decedent has transferred after December 31, 1976 and during the

¹³ Revenue Act of 1954, § 2012(a), 68A Stat. 375 (1954) (not applicable to gifts made after December 31, 1976, for estates of decedents dying after that date. I.R.C. § 2012(e)).

¹⁴ Under I.R.C. § 2053(a)(3), gift taxes due on lifetime transfers, but not yet paid, are deductible from the gross estate as debts of the estate.

¹⁵ JOINT COMMITTEE REPORT, *supra* note 4, at 526, 1976-3 [vol. 2] C.B. at 538. See generally Ingram, *supra* note 11, at 741; Donaldson, *supra* note 4, at 543; Castleman, *Lifetime Gifts in Estate Planning Under 1976 Tax Reform Act*, 26 DRAKE L. REV. 313, 316-17 (1976-77).

¹⁶ See JOINT COMMITTEE REPORT, *supra* note 4, at 526, 1976-3 [vol. 2] C.B. at 538; Castleman, *supra* note 15, at 313.

¹⁷ JOINT COMMITTEE REPORT, *supra* note 4, at 526, 1976-3 [vol. 2] C.B. at 538.

¹⁸ H.R. REP. NO. 94-1380, 94th Cong., 2d Sess. 1, 5 (1976), reprinted in [1976] U.S. CODE CONG. & AD. NEWS 3356, 3359.

¹⁹ See Kurtz and Surrey, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, the Criticisms, and a Rebuttal*, 70 COLUM. L. REV. 1365, 1367 (1970). For a contrary view of progressivity and estate taxes, see *Annual Report of the Secretary of the Treasury, Proposed Estate and Gift Tax Revision: Hearings Before the House Ways and Means Committee*, H.R. DOC. NO. 3270, 94th Cong., 2d Sess. (1976) (statement of Treasury Secretary William Simon).

²⁰ JOINT COMMITTEE REPORT, *supra* note 4, at 526, 1976-3 [vol. 2] C.B. at 538; H.R. REP. NO. 94-1380, 94th Cong., 2d Sess. 1, 5 (1976), reprinted in [1976] U.S. CODE CONG. & AD. NEWS 3356, 3359.

three years immediately preceding his death.²¹ There are, however, exceptions to this basic rule. For example, section 2035 does not include in the gross estate property that is transferred incident to a bona fide sale.²² It also does not include any gift which is not subject to gift tax because of the \$3,000 annual exclusion from gift taxation.²³ If, however, a gift qualified for the \$3,000 annual gift tax exclusion and was treated as a gift made one half by each spouse by reason of section 2513,²⁴ then section 2035 (b)(2) treats the transfer as though no gift splitting had occurred.²⁵ Section 2035 also includes in the gross estate an amount equal to any gift taxes paid by the decedent or his estate on any gift made by the decedent or decedent's spouse after December 31, 1976 and during the three year period preceding decedent's death.²⁶

Because section 2035 deals with aspects of both estate and gift taxation, it can play a significant part in the planning of estates and lifetime gift giving. It encourages lifetime gift giving by allowing annual gifts of \$3,000 or less per beneficiary per year to escape both estate taxes and gift taxes. It discourages such gift giving primarily by removing some of the incentives that previously existed for those who could afford extensive lifetime gift giving.

This note will focus on the changes in estate and gift planning as a result of the amendment of section 2035. First, it will deal with the constitutionality of the change in section 2035. Second, it will take up the practical consequences of the section on estate and gift planning. In doing so, this note will examine what constitutes a bona fide sale for purposes of excluding certain transfers from the operation of the inclusionary rule, the \$3,000 annual gift tax exemption and section 2035, and section 2035(c), which returns to the gross estate an amount equal to any gift taxes paid on lifetime transfers during the three years preceding the donor's death. Finally, this note will discuss legislative changes in section 2035 that are expected in the Technical Corrections Bill of 1977.²⁷

I. THE CONSTITUTIONALITY OF THE ABSOLUTE RULE OF INCLUSION OF SECTION 2035

The most important feature of section 2035 is its provision including in a decedent's gross estate all gifts made by the decedent in the three years preceding his death regardless of the motive for making the gift. This absolute rule of inclusion reflects Congress' continuing effort to prevent taxpayers' avoidance of estate taxation by making gifts shortly before death. Most predecessors of section 2035 stated a rebuttable presumption

²¹ I.R.C. § 2035(a), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a), 90 Stat. 1848.

²² I.R.C. § 2035(b)(1), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a), 90 Stat. 1848.

²³ I.R.C. § 2503.

²⁴ I.R.C. § 2513.

²⁵ I.R.C. § 2035(b)(2), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a), 90 Stat. 1848.

²⁶ I.R.C. § 2035(c), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a), 90 Stat. 1848-49.

²⁷ H.R. 6715, 95th Cong., 1st Sess. (1977).

that gifts made within a certain number of years before death were made in contemplation of death and hence were to be included in the gross estate.²⁸ The ease with which this presumption was rebutted led Congress to enact the absolute rule of section 2035. Because this rule is absolute, however, it arguably constitutes an unconstitutionally arbitrary classification of gifts. It also may be attacked as an irrebuttable presumption that gifts made shortly before death are made in order to avoid estate taxes under the Supreme Court's 1932 decision in *Heiner v. Donnan*.²⁹

Heiner dealt with section 302(c) of the Revenue Act of 1926.³⁰ That provision created an irrebuttable presumption that gifts of more than five thousand dollars to any single beneficiary made within two years preceding a donor's death were made in contemplation of death, and thus to be included in the gross estate for estate tax purposes.³¹ The decedent in *Heiner* has made inter vivos gifts not in contemplation of death to his children within the two years preceding his death. The Supreme Court held that these gifts could not be included in the decedent's gross estate because the statute contained an irrebuttable presumption of fact in violation of the due process clause of the fifth amendment.³² While the Court did not doubt the power of Congress to tax gifts made in contemplation of death,³³ it rejected the idea that gifts bearing no relationship to death could be the subject of a death tax, since death was the generating source of the estate taxing power.³⁴ In its attempt to bring gifts bearing a relationship to death within the estate taxing power, section 302(c) declared *all* gifts made shortly before the donor's death to be gifts in contemplation of death, even where the death of the donor was merely a fortuitous event. As a result, gifts bearing no relationship to the donor's death were subject to the estate tax.

²⁸ See note 7 *supra*.

²⁹ 285 U.S. 312 (1932).

³⁰ Revenue Act of 1926, § 302(c), 44 Stat. 70 (1926). The statute provided, in pertinent part:

The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—

....
(c) To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, in contemplation of . . . death, except in case of a bona fide sale for an adequate and full consideration in money or money's worth. Where within two years prior to his death but after the enactment of this Act and without such a consideration the decedent has made a transfer or transfers, by trust or otherwise, of any of his property, or an interest therein, not admitted or shown to have been made in contemplation of . . . death, and the value or aggregate value, at the time of such death, of the property or interest so transferred to any one person is in excess of \$5,000, then, to the extent of such excess, such transfer or transfers shall be deemed and held to have been made in contemplation of death within the meaning of this title. . . .

³¹ *Id.*

³² *Heiner*, 285 U.S. at 328-29. Because the Court in *Heiner* was dealing with a federal statute, the fifth amendment rather than the fourteenth amendment was applicable. However, the same principles applied to the due process clauses of both amendments. *Id.* at 326.

³³ *Id.* at 324. Despite this statement by the Court, it later rejected the notion that section 302(c) was valid as a tax on gifts because the category of gifts selected for taxation was so narrow and so strange as to be wholly arbitrary. *Id.* at 331.

³⁴ *Id.* at 332.

This, said the Court, was an unconstitutional attempt to legislate a fact into existence which denied taxpayers a fair opportunity to offer proof in rebuttal.³⁵

Congress in 1976 was well aware of the *Heiner* Court's rejection of an irrebuttable presumption of the decedent's motive for making a gift.³⁶ The Joint Committee on Taxation and the House Ways and Means Committee both expressed the opinion that the absolute rule of inclusion is distinguishable from the irrebuttable presumption of the 1926 statute.³⁷ In their view, the absolute rule of inclusion precludes any objection to it as an irrebuttable presumption because it lacks any reference to the decedent's motive in making the gift.³⁸ The absolute rule of inclusion reflects an effort to treat all gifts made within three years of death, whether or not made in contemplation of death, in the same fashion. Thus, section 2035 completely abandons previous attempts to distinguish between gifts made in contemplation of death and other gifts made shortly before death. Since the *Heiner* Court's principal objection was to a conclusive legislative declaration of motive,³⁹ the Committees' conclusion that present section 2035 is unobjectionable as an irrebuttable presumption seems correct.

Even if the Committees' conclusion is correct, however, *Heiner* raises other questions concerning the validity of present section 2035. While the *Heiner* Court objected to the 1926 statute primarily on the grounds that it constituted an irrebuttable presumption, the Court expressed two other objections to the statute. First, the Court asserted that the statute operated as a tax imposed on the decedent's estate measured by property that already had passed irrevocably to a donee.⁴⁰ This was especially objectionable in its view because the value of the property to be included in the gross estate was determined at the time of the decedent's death rather than at the time of the original transfer.⁴¹ Finally, the Court reasoned that taxing inter vivos gifts made within a certain number of years prior to death and not other inter vivos gifts made at a time more distant from death was wholly arbitrary.⁴² Both of these objections could be made concerning section 2035 since that statute taxes an estate based upon the value of a gift that was never part of the estate. Moreover, section 2035 taxes inter vivos gifts made more than three years before the donor's death differently from gifts made less than three years prior to death.

The Joint Committee on Taxation states in its report that the imposition of a tax on the estate based upon the value of property which has

³⁵ *Id.* at 328-29.

³⁶ JOINT COMMITTEE REPORT, *supra* note 4, at 528-29, 1976-3 [vol. 2] C.B. at 540-41.

³⁷ *Id.*; H.R. REP. NO. 94-1380, 94th Cong., 2d Sess. 1, 14 (1976), reprinted in [1976] U.S. CODE CONG. & AD. NEWS 3356, 3368.

³⁸ JOINT COMMITTEE REPORT, *supra* note 4, at 529, 1976-3 [vol. 2] C.B. at 541.

³⁹ *Heiner*, 285 U.S. at 328-29.

⁴⁰ As Justice Sutherland stated,

the result is that upon those who succeed to the decedent's estate there is imposed the burden of a tax, measured in part by property which comprises no portion of the estate, to which the estate is in no way related, and from which the estate derives no benefit of any description. Plainly, this is to measure the tax on A's property by imputing to it in part the value of the property of B

Id. at 327.

⁴¹ *Id.*

⁴² *Id.* at 331.

passed irrevocably to a donee poses no obstacle for the statute.⁴³ In the Committee's view, the *Heiner* Court's objection to this method of taxation in the 1926 statute was influenced by the impact of the rule in a tax system where substantial differences in tax liability would have arisen depending upon whether the transfer was taxed as simply an inter vivos gift or was returned to the estate and thereby subject to estate taxes.⁴⁴ Such disparate tax treatment of gifts and estates no longer exists due to the new unified rate schedule for gifts and estates established by the Tax Reform Act of 1976.⁴⁵ The tax imposed upon an estate as a result of the inclusion of gifts in the gross estate will not differ greatly from the tax that would be imposed upon simple lifetime gifts. Therefore, the objection of the *Heiner* Court to an undue burden imposed upon an estate based upon gifts no longer a part of the estate is not relevant to the present statute.

As to the *Heiner* Court's other major objection to the 1926 statute, it is doubtful that *Heiner* is still valid precedent on the question of the reasonableness of a classification which taxes certain inter vivos gifts as though they were part of the donor's estate.⁴⁶ In decisions subsequent to *Heiner*, the Supreme Court has virtually abandoned its position that it is arbitrary to tax gifts made near death differently from gifts made earlier in the donor's life. Shortly after *Heiner*, the Court held that Congress legitimately could impose an estate tax on inter vivos transfers, the enjoyment of which was subject to change before the donor's death,⁴⁷ and on inter vivos transfers of property with reservation of a life estate,⁴⁸ if such treatment were reasonably required to prevent estate tax evasion.⁴⁹ Since Congress had the power to tax gifts of this sort, it was of no consequence whether the tax was denominated as an estate tax or a gift tax.⁵⁰ These cases are indicative of an important change in the Court's attitude towards legislative classification schemes which sweep broadly in their attempts to eliminate an evil.⁵¹ The

⁴³ JOINT COMMITTEE REPORT, *supra* note 4, at 528-29, 1976-3 [vol. 2] C.B. at 540-41.

⁴⁴ *Id.* Indeed, the *Heiner* Court mentioned several times its objection to "the burden" that would be imposed by an estate tax based on the inter vivos gifts returned to the gross estate. See *Heiner*, 285 U.S. at 327, 328, 332.

⁴⁵ JOINT COMMITTEE REPORT, *supra* note 4, at 528-29, 1976-3 [vol. 2] C.B. at 540-41. Two features of the unified transfer tax system have eliminated the tremendous advantages that lifetime gifts once enjoyed over testamentary transfers. The first is the identical rate schedules for estate and gift taxes. Compare I.R.C. § 2502(a) with I.R.C. § 2001(c). Furthermore, lifetime transfers subject to tax after 1976 are taken into consideration in determining the net taxable estate and the applicable marginal rate of estate tax. I.R.C. § 2001(b).

⁴⁶ JOINT COMMITTEE REPORT, *supra* note 4, at 529, 1976-3 [vol. 2] C.B. at 541.

⁴⁷ *Helvering v. City Bank Farmers Trust Co.*, 296 U.S. 85 (1935) (upholding Revenue Act of 1926, § 302(d), 44 Stat. 71 (1926)).

⁴⁸ *Helvering v. Bullard*, 303 U.S. 297 (1938) (upholding Revenue Act of 1926, § 302(c), 44 Stat. 70 (1926)).

⁴⁹ See *Helvering v. City Bank Farmers Trust Co.*, 296 U.S. 85, 90 (1935); *Helvering v. Bullard*, 303 U.S. 297, 302 (1938). Compare *Heiner v. Donnan*, 285 U.S. 312, 339 (1932) (Stone, J., dissenting).

⁵⁰ *Helvering v. Bullard*, 303 U.S. 297, 301-02 (1938).

⁵¹ *Helvering v. City Bank Farmers Trust Co.*, 296 U.S. 85 (1935), and *Helvering v. Bullard*, 303 U.S. 297 (1938), do not completely ignore the *Heiner* Court's concern with imposing an estate tax on gifts inter vivos. Like *Heiner*, both of these cases involved sections of the Code which included the value of inter vivos transfers in the gross estate for estate tax purposes. Unlike the situation in *Heiner*, however, a benefit passed to the donee at the donor's death in both of these cases: irrevocable enjoyment of the gift in *City Bank Farmers Trust Co.*, and the remainder interest in *Bullard*. For this reason, the transfers in these two cases are much more

decline after *Heiner* of an economic substantive due process approach to legislative classification schemes is not limited simply to tax legislation but is reflected throughout later Court opinions.⁵²

It appears, therefore, that the Court's objection of a rule which treats gifts made near death differently from gifts made at a time more remote from death has disappeared. For the present version of section 2035 this indicates that there is no serious objection to the statute as one which arbitrarily classifies and taxes certain kinds of inter vivos gifts differently from other kinds of inter vivos gifts. The statute is not objectionable because it includes gifts made within three years of death in the gross estate, and thereby subjects them to a possibly higher tax to which other inter vivos gifts are not subject. Coupled with the unassailability of section 2035 on the grounds that it presents an irrebuttable presumption, the constitutionality of section 2035 is not in serious doubt.

II. SECTION 2035(a) AND THE ABSOLUTE RULE OF INCLUSION

Assuming the constitutionality of the absolute rule of inclusion set out in section 2035(a), the next question raised by this section is its practical consequences for lifetime gift giving and estate planning. Undoubtedly the most significant effect of section 2035(a) is the inescapable imposition of estate taxes on any appreciation in value of a gift that is returned to the gross estate between the time of the transfer and that of the donor's death. Since all gifts made within three years of the donor's death are returned to the gross estate by section 2035(a) and probably will be valued as of the date of the donor's death, any increase in the value of the gifts between the time the gifts are made and the donor's death will be subject to estate taxation. This section of the note will first examine the taxation of appreciation. It will then turn to what Congress has suggested is a second consequence of section 2035(a): an increase in the marital deduction permitted by section 2056.⁵³

Whether any appreciation in value of a gift accruing between the original transfer of the gift and the donor's death is subject to estate taxes depends upon whether the gift is returned to the gross estate. Before 1976, it was possible to establish a life motive for a gift, thus rebutting the presumption that the gift was made in contemplation of death. As a result, the gift was not returned to the gross estate, and any appreciation in the value of the gift accruing between the time of giving and the date of the donor's death completely escaped transfer taxation. After 1976, any gift made within three years of the donor's death is automatically returned to the gross estate and is subject to estate taxes. Consequently, the date on which the gift is valued becomes extremely important. If it is valued as of the date of

closely connected with what the Court in *Heiner* called the "generating source" of the estate taxing power: death. See *Heiner*, 285 U.S. at 322. On their facts, therefore, these cases are not altogether inconsistent with *Heiner*.

⁵² See generally *Williamson v. Lee Optical Co.*, 348 U.S. 483 (1955); *United States v. Caroline Prods. Co.*, 304 U.S. 144 (1938); *West Coast Hotel Co. v. Parrish*, 300 U.S. 379 (1937).

⁵³ I.R.C. § 2056(a). See JOINT COMMITTEE REPORT, *supra* note 4, at 529, 1976-3 [vol. 2] C.B. at 541.

the transfer, then subsequent appreciation in its value will not be taxed. If it is valued as of the date of the donor's death, then subsequent appreciation will be taxed.

Amended section 2035(a) does not specifically provide that the value of gifts returned to the gross estate shall be determined as of the time of the decedent's death, as opposed to as of the date of the gift. In the absence of any change in the language of section 2035(a), however, it can be assumed that the property will be valued at the donor's death as it was under the prior versions of section 2035.⁵⁴

Under section 2035 prior to the 1976 Act, transfers made before death but returned to the gross estate were valued at their fair market value at the time of the decedent's death⁵⁵ or at the optional alternative valuation date.⁵⁶ As a result, stock, bonds, and other appreciating or depreciating property often are given a higher or lower value when included in the gross estate than they had at the time of the transfer.⁵⁷

In contrast to the treatment of simple appreciation of property, income or interest attributable to a gift which accrues between the time of the transfer and the date of the donor's death is not taken into account in establishing the value of the property at the time of the decedent's death.⁵⁸ For example, stock worth \$100,000 at the time of the transfer, which increases in value to \$120,000 at the time of the donor's death, would increase the gross estate by \$120,000 under section 2035(a). If, however, this stock also produced income of \$5,000, this income would not increase the gross estate. The special treatment⁵⁹ accorded income or interest from gifts frequently is applied to increases in value due to the donee's own ingenuity

⁵⁴ The Joint Committee on Taxation contemplated that the revision of section 2035 would not alter the previous practice of valuing gifts at their market value at the time of the decedent's death rather than as of the date of the transfer. JOINT COMMITTEE REPORT, *supra* note 4, at 529, 1976-3 [vol. 2] C.B. at 541. As the Committee stated, "[t]he most significant adverse consequence would result where the property transferred substantially appreciates in value between the date of the transfer and the date of the decedent's death." *Id.*

⁵⁵ Rev. Rul. 76-235, 1976-1 C.B. 277, 278.

⁵⁶ I.R.C. § 2032(a) provides that an executor may elect to value property included in the gross estate as of a date six months after the decedent's death, or at the time of any sale, distribution, or disposal of property within six months of the decedent's death.

⁵⁷ The classic example of property which appreciates significantly between the time of transfer and the decedent's death is insurance policies. In *Estate of Hull v. Commissioner*, 38 T.C. 512 (1962), policies which were included in the gross estate by virtue of section 2035 were valued at full face. The court reasoned that the value of the interest transferred in contemplation of death was the value of all the rights under the policy, including the right to the face amount of the policy in the event the insured died. *Id.* at 529.

⁵⁸ See *Gidwitz' Estate v. Commissioner*, 196 F. 2d 813, 818 (7th Cir. 1952) (the court disallowed the inclusion of trust income in the value of a trust for purposes of section 2035(a) on the grounds that the income was paid to the beneficiaries of the trust rather than the decedent); *Burns v. Commissioner*, 177 F.2d 739, 741 (5th Cir. 1949); *McGehee v. Commissioner*, 260 F.2d 818, 820 (5th Cir. 1958).

⁵⁹ The treatment accorded to income or interest attributable to a gift is indeed special when the purpose of section 2035 is considered. The purpose of section 2035 is to "freeze" the estate as of a date three years prior to the decedent's death, and to reach the same tax results as if the decedent had kept the property instead of transferring it. *Humphrey's Estate v. Commissioner*, 162 F.2d 1, 2 (5th Cir. 1947). If property had been kept by the decedent, the income from it would have been collected by the decedent. Thus, the gross estate would be larger. Logically, therefore, any income from a gift should be considered in determining the value of the gift to be returned to the gross estate.

or resourcefulness.⁶⁰ Thus, the value of any gift returned to the gross estate by present section 2035(a) will reflect any increase or decrease in value during the period between the original transfer and the donor's death unless the increase is merely interest or income from the gift or appreciation due to the donee's own efforts.

While the taxing of appreciation in the value of inter vivos gifts may be the most significant effect of section 2035(a) after the Tax Reform Act of 1976, the Joint Committee Explanation accompanying the Act states that the change in section 2035(a) also will enlarge the marital deduction.⁶¹ Under section 2056 of the Code,⁶² property passing to a surviving spouse is deductible in computing the net taxable estate to the extent that the value of the property passing to the surviving spouse is included in the gross estate. Section 2056(c)(1)(A) limits this deduction to the greater of \$250,000 or fifty percent of the adjusted gross estate.⁶³ By including inter vivos gifts in the gross estate, section 2035(a) increases the total value of the estate. For those estates that determine the marital deduction by calculating fifty percent of the adjusted gross estate, the increase in the value of the estate concomitantly increases the deduction.

However, the Committee's statement that present section 2035(a) will increase the marital deduction is an oversimplification. In practical terms, the marital deduction is the full amount of a bequest to the surviving spouse if the adjusted gross estate is under \$250,000.⁶⁴ For adjusted gross estates valued between \$250,000 and \$500,000, with a marital bequest of under \$250,000, the deduction will be, in effect, \$250,000.⁶⁵ For adjusted gross estates of over \$500,000, with a marital bequest of over \$250,000, the deduction will be fifty percent of the gross estate.⁶⁶ Therefore, the only estates which determine their marital deduction on the basis of fifty percent of the gross estate are those valued in excess of \$500,000. Because an increase in the value of the gross estate will aid only estates for which the fifty percent marital deduction is taken, section 2035(a) will benefit only estates valued at over \$500,000.

⁶⁰ For example, where the donee sold stock worth fifty dollars a share that was given to him by the decedent in contemplation of death, and with the proceeds of the sale purchased new stock valued at seventy-five dollars per share, the value of the transfer for purposes of section 2035(a) was deemed to be only fifty-five dollars per share, the fair market value of the original shares at the donor's death. Rev. Rul. 72-282, 1972-1 C.B. 306, 306-07. So too, where the donee is peculiarly responsible for a dissipation, or even total loss of a gift made in contemplation of death, the value of the gift property for purposes of section 2035(a) was deemed to be the fair market value that property would have had at the date of the donor's death. Rev. Rul. 76-235, 1976-1 C.B. 277, 278.

⁶¹ JOINT COMMITTEE REPORT, *supra* note 4, at 529, 1976-3 [vol. 2] C.B. at 541.

⁶² I.R.C. § 2056(a).

⁶³ See generally, Piper & Fremont-Smith, *Principles for Effective Use of Marital Deductions*, in this issue, *supra* at p. 403.

⁶⁴ See [1977] 2 FED. EST. & GIFT TAX REP. (CCH) ¶ 7595.03.

⁶⁵ See *id.* However, the three year transitional rule of the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2002(d)(1), 90 Stat. 1856, disallows the use of the \$250,000 deduction in conjunction with wills or trusts executed before January 1, 1977 that contain marital deduction formulas providing that the spouse is to receive the maximum amount qualifying for a marital deduction, if the decedent dies before 1979 without amending his will or trust, and the decedent's state does not enact a statute which construes the marital deduction formula in light of the new \$250,000 limitation.

⁶⁶ See [1977] 2 FED. EST. & GIFT TAX REP. (CCH) ¶ 7595.03.

It is questionable, however, whether the amendment of section 2035(a) legitimately can be credited with the increase in the marital deduction that is available for estates valued at over \$500,000. As the Joint Committee's explanation states,⁶⁷ the marital deduction is increased by bringing into the gross estate inter vivos gifts made within three years of the donor's death. However, to the extent that the prior version of section 2035(a) brought gifts inter vivos back into the gross estate, it also would have increased the marital deduction. Thus, all that the amendment of section 2035(a) actually accomplishes in regard to increasing the gross estate and, consequently, the marital deduction, is to make inclusion of gifts made within three years of the donor's death inescapable. The effect of amended section 2035(a) upon the marital deduction remains essentially unchanged from prior law.

In summary, clearly the most significant effect of section 2035(a) is that by automatically returning to the gross estate any inter vivos gifts made within three years of death it reaches gifts that might have escaped inclusion in the gross estate under previous law. Consequently, the valuation of property in the gross estate, including section 2035 property, as of the date of the decedent's death is a crucial factor. This makes it impossible to exclude from the gross estate any appreciation in the value of property transferred before death. Section 2035(a) thus eliminates one remaining advantage of treating a transfer near death as simply an inter vivos gift. In light of the greater estate tax liability as a result of this taxation of appreciation, the possibility of an increase in the marital deduction that section 2035(a) also affords looks less like a benefit and more like a consolation prize.

III. SECTION 2035(b)(1) AND "FULL AND ADEQUATE CONSIDERATION"

In contrast to section 2035(a), section 2035(b)(1) remains unchanged by the Tax Reform Act of 1976. As it did prior to 1976, section 2035(b)(1) provides that bona fide sales and transfers for full and adequate consideration are not gifts, and therefore are not to be included in the decedent's gross estate.⁶⁸ Although the consideration received for the transfer need not be cash,⁶⁹ the courts have been fairly strict in requiring that non-cash consideration be substantial and not merely a sham transaction for the avoidance of estate and gift taxes.⁷⁰ If a transaction fails to meet the full

⁶⁷ JOINT COMMITTEE REPORT, *supra* note 4, at 529, 1976-3 [vol. 2] C.B. at 541.

⁶⁸ I.R.C. § 2035(b)(1), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a), 90 Stat. 1848.

⁶⁹ See, e.g., *Estate of Friedman v. Commissioner*, 40 T.C. 714, 720 (1963) (release of unliquidated claims to property constituted adequate consideration); *Estate of Want*, 29 T.C. 1223, 1243-44 (1958), *rev'd on other grounds*, 280 F.2d 777 (2d Cir. 1960) (promise to care for the donor's minor daughter after death was adequate consideration); *Estate of Mills*, 5 T.C.M. (CCH) 768, 773 (1946) (agreement to manage a turpentine operation for four years on a percentage basis ten percent lower than customarily given to managers was full consideration); *Siegel v. Commissioner*, 19 B.T.A. 683, 688 (1930) (release from the "responsibilities" of managing a closely-held corporation was adequate consideration).

⁷⁰ *Estate of Pritchard*, 4 T.C. 204, 209 (1944) (no adequate consideration where terminally ill decedent transferred life insurance policies in exchange for the policies' cash surrender value); *Estate of Bergan v. Commissioner*, 1 T.C. 543, 554 (1943) (no adequate consideration where elderly decedent transferred property in exchange for promise by the transferee to support her for the remainder of her life); *Schoenheit v. Commissioner*, 14 B.T.A. 33, 52

and adequate test of section 2035(b)(1), and the transfer was made within the three years preceding the donor's death, then the value of the property returned to the gross estate will be only the excess of the fair market value of the property at the time of death over the value of any consideration given to the transferor in exchange for the property.⁷¹ Subsection (b)(1) serves an important structural function in section 2035 as a whole. By exempting transfers of property incident to bona fide sales from the operation of the inclusionary rule, it prevents the taxation of both the property transferred and the proceeds of the sale of that property which, presumably, remain in the estate.

IV. SECTION 2035(b)(2) AND THE \$3,000 ANNUAL GIFT TAX EXEMPTION

Prior to the 1976 Act, all gifts which met the other requirements of section 2035 were returned to the gross estate for tax purposes.⁷² The Tax Reform Act of 1976 added subsection (b)(2):

(b) EXCEPTIONS.—Subsection (a) shall not apply to—

(2) any gift excludable in computing taxable gifts by reason of section 2503(b) (relating to \$3,000 annual exclusion for purposes of the gift tax) determined without regard to section 2513(a).⁷³

Section 2503(b) allows a taxpayer to make tax-free gifts of present interests in property⁷⁴ up to \$3,000 per beneficiary each year.⁷⁵ There is no limit on the number of beneficiaries,⁷⁶ or on the number of years in which the exclusion may be utilized, nor does taking an exemption under section

(1928) (capital stock sold at a price representing the cost of the stock to the decedent was not a transfer for adequate consideration).

⁷¹ I.R.C. § 2043(a).

⁷² Revenue Act of 1954, § 2035, 68A Stat. 381-82.

⁷³ I.R.C. § 2035 (b), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a), 90 Stat. 1848.

⁷⁴ Treas. Reg. § 25.2503-2(a) (1972). Clear examples of a transfer of a present interest in property include gifts of cash, stock, bonds, etc. A great deal of litigation has revolved around the question of the extent to which a transfer can occur when a trust is involved. *See* Rev. Rul. 58-242, 1958-1 C.B. 251, 253 (right to receive income from a trust for ten and one-half years or the earlier death of the beneficiaries was a gift of a present interest). *See also* *Blasdel v. Commissioner*, 478 F.2d 226, 227 (5th Cir. 1973); *Jolley v. United States*, 259 F. Supp. 315, 319 (D.S.C. 1966).

⁷⁵ In order to qualify for the exclusion, the present interest must be capable of valuation, something which is not always easy. *See Jolley v. United States*, 259 F. Supp. 315, 324 (D.S.C. 1966).

⁷⁶ Treas. Reg. § 25.2503-2(a) (1972). A gift to any person can qualify for the exclusion. This led to the concoction of several devices designed to exploit the exclusion to its fullest. The first was the practice of making several small trusts and claiming an exclusion for each trust on the theory that the trusts were the donees, regardless of the fact that the beneficiaries of the various trusts were the same person. *See Cox v. Commissioner*, 38 B.T.A. 865, 867 (1938). This practice was halted with *Helvering v. Hutchings*, 312 U.S. 393, 397-98 (1941). The second device was the "reciprocal gift," whereby the taxpayer made a gift of stock to each of his three children and to his brother's three children at the same time that his brother made an identical gift of stock to each of his own three children and to the taxpayer's children, each brother claiming six exclusions. *Schultz v. United States*, 493 F.2d 1225, 1225 (4th Cir. 1974). This attempt failed on the basis that the taxpayer intended to benefit only his own children, and not his brother's children by making the gift. *Id.* at 1226.

2503(b) affect the donor's right to the specific exemption under section 2521.⁷⁷ Thus, after the 1976 Act, gifts which qualify for the \$3,000 annual gift tax exemption of section 2503(b) are not affected by the inclusionary rule of section 2035(a) even though such gifts are made in the three years prior to the donor's death.

The exemption from both gift and estate taxes that section 2035(b)(2) provides for annual gifts of \$3,000 or less has a definite limitation. It is computed without regard to the gift splitting privileges of section 2513(a).⁷⁸ The latter provision allows a husband or wife to treat a gift made by one spouse to any person except the other spouse as having been made one half by each spouse, provided both have consented to such treatment.⁷⁹ In the case of gifts made within three years of the donor's death, however, section 2035(b)(2) requires that the value of the gift to be included in the gross estate be determined as though the gift splitting privilege were never utilized.⁸⁰ Thus, for example, where a taxpayer makes a gift of \$6,000 in 1977, and takes advantage of the gift splitting privilege in that year, the \$3,000 attributable to him would qualify for the taxpayer's annual gift tax exclusion, and \$3,000 would qualify for the annual gift tax exclusion of the taxpayer's spouse. Accordingly, no gift tax would result from the transfer. If the taxpayer then dies within three years of making this gift, section 2035(b)(2) excludes \$3,000 of the gift from the taxpayer's gross estate, but the \$3,000 attributable to the taxpayer's spouse is returned to the estate as though the gift splitting privilege had never been utilized and the entire gift had been attributable to the decedent all along.⁸¹

⁷⁷ I.R.C. §§ 2503(a), 2521. The gift tax specific exemption was a one-time \$30,000 exemption from gift taxes that could be used all at once or over the course of the donor's lifetime. It was repealed by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(b), 90 Stat. 1849.

⁷⁸ I.R.C. § 2035(b)(2), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a), 90 Stat. 1848.

⁷⁹ I.R.C. § 2513(a)(2). After consent is given, all gifts made during the calendar quarter must be treated in the same manner. I.R.C. § 2513(d).

⁸⁰ Under prior versions of section 2035, split gifts were included in the gross estate of the donor spouse to the extent the donor spouse furnished consideration therefor. Ingram, *supra* note 11, at 743. Gift splitting is considered to be merely an accounting technique for gift tax purposes, and not a reflection of who actually made the gift. Gift splitting, therefore, does not change "the extent of any interest [in the gift] of which the decedent has at any time made a transfer." I.R.C. § 2035(a).

⁸¹ This example is not applicable in every case, for the disallowance of gift splitting when computing the \$3,000 exclusions from the gross estate is affected by whether the taxpayer resides in a community property or noncommunity property jurisdiction. Ingram, *supra* note 11, at 747. There are eight community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington. In these states the tax consequences of gift splitting under section 2513(a) are accomplished without actual resort to that provision, since either spouse in the community has only a half interest in the property transferred and therefore cannot transfer more than this interest in the property. *Id.*; Comment, *Property Owned with Spouse: Joint Tenancy, Tenancy by the Entireties and Community Property*, 11 REAL PROP. PROB. & TR. J. 405, 442-43 (1976). See also *Commissioner v. Chase Manhattan Bank*, 259 F.2d 231, 239 (5th Cir. 1958). Thus, a gift of community property to a third party constitutes a taxable transfer by each spouse of one half of the value of the gift. See *Perkins v. Commissioner*, 1 T.C. 982, 986 (1943). Of course, where noncommunity property is transferred by gift, gift splitting for tax purposes necessitates resort to section 2513(a). Moreover, the burden rests with the taxpayer to establish that property treated as split between the spouses is community property. Cf. *Damner v. Commissioner*, 3 T.C. 638, 642-43 (1944) (presumption of the correctness of the Commissioner's determination that a gift consisted of separate property

The exemption in section 2035(b)(2) of gifts which qualify for the \$3,000 annual exclusion from the inclusionary rule of section 2035(a) leaves unanswered the question whether this exclusion exempts any gift which was valued at less than \$3,000 at the time the gift was made, or exempts such gifts only to the extent that they are valued at \$3,000 or less at the time of the decedent's death.⁸² It is possible that the appreciation in the value of a gift between the time of the transfer and the date of the decedent's death will be included in the gross estate, even if the gift is one on which no gift tax was paid at the time of the transfer because its original value was \$3,000 or less.⁸³ Language in the Joint Committee's explanation of the Act supports such an approach. In its report the Committee stated, "[t]he most significant adverse consequence [to an estate] would result where the property transferred substantially appreciates in value between the date of the transfer and the date of decedent's death."⁸⁴ This suggests that section 2035 may be designed to reach the appreciation in value of property transferred in the three years preceding the decedent's death. If adopted, such an approach will require valuation of all transfers of property within the three year period of section 2035 as of the date of the donor's death, and then deduction of \$3,000 from each annual gift to a single beneficiary.⁸⁵

It is possible, however, that gifts made within three years of the donor's death will not have to be revalued under section 2035. There is support for interpreting section 2035(b)(2) as allowing valuation of transfers of property in the three years preceding the donor's death as of the date of the original transfer. The Joint Committee, writing about section 2035(b)(2), stated that, "another exception is provided on the basis of administrative convenience so that the amount of gifts included [in the gross estate] is limited to the excess of the estate tax value over the amount excludible with respect to the gifts under the \$3,000 annual gift tax exclusion."⁸⁶ There can be scarcely any administrative convenience as a result of section 2035(b)(2), however, if an executor or administrator is faced with the difficult task of tracking down small gifts to numerous beneficiaries for which no gift tax return was ever filed, valuing these gifts anew, and then subtracting up to \$3,000 for each beneficiary each year. Such elaborate procedures would be necessary, however, if qualification for exclusion from

overcomes a presumption that commingled property is community property). Consequently, section 2035(a) includes only one half of a gift of community property in the taxpayer's gross estate. If, however, the taxpayer makes a gift of noncommunity property, even if the taxpayer resides in a community property jurisdiction, the entire gift is included in the gross estate.

⁸² Ingram, *supra* note 11, at 745. The valuation date of property which may qualify for exclusion could be important if a large number of gifts were made under section 2503(b) during the three year period preceding the donor's death, particularly if they were gifts of rapidly appreciating property. *Id.*

⁸³ This is merely a continuation of the previous practice of taxing gifts included in the gross estate at their value as of the date of the transferor's death, including of course, any appreciation accruing since the time of the transfer. See text at notes 54-60 *supra*.

⁸⁴ JOINT COMMITTEE REPORT, *supra* note 4, at 529, 1976-3 [vol. 2] C.B. at 541.

⁸⁵ [1977] 2 FED. EST. & GIFT TAX REP. (CCH) ¶ 6675.03.

⁸⁶ JOINT COMMITTEE REPORT, *supra* note 4, at 529, 1976-3 [vol. 2] C.B. at 541. This statement by the Joint Committee is not unambiguous, however, and it has been interpreted to support the other alternative, valuation as of the date of the donor's death, with a deduction based on section 2503(b) in light of the gift's current value. See [1977] 2 FED. EST. & GIFT TAX REP. (CCH) ¶ 6675.03.

the gross estate is based upon the value of a gift at the time of the donor's death. Thus, if the purpose of section 2035(b)(2) is to provide administrative convenience in computing the gross estate, it should allow the administrator or executor simply to ignore gifts made taxfree by the \$3,000 annual exclusion.⁸⁷

In all probability, the valuation date for the purpose of determining qualification for exclusion from the gross estate under section 2035(b)(2) will be the date of transfer of a gift. The Technical Corrections Bill of 1977,⁸⁸ now before Congress, proposes an amendment to section 2035(b)(2) which would resolve the ambiguity in favor of valuation at the time of the transfer for purposes of determining the gift's qualification for exclusion from the gross estate.⁸⁹

In section 2035(b)(2), Congress has consciously preserved some of the advantages of inter vivos gift giving by allowing taxpayers to make gifts of \$3,000 or less without incurring either estate or gift tax liability, regardless of the proximity of the gift to the donor's death. Assuming that these gifts will be valued at the time of transfer, the advantages of making small lifetime transfers may be enhanced all the more if these gifts consist of rapidly appreciating property.

V. THE GROSS UP PROVISION OF SECTION 2035(c)

The congressional encouragement of inter vivos gift giving which seems to underscore section 2035(b)(2) does not extend to transfers made for the sole purpose of avoiding estate tax liability. In order to eliminate any residuary advantages to making deathbed transfers in order to remove from the gross estate an amount equal to the gift tax liability resulting from such transfers,⁹⁰ the 1976 Act added section 2035(c) to "gross up" in the estate any gift taxes paid by the decedent on any gift made by him or his spouse in the three years prior to his death.⁹¹ Subsection (c) provides:

(c) INCLUSION OF GIFT TAX ON CERTAIN GIFTS MADE DURING 3 YEARS BEFORE DECEDENT'S DEATH.

—The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse after December 31, 1976, and during the 3-year period ending on the date of the decedent's death.⁹²

⁸⁷ A rather implausible argument may be made that transfers which are not subject to tax because of the \$3,000 annual exclusion are not gifts *for tax purposes*. Therefore, the Joint Committee's statement at 529, that, "[g]enerally the inclusion rule [of § 2035(a)] will only apply to transfers treated as gifts for tax purposes" implies that transfers excludible at one time under the \$3,000 annual gift tax exclusion are forever free. The problem with this argument is that gifts of \$3,000 or less *are* gifts for tax purposes irrespective of the fact that they are not taxed by virtue of § 2503(b). The quoted phrase cannot be read apart from the sentence preceding it which refers to transfers which are excluded under section 2035(b)(1) because they are in the nature of bona fide sales.

⁸⁸ H.R. 6715, 95th Cong., 1st Sess. (1977).

⁸⁹ See text at notes 108-12 *infra*.

⁹⁰ See text at notes 13-15 *supra*.

⁹¹ JOINT COMMITTEE REPORT, *supra* note 4, at 527, 529, 1976-3 [vol. 2] C.B. at 539, 541.

⁹² I.R.C. § 2035(c).

This provision contrasts with the law before 1977, under which gifts in contemplation of death were returned to the gross estate, but any gift taxes assessed on such transfers escaped recapture. Thus, the net taxable estate and the marginal rate of tax applicable to it were less than if no gift had been made and consequently no gift taxes paid out of the decedent's assets. For example, a taxpayer with a net worth of \$1,000,000 who, prior to 1977, made a gift of \$100,000 shortly before death, would incur gift tax liability of \$15,525.⁹³ Even if the value of the \$100,000 gift were returned to the gross estate by operation of former section 2035(a),⁹⁴ the taxpayer would have saved \$8,944, the difference between estate tax liability with the estate valued at \$1,000,000 and estate tax liability with the amount of the gift tax paid on the earlier transfer removed from the estate.⁹⁵ Under present section 2035(c), the value of the \$15,525 in gift taxes paid by the taxpayer would return to the gross estate together with the \$100,000 gift.⁹⁶ As a result, the taxpayer's estate tax liability would be unaffected by the transfer before death.⁹⁷

In addition to returning to the gross estate any gift taxes on gifts attributable to the decedent in the three years preceding his death, section 2035(c) includes in the gross estate any gift taxes paid by the decedent which are allocable to the spouse's half of a gift splitting transfer.⁹⁸ Section 2035(c) includes in the gross estate any gift taxes paid by the decedent decedent "on any gift made by the decedent or his spouse"⁹⁹ If this language is taken literally, any gift taxes paid by the decedent with respect to his spouse's gift tax liability are returned to his gross estate, even where the liability arises from a transfer by the spouse alone and not from a split gift.¹⁰⁰ Legislative history does not indicate whether this is intended. However, the purpose of section 2035 as a whole seems to support a literal interpretation of this language. Section 2035 is designed to restore any depletion of the decedent's estate which occurs in the three years prior to his death whether that depletion is due to a gift transfer or attendant gift tax payments.¹⁰¹ Since payment by the decedent of the spouse's gift tax liability depletes the estate as much as payment of the decedent's own gift tax liabil-

⁹³ See I.R.C. § 2502(a)(2).

⁹⁴ It was by no means certain that, under section 2035 prior to the Act, gifts made by the decedent within three years of his death would be included in the gross estate. See text at notes 9-12 *supra*.

⁹⁵ See I.R.C. § 2001(a)-(c).

⁹⁶ See I.R.C. § 2035(a).

⁹⁷ The estate tax liability in the example cited would differ between the pre-1977 case and the post-1976 case due to the change in the rate of tax under the unified tax schedule. The estate tax on the \$1,000,000 estate prior to 1977 would be \$325,700; after 1976, the estate tax on the same estate would be \$345,800. Compare I.R.C. § 2001(c), as amended by Tax Reform Act of 1976, § 2001(a)(1), (d)(1), 90 Stat. 1847, with Revenue Act of 1954, § 2001(a), 68A Stat. 373-74.

⁹⁸ See text at notes 74-77 *supra*. The Joint Committee wrote that "[t]he effect of this treatment is to reverse the consequences of having treated the surviving spouse as the donor of one-half of a gift made to a third party for gift tax purposes where the property transferred is subsequently included in the decedent's gross estate." JOINT COMMITTEE REPORT, *supra* note 4, at 528, 1976-3 [vol. 2] C.B. at 540.

⁹⁹ I.R.C. § 2035(c), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a), 90 Stat. 1848-49.

¹⁰⁰ Ingram, *supra* note 11, at 745-46.

¹⁰¹ *Id.* at 747.

ity, section 2035(c) probably will return such a payment to the gross estate.¹⁰²

By returning to the estate all gift taxes paid by the decedent in the three years preceding death, section 2035(c) increases estate tax liability. In general, when a donor makes an inter vivos gift, no transfer tax is levied against the amount actually used to pay the gift tax.¹⁰³ The amount used to pay an estate tax, however, is subject to transfer tax because there is no provision for an exclusion from the gross estate of the amount of the estate tax.¹⁰⁴ By returning to the estate gift taxes paid by the decedent in the three years preceding his death, section 2035(c) makes the amount used to pay gift taxes subject to estate taxation. Ultimately, the tax liability generated by a lifetime transfer within the three year period preceding death is identical to the tax liability resulting from an identical testamentary disposition. Consequently, the gross up provision reduces the tax incentives for making lifetime transfers which would exist in the absence of this provision even under the unified transfer tax approach adopted in the 1976 Act.

In some cases, section 2035(c) may even be a disincentive to making lifetime gifts. The ultimate tax liability resulting from an inter vivos transfer within three years of death is the same as estate tax liability if no inter vivos gift is made. In the case of a gift, that liability is incurred at the time of transfer, whereas when no gift is made, that liability is not incurred until some time after the donor's death. Since there is a disadvantage to paying taxes before they are necessary,¹⁰⁵ lifetime gift giving thus may be discouraged. Nevertheless, in most cases the prospect that the donor will survive more than three years after the gift probably outweighs any disadvantages of incurring tax liability before it is necessary, since section 2035 grosses up only those gifts and gift taxes paid in the three years preceding the decedent's death.

In relation to section 2035 as a whole, subsection (c) helps to tie together the estate and gift tax systems by removing one advantage that inter vivos gifts once had over testamentary transfers. An amount used to pay gift taxes in the three years preceding death eventually is subject to transfer taxation in the same way that an amount used to pay estate taxes was

¹⁰² This interpretation seems all the more probable considering that a payment by the decedent of his spouse's gift tax liability can be viewed as a gift to the spouse, includible in the decedent's gross estate under section 2035(a). *Id.* at 746.

Section 2035(c), however, would not return the full amount of a gift tax payment made with community funds. The divergent effect of gift splitting between community property and noncommunity property jurisdictions reappears in section 2035(c). See note 81 *supra*. In community property states, payment of gift taxes with community funds is treated as though each spouse paid half of the tax, regardless of whether a split gift, gift of community property, or gift of separate property is involved. Therefore, only half of any gift tax payments made with community funds would be grossed up under this section. In contrast, the full amount of any gift tax payments made with noncommunity funds would be grossed up under section 2035(c).

¹⁰³ See text at notes 13-15 *supra*.

¹⁰⁴ See Castleman, *supra* note 15, at 316-17.

¹⁰⁵ Postponed tax liability is, in effect, interest-free borrowing from the government. Therefore, as one commentator suggests, [b]ecause inter vivos giving that is subject to gift taxation is, due to the unification of the estate and gift tax systems, a process that incurs tax liability at a date earlier than it would have been incurred if the transfers were made at death, with little opportunity for transfer tax savings, taxable inter vivos giving is discouraged by the Reform Act.

Donaldson, *supra* note 4, at 540-41.

subject to tax. Moreover, by grossing up with the estate *all* gift taxes paid by the decedent during the three year period, section 2035(c) restores the estate to its size three years before the decedent's death. Thus, it defeats last minute efforts to avoid estate tax liability.

VI. EXPECTED CHANGES IN SECTION 2035 AND RELATED ESTATE TAX PROVISIONS

Discussion of the practical consequences of the amendment of section 2035 reveals some unresolved questions. In particular, there remains the question of when gifts excluded from the operation of that section by virtue of subsection (b)(2) are to be valued.¹⁰⁶ There is also a question that arises when annual taxfree gifts of \$3,000 or less are included in the gross estate as though the gift splitting had never occurred: are the other consequences of gift splitting also reversed? The Technical Corrections Bill of 1977,¹⁰⁷ currently before Congress, seeks to resolve these questions.

First, the Bill resolves the question raised by section 2035(b)(2) whether gifts made within three years of the donor's death should be valued to determine whether they qualify for exclusion from the gross estate at the date the gift is made or at the date of the donor's death.¹⁰⁸ Section 3(f) of the Bill¹⁰⁹ provides that the exception of section 2035(b)(2) to the rule which includes gifts in the gross estate applies to any gifts for which the donor filed no gift tax return.¹¹⁰ Since, by necessity, a donor must determine whether a return should be filed at the time of the gift, the date of valuation is the time the gift is made. Accordingly, any appreciation in the value of the gift between the time of transfer and the donor's death will escape estate taxation.

Section 3(f) of the Bill makes one exception to the exclusion from the gross estate of property valued at \$3,000 or less at the time of transfer: transfers of life insurance policies within three years of death do not qualify for exclusion from a gross estate even if they are valued at less than \$3,000 at the time of the transfer.¹¹¹ This exception precludes the exclusion of the transfer of a policy for which no gift tax return is filed because its value at the time of transfer, usually the cash surrender value of the pol-

¹⁰⁶ See text at notes 82-89 *supra*.

¹⁰⁷ H.R. 6715, 95th Cong., 1st Sess. (1977). Section 3(f) of the Bill, an amendment to section 2035(b), provides,

(b) EXCEPTIONS.—Subsection (a) shall not apply—

(1) to any bona fide sale for an adequate and full consideration in money or money's worth, and

(2) to any gift to a donee made during a calendar year if the decedent was not required by section 6019 to file any gift tax return for such year with respect to gifts to such donee.

Paragraph (2) shall not apply to any transfer with respect to a life insurance policy.

¹⁰⁸ See text at notes 82-89 *supra*.

¹⁰⁹ H.R. 6715, § 3(f), 95th Cong., 1st Sess. (1977).

¹¹⁰ JOINT COMMITTEE ON TAXATION, DESCRIPTION OF H.R. 6715; TECHNICAL, CLERICAL AND CONFORMING AMENDMENTS OF THE TAX REFORM ACT OF 1976, 95th Cong., 1st Sess. 25 (CCH ed. 1977).

¹¹¹ H.R. 6715, § 3(f), 95th Cong., 1st Sess. (1977).

icy, is little, but which will be worth substantially more after the donor's death.¹¹²

The Technical Corrections Bill also addresses the problems associated with gift splitting and section 2035. Section 3(h) of the Bill¹¹³ attempts to coordinate section 2513, which deals with split gifts, and section 2035 in order to reverse some of the transfer tax consequences of gift splitting to the nondonor consenting spouse. Presently, if a donor dies within three years of making a split gift, no adjustment is made in the tax status of the nondonor spouse when the gift is brought back into the gross estate.¹¹⁴ Under the present system, a nondonor taxpayer's transfer tax bracket is raised because the nondonor spouse is credited with having made a taxable gift. The nondonor spouse also may lose part of his unified credit¹¹⁵ or gift tax specific exemption¹¹⁶ if either is used when the gift splitting election is made. While at present section 2035(b)(2) reverses the effects of a split gift so far as the donor spouse is concerned,¹¹⁷ it does not reverse the effects to the nondonor spouse. The result of the loss of these benefits is the same as if the gift were taxed at one and a half times the regular rate.¹¹⁸ Under the revisions proposed by the Bill, the amount of the split gift included in the donor spouse's estate will be excluded from computation of the adjusted taxable gifts of the nondonor spouse.¹¹⁹ Thus, the nondonor spouse will no longer be credited with having made a taxable gift, the value of the split gift will be subtracted from the cumulative taxable gifts of the nondonor spouse, and the nondonor's tax bracket will be reduced accordingly. However, the Bill does not restore any of the unified credit or gift tax specific exemption that the nondonor spouse may have used when the split gift was made. Nevertheless, the amendment should alleviate the most glaring inequities of the present situation.

The Technical Corrections Bill has two important effects on section 2035. By allowing the executor to use the value of the gift at the time of the transfer to determine qualification for exclusion of gifts from the gross estate under section 2035(b)(2), it relieves the executor of the difficult task of finding and appraising all of the small gifts made by the decedent over the course of three years. In order to be consistent with the reversal of the effects of gift splitting for the donor under section 2035(b)(2), it also reverses some of the adverse effects of gift splitting for the nondonor spouse. Although the Bill makes no substantive changes in section 2035, it does alleviate two of the section's most pressing problems.

¹¹² There is some question whether it is necessary to except life insurance from the operation of section 2035(b)(2) in light of such cases as *Estate of Pritchard*, 4 T.C. 204 (1944). In *Pritchard*, the court held that the present value of a life insurance policy is not limited to its cash surrender value, but is based on all the rights that the transferee assumes as well. The end result in that case was that the policy transferred was valued at much more than its cash surrender value at the time of the transfer. *Id.* at 207-08.

¹¹³ H.R. 6715, § 3(h), 95th Cong., 1st Sess. (1977).

¹¹⁴ See Donaldson, *supra* note 4, at 546-47.

¹¹⁵ I.R.C. § 2010. The unified transfer tax credit replaces the estate tax exemption and the once-a-lifetime gift tax exemption which existed before the 1976 Act. The \$47,000 credit first offsets any lifetime transfers; any unused credit is then offset against the estate.

¹¹⁶ I.R.C. § 2503(b). See also *Ingalls v. Commissioner*, 336 F.2d 874, 875-76 (4th Cir. 1964); *English v. United States*, 284 F. Supp. 256, 257-58 (N.D. Fla. 1968).

¹¹⁷ See text at notes 78-81 *supra*.

¹¹⁸ See Donaldson, *supra* note 4, at 547.

¹¹⁹ H.R. 6715, § 3(h), 95th Cong., 1st Sess. (1977).

CONCLUSION

Taking into consideration both the version of section 2035 enacted in the Tax Reform Act of 1976 and the amendments to it proposed in the Technical Corrections Bill of 1977, revised section 2035 will affect not only decedents' estates but also patterns of lifetime gift giving. On one hand, section 2035 encourages lifetime gift giving. It allows gifts of \$3,000 or less per beneficiary per year to escape estate taxes as well as gift taxes, although the benefits of gift splitting with respect to any of these gifts will be lost. In addition, any appreciation in the value of an inter vivos gift after it is made is not subject to transfer tax if the donor lives for at least three years after the transfer. On the other hand, section 2035 has removed some of the incentives for inter vivos gift giving which previously were available, especially to those who could afford extensive lifetime gift giving. The section eliminates the previous advantage of making a lifetime transfer in order to remove from the gross estate an amount equal to the gift tax liability resulting from the transfer. Section 2035(c) returns to the gross estate any gift taxes paid to the decedent in the three years preceding his death.

Even with the most careful gift and estate tax planning, however, the changes in section 2035 will have one significant effect. By including in the gross estate all gifts made within three years of the donor's death, except gifts which are tax-free under the \$3,000 annual gift tax exclusion, and all gift taxes paid by the decedent, section 2035 undoubtedly will increase the estate tax liability of many taxpayers who die after 1976.

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