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Federal Estate Tax—Transfer of Jointly Held Property Made in Contemplation of Death or Accompanied by Retention of Life Interests: *Heasty v. United States*, 370 F.2d 525 (10th Cir. 1966)

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FEDERAL ESTATE TAX—TRANSFER OF JOINTLY HELD PROPERTY MADE IN CONTEMPLATION OF DEATH OR ACCOMPANIED BY RETENTION OF LIFE INTERESTS—*Heasty v. United States,* 370 F.2d 525 (10th Cir. 1966).

In *Heasty v. United States,*[1] the decedent George Creekmore acquired several tracts of land supplying the entire consideration for each purchase. Subsequently, he conveyed this land to himself and his wife as joint tenants. Two years later, Creekmore and his wife transferred their interests, in fee, to their daughters and grandchildren reserving for themselves a life estate, with right of survivorship. The necessary gift tax was paid. This transfer was sufficient to sever the joint ownership under the applicable Kansas and Oklahoma state property laws. When Mrs. Creekmore died in 1952, no estate tax was payable as her gross estate was less than 60,000 dollars. However, when Mr. Creekmore died eight years later, the Commissioner included the full value of the reality in his gross estate and assessed taxes thereon under section 2036.[2]

The Commissioner based his assessment on the supposition that under section 2036, Creekmore was the transferor, for estate tax purposes, of the interest that would have otherwise been taxable to him under section 2040 had the property been held jointly at the time of his death. The Kansas Federal District Court granted the Creekmore estate a refund. On appeal the Circuit Court of Appeals for the Tenth Circuit affirmed. Although both courts held that Creekmore's interest in the transferred property was includable in his estate under section 2036, they determined that the "interest" and "transfer" taxed by that section were to be determined by reference to applicable state property law. The Court of Appeals for the Tenth Circuit reasoned that since a joint tenant could, under Kansas and Oklahoma property law, convey or sever no more than a one-half interest in jointly held property without the consent of

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1 370 F.2d 525 (10th Cir. 1966).

2 INT. REV. CODE OF 1954, § 2036 provides in part that: "(a) General rule—the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) the possession or enjoyment of, or the right to income from, the property . . . ."

the other tenant,[3] only a one-half interest could have been transferred by Creekmore and one-half was therefore properly includable in his gross estate.[4]

Section 2040[5] treats property held jointly at the time of the tenant's death[6] as if it belonged entirely to the tenant who has supplied the consideration for its original purchase.[7] Thus where the property is taxable under section 2040 the prior transfer to the non-contributing tenant is deemed sufficiently testamentary to

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[3] Of special interest to Nebraska lawyers is the article on severance of jointly held property at Comment, *Estate Planning and the Severance of Joint Tenancies In Nebraska*, 43 NEB. L. REV. 587 (1964).

[4] The tax advantages of this interpretation of state property law are at once apparent. The exact amount by which a decedent's estate tax may be reduced will depend, of course, on a variety of factors, not the least of which is the potential gift tax consequences of such a severance. However, as an example, assume that *H* has an anticipated adjusted gross estate of $120,000, consisting solely of property held jointly with his wife. In that situation a severance of the joint ownership during life would not reduce estate taxes at all if it were intended that the wife should get the whole estate. In that case, the exemption and marital deduction would be sufficient to free the whole estate from taxation. However, if *H*'s anticipated adjusted gross estate had been $240,000, the exemption and marital deduction would have freed only $180,000 from taxation. Here severance of jointly owned property, during life, with *H*'s one-half retained life interest going to the wife at his death, would free the whole $240,000 from taxation.

[5] INT. REV. CODE of 1954, § 2040. The material portions of this section provide that: "The value of the gross estate shall include the value of all property to the extent of the interest therein held as joint tenants by the decedent and any other person, or as tenants by the entirety by the decedent and spouse, . . . except such part thereof as may be shown to have originally belonged to such other person and never to have been received or acquired by the latter from the decedent for less than an adequate and full consideration in money or money's worth. . . ."

[6] There is little doubt that section 2040 applies only to those interests held jointly at the time of death. This construction appears from the plain language of the statute and is specifically set out in Treas. Reg. 65, § 20.2040-1(a) (1965). In addition, this restriction on the applicability of section 2040 has been given wide recognition by the courts. In United States v. Jacobs, 306 U.S. 363 (1939), the United States Supreme Court specifically stated that by severance of a joint tenancy during life, a taxpayer could avoid the application of what is now section 2040. *See also* Glaser v. United States, 306 F.2d 57, 60 (7th Cir. 1962) and Sullivan's Estate v. Commissioner, 175 F.2d 657, 659 (9th Cir. 1949).

[7] For an examination of the estate tax consequences where joint property is held at the time of the contributing decedent's death see Comment, *Problems of Estate and Gift Taxation of Joint Ownership Interests*, 10 U.C.L.A. L. REV. 1205, 1211-12 (1963).

warrant the adoption of an estate tax construction of the decedent's property interest. This estate tax concept is, of course, distinct from the decedent's interest as defined by state property law concepts.[8]

In *Heasty*, the government urged the court to apply a federal estate or "tax substance" construction of "transfer" and "interest" as taxed in section 2036. It reasoned that both sections 2040 and 2036 were aimed at preventing easy avoidance of estate tax consequences by transfers that were substantially testamentary in character and that these sections should be read together to effectuate this common taxing policy. Thus the government argued that since Creekmore would have been taxed under section 2040 on the full value of the real estate had he died prior to the transfer to his daughters and grandchildren, he should not, merely because he made a testamentary transfer of only one-half of the property under state property law, be allowed to escape full inclusion under section 2036. Therefore, the government urged the court to interpret the "interest" and "transfer" taxed by section 2036 as being the "interest" that would have been taxed under section 2040 had the subsequent transfer not occurred.[9]

The government has advanced similar arguments in situations where jointly held property was severed by a transfer made in contemplation of death and therefore taxable under section 2035. However, in neither instance has the government's position met with much success.[10]

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8 United States v. Jacobs, 306 U.S. 363 (1939).

9 Alternatively it has been argued in severance cases arising under section 2036 that even though there has been a severance of the jointly owned property, the resulting retained life estate with survivorship is in substance, if not in form, merely a continuation of the joint interest. It has been pointed out that in these situations the contributing tenant maintains the same degree of enjoyment and control as he had prior to the transfer. Therefore it is urged that the substantial reality of the result is sufficient to warrant imposition of estate tax on the whole estate under section 2036. Certainly the transaction is no less testamentary than the transfer into joint tenancy in itself. The ripening of the noncontributing tenant's interest still depends on the pivotal event of the prior death of the contributing tenant. *See* Glaser v. United States, 306 F.2d 57, 60 (7th Cir. 1962).

10 This basic issue was thought to have been settled in the early case of Sullivan's Estate v. Commissioner, 175 F.2d 657 (9th Cir. 1949). In *Sullivan*, the contributing decedent held property jointly with his wife. The joint ownership was severed by contract, transferring the respective interests to the decedent's son in contemplation of the decedent's death. The court held that what is now section 2040 was applicable only to property held jointly at the time of the contributing decedent's death and found that the "interest" taxed by what is now section 2035 was to be determined by reference to the applicable state property

Notably, the only evidence that the government's view has ever been adopted in a severed joint ownership situation is found in the Nebraska Federal District Court case of *Harris v. United States.*[11] There, in holding the entire value of property includable in the contributing decedent's gross estate where the joint ownership was severed in contemplation of death, the court seemed to entirely avoid the issue that is central to *Heasty*. In *Heasty* the court focused its attention on the relationship between section 2036 and section 2040. The dominate inquiry in *Heasty* was whether the "interest" taxed under section 2036 was to be given an estate tax construction giving credence to the underlying policy of these sections or whether it was to be restricted in scope to the interest that the decedent transferred under state property law. The *Harris* court, however, made no inquiry into the relationship between sections 2035 and 2040. Instead, after referring only briefly to the effects of section 2040, the court based its opinion on the apparent supposition that section 2035 was, by itself, sufficiently broad to warrant inclusion of the full value of the property in the contributing decedent's gross estate.

Harris reaches a result that is not only *contra* to the decided weight of authority, but which is conspicuously devoid of any definitive rationale. *Harris,* therefore, seems to lend little support to the government's argument that if a jointly owned property is severed either in contemplation of death or with retention of life interests, section 2035 or section 2036 should be read together with section 2040.

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law. Therefore the court included only one-half of the value of the property in the decedent's gross estate. *See* Note, *Joint Tenancy and Estate Tax Avoidance: A Widening Loophole For Transfers In Contemplation of Death,* 66 YALE L.J. 142 (1956) and Wright, *Transfers of Joint Property In Contemplation of Death,* 55 MICH. L. REV. 1 (1956).

Sullivan was widely accepted. The decision was extended to transfers of property held in tenancy by the entirety in Estate of Borner v. Commissioner, 25 T.C. 584 (1953). *But cf.* Comment, *Problems of Estate and Gift Taxation of Joint Ownership Interests,* 10 U.C.L.A. L. REV. 1205, 1217 (1963). In addition, *Sullivan* has recently been adopted by the seventh circuit in a section 2036 severance situation, Glaser v. United States, 306 F.2d 57 (7th Cir. 1962). *See also* Estate of Brockway v. Commissioner, 18 T.C. 489 (1952); Carnall v. Commissioner, 25 T.C. 584 (1955); and Baltimore National Bank v. United States, 136 F. Supp. 642 (D.C. Md. 1955).

The *Sullivan* rule, though specifically limited to its precise facts, was even included in the formulation of the estate regulations under the 1954 Code. Proposed Treas. Reg. § 20.2040-1(d), 21 Fed. Reg. 7879 (1956). However, the proposed regulation was deleted in the final promulgation.

11 193 F. Supp. 736 (D.C. Neb. 1961).

These sections must be read together, the Commissioner contends, if the "interest" taxed by those sections is to have a federal estate tax construction which includes the entire amount taxable under section 2040 had the subsequent transfer not have taken place. The weight of *Harris* as authority is particularly questionable in view of the decision in *Heasty*.[12]

In pursuing this argument in *Heasty*, the government relied on *United States v. O'Malley*[13] and *United States v. Allen*[14] as authoritative support for its position. In *O'Malley*, the United States Supreme Court disregarded traditional property law concepts and applied a federal estate tax concept to the "interest" taxed under section 2036. However, it is significant that the court in *O'Malley* was not faced with a determination of the interrelation of section 2040 with either section 2035 or section 2036. *O'Malley* concerned only the application of the specific statutory language of section 2036 as it applied to a life interest retained in property owned entirely by a single decedent transferor. The Court held that accumulated earnings of trust property, over which the decedent retained the power to designate beneficiaries, were includable in the decedent's gross estate under section 2036. The Court carefully distinguished this holding from section 2035 situations in which there has been a completed inter vivos transfer. Certainly, *O'Malley* does not seem to offer any compelling reason for adopting the government's position.[15]

Allen,[16] however, stands in a different posture. Though the factual context of *Allen* is certainly distinguishable from that of *Heasty* the essential issue is precisely the same. In *Allen*, the Tenth Circuit determined that in such situations the "interest" taxed under section 2035 was the interest that would have been included had the transfer not occurred. In so doing the court clearly seemed to conclude that section 2035, section 2036, and presumably section 2040 were interrelated sections which should be read together to

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12 Gradwohl, *Estate Taxation of Joint Tenancies Severed In Contemplation of Death*, 10 NEB. S. B. J. 115 (1961). In fact, as of this writing, *Harris* has not been cited as authority by any court.

13 383 U.S. 627 (1965).

14 293 F.2d 916 (10th Cir. 1961), *cert. denied*, 368 U.S. 944 (1961).

15 The court in *O'Malley* found that in the section 2036 situation the grantor retains an interest in the property or in its income and that his death is the significant step in effectuating the transfer which began inter vivos but which becomes effective only at his demise. This is in contrast to the section 2035 situation where the court considers the taxable event to be a completed inter vivos transfer which is in no way dependent on the grantor's death.

16 293 F.2d 916.

effectuate a common taxing policy. In fact, prior to *Heasty* many commentators pointed to *Allen* as positive evidence of the Tenth Circuit's intent to reach a similar result when confronted with the *Heasty* type situation.[17]

In *Allen* the decedent transferred property, which she alone owned in fee, to a trust and retained a three-fifths life interest in the income. Shortly before her death she sold the retained life interest (then having an actuarial value of 135,000 dollars) to her son for 140,000 dollars. The court read what are now section 2035 and section 2036 together and construed the "interest" taxed under section 2035 in a federal estate tax sense. Thus the court found that in order to constitute "full and adequate consideration" and thereby remove the transfer from taxation under section 2035, the decedent's son would have had to have paid an amount equal to the interest which would have been included in the decedent's gross estate under section 2036 had the transfer not been made. This would have amounted to the value of three-fifths of the corpus of the trust, or about 900,000 dollars. By this rationale the court found that the full 900,000 dollars (three-fifths of the corpus) was properly includable in the decedent's gross estate even though the interest that the decedent had transferred, measured by traditional property concepts, was worth at most 135,000 dollars.

The *Allen* court stated that:

> It does not seem plausible, however, that Congress intended to allow such an easy avoidance of the taxable incidence befalling reserved life estates. This result would allow a taxpayer to reap the benefits of property for his lifetime and, in contemplation of death, sell only the interest entitling him to the income, thereby removing all of the property which he has enjoyed from his gross estate. Giving the statute a reasonable interpretation, we cannot believe this to be its intendment.[18]

In *Heasty*, however, the Tenth Circuit aligned itself with the earlier decisions of the Seventh and Ninth Circuits and distinguished its earlier decision in *Allen*.[19]

Apparently recognizing the policy that a taxpayer may arrange his affairs as he choses and may by his actions remove his entire

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[17] Cohen, *Treasury Views On Current Questions*, 104 J. TRUSTS & EST. 13 (1965); Polasky, *Current Tax Developments*, 103 J. TRUSTS & EST. 253, 255 (1964); Young, *CA-7 Follows Sullivan In Severance of Joint Tenancies; Sets Stage For High Court Review*, 17 J. TAXATION 296, 298 (1962).

[18] 293 F.2d at 918.

[19] Note 9 *supra*, Glaser v. United States, 306 F.2d 57 (7th Cir. 1962); Sullivan's Estate v. Commissioner, 175 F.2d 657 (9th Cir. 1949).

estate from the scope of the taxing acts;[20] the *Heasty* court seems to echo the conclusions of the earlier Tax Court decisions holding that, if in fact, such transactions are not within the present statutory scheme, the remedy must come from Congress and not from the courts.[21]

While the *Heasty* court did not overrule *Allen,* it certainly limited the application of that case to its particular facts. Although *Heasty* talks in terms of accepting alternative constructions of the "transfer," referred to in section 2036, its actual inquiry focused on the "interest" that was in fact transferred and, therefore, taxable under that section. There was no doubt but that a transfer of property had taken place. It was the interest held prior to the transfer that was significant and not the transfer itself. Thus the distinction that was crucial to the *Heasty* holding was that the transfer which resulted in the severance of the jointly held property was made by two persons instead of one; and more basically that the original ownership interest of the joint property was vested not in just one individual as in *Allen* or *O'Malley,* but in two distinct individuals. The court in *Heasty* stated that: "So also would the *Allen* case stand in a different posture if one-half the corpus of the trust had been 'transferred' by some one other than the decedent."[22]

In evaluating the court's distinction, it is interesting that a transfer into joint ownership is deemed sufficiently testamentary to justify imposition of estate taxation under section 2040,[23] and that a transfer with retention of a life estate or in contemplation of death is considered sufficiently testamentary to justify taxation under section 2035 or section 2036.[24] Yet, when these same transactions are made in succession, by applying the *Heasty* rationale, one-half of the property loses its testamentary character and is insulated from the application of any estate tax construction of the "interest" taxed under either section 2035 or section 2036.

This distinction may be explained by the contention that these sections are simply not broad enough to reach jointly held property which has been severed prior to death even though the severance was in contemplation of death or accompanied with the reservation

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20 Gregory v. Helvering, 293 U.S. 465, 469 (1935); Pacific Southwest Realty Co. v. Commissioner, 128 F.2d 815, 818 (9th Cir. 1942).

21 Estate of Broackway v. Commissioner, 18 T.C. 498 (1952).

22 Heasty v. United States, 370 F.2d 525, 528–29 (10th Cir. 1966).

23 United States v. Jacobs, 306 U.S. 363 (1939).

24 *See generally* INT. REV. CODE of 1954, §§ 2035 and 2036 and Note, *Joint Tenancy and Estate Tax Avoidance: A Widening Loophole For Transfers In Contemplation of Death,* 66 YALE L.J. 142 (1956).

of a life interest. It is at least arguable that the legislative history does not justify the construction of these sections in the light of any overriding taxing policy.[25] Alternatively, it has been suggested that the transfer into joint tenancy is a completed inter vivos transfer which creates new and distinctive rights to the property in the tenants and that, therefore, its subsequent severance requires the application of state property law concepts.[26] However, none of these approaches seem theoretically adequate to justify the *Heasty* distinction, particularly in view of the approach adopted in *Allen* and the broad taxing policy which underlies sections 2040, 2035, and 2036.[27]

Nevertheless, it is clear that as a result of the *Heasty* decision the intermediate ownership arising in the joint tenancy situation is sufficient to insulate the "interest" taxed by either section 2035 or 2036 from being given any federal estate tax interpretation.

It is apparent that the distinction which *Heasty* draws does not rest upon any grounds peculiar to section 2036 but is based, instead, on the nature of the ownership interests held prior to the taxable transfer.[28] Therefore the *Heasty* rationale would seem applicable to any transfer of jointly owned property whether accompanied by retention of a life estate or made in contemplation of death. In the section 2035 situation then, *Heasty* would compel like estate tax results. *Allen* would not affect the viability of the *Heasty* distinction in situations where the severance was made in contemplation of death, as the very basis of the *Heasty* distinction is contrary to such a contention.

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25 Certainly Congressional intent that these sections should be read together to effectuate a broad underlying taxing policy is far from conclusive. *See* Wright, *Transfers of Joint Property In Contemplation of Death*, 55 MICH. L. REV. 1 (1956). In addition it is notable that in the Code, specific provisions have been established for similar contingencies with respect to section 2041. INT. REV. CODE of 1954, § 2041.

26 Comment, *Loopholes and Ambiguities of Section 2036*, 65 MICH. L. REV. 508, 513 (1967).

27 It is interesting to note that the Federal Estate Tax Regulations specifically adopt a federal estate tax construction of the interest taxed by section 2035 of the Internal Revenue Code of 1954. Although Regulation 20.2035-1(b) limits this interpretation to transfers which would otherwise be taxable under sections 2036, 2037, or 2038, the mere fact that such an approach is taken with respect to those sections militates against the *Heasty* type rationale.

28 Woolfolk, *New Case Points Out Route To Prevent Entire Transferred Joint Tenancies From Being Taxed*, 26 J. TAXATION 246 (1967).

In addition, in view of the earlier cases, it would seem that *Heasty* is not limited to joint tenancy situations but extends as well to severance of property held in tenancy by the entirety.[29]

For these reasons it appears that *Heasty* has eliminated the previous uncertain estate tax consequences of severing jointly owned property. In *Heasty* the Tenth Circuit has aligned itself with the Seventh and Ninth Circuits and firmly reinforced the refusal of the courts to adopt an estate tax construction of "interest" as taxed by either section 2035 or section 2036 in severed joint ownership situations. Thus, in the absence of an amendment to the federal estate tax statutes, it appears that estate planners may continue with confidence to advise severance of jointly held property.[30]

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29 *See* note 9 *supra.*

30 The Commissioner, apparently encouraged by the results in *Harris* and *Allen* withdrew his prior acquiescence to the earlier Tax Court decisions and entered a nonacquiescence to those decisions. INT. REV. BULL. 1962-20 May 14, 1962. However, it would appear that the government does not intend to continue to litigate these cases. It was stated recently in *Tax Management Tidbits* that: "The Chief Counsel, Tax Management is advised, will not litigate in the Tax Court the question of whether the full value of formerly jointly owned property is includable in a decedent's gross estate where, shortly prior to death, the decedent and the co-tenant either transferred or severed such property. . . . However, this question will be litigated in the district courts if a refund suit is brought, but apparently the taxpayer will prevail on this issue (citations omitted) . . . ." TAX MANAGEMENT INCORPORATED, TAX MANAGEMENT TIDBITS 15 (1968).