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Federal Estate Taxes—Deviation from Mortality Tables under Section 2037

Steven D. Brumley
University of Nebraska College of Law

FEDERAL ESTATE TAXES— DEVIATION FROM MORTALITY TABLES UNDER SECTION 2037

A recent decision by the United States Court of Appeals for the Seventh Circuit[1] has caused some discussion by legal writers[2] and undoubtedly some apprehension by the Commissioner of Internal Revenue.[3] The case is *Hall v. United States*[4] and the problem presented was whether the United States Life Table 38[5] is the exclusive method of determining the value of a reversionary interest under section 2037 of the Internal Revenue Code.[6] The Seventh Circuit, in allowing the use of evidence to show the decedent's actual life expectancy, found that the words "by usual methods of valuation" in the code[7] made it "plain that the statute does not contemplate that valuation shall be determined in all cases solely by use of tables of mortality and actuarial principles. . . ."[8]

In this article an attempt will be made to evaluate the holding in the *Hall* case and the policy reasons for allowing valuation of reversionary interests by actual life expectancy. This will be done with an eye toward giving guidelines for future use of evidence showing decedent's poor health prior to death under section 2037. These purposes will be accomplished through an examination of the purpose of the five per cent rule in section 2037, an analysis of the arguments both for and against the exclusive use of mortality and actuarial tables as a valuation device, and an evaluation of pertinent cases in light of the purpose of the rule and the arguments relevant to its application. Finally an attempt will be made to draw these considerations together into some tests which may be used in evaluating the merits of asserting a decedent's poor health prior to death under section 2037.

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1 Hall v. United States, 353 F.2d 500 (7th Cir. 1965).

2 Note, 54 CALIF. L. REV. 2180 (1966); Abstract, 68 W. VA. L. REV. 430 (1966); Recent Developments, 66 COLUM. L. REV. 797 (1966).

3 This apprehension would be based on the practical problems which would arise when the commisioner tries to rebut evidence of a decedent's poor health which is introduced to meet the 5% test of § 2037.

4 353 F.2d 500 (7th Cir. 1965).

5 UNITED STATES BUREAU OF THE CENSUS, UNITED STATES LIFE TABLES AND ACTUARIAL TABLES, 1939-1941, Table 38 [hereinafter cited as United States Life Tables].

6 INT. REV. CODE OF 1954, § 2037.

7 *Id.* § 2037(b)(2).

8 Hall v. United States, 353 F.2d 500, 503 (7th Cir. 1965).

THE PURPOSE OF THE FIVE PER CENT RULE

The Federal Estate Tax Law of 1916[9] contained a provision which taxed transfers "intended to take effect in possession or enjoyment after [the transferor's] death."[10] This is the so-called "postponed-possession-or-enjoyment" clause. Among the transfers of property which could be reached under this clause was the gift of property in which the transferor or his estate had a possibility of reverter. This phrase appeared as section 811(c) of the Internal Revenue Code of 1939.

Court rulings under section 811(c)[11] were varied. In one case the United States Supreme Court indicated that taxation under this clause might be unconstitutional if construed to include other than those interests passing from the possession, enjoyment, or control of the donor at his death.[12] In an attempt to make the most out of the tax law after this case, the commissioner attacked cases in which the decedent had disposed of property and retained the income or a reversionary interest in the property. The Supreme Court disposed of the former as an avenue of collection in *May v. Heiner*,[13] but found that the latter was a transfer which could properly be taxed in *Klein v. United States*.[14] Later in *Helvering v. Hallock*[15] the Supreme Court disposed with any technical distinctions based on the common-law rules of vesting and made it clear that it was the possibility of reverter which subjected the transfer to taxation.

The rule in the *Hallock* case proved to be a harsh one when applied to the facts of *Estate of Spiegel v. Commissioner*.[16] In this case a reversionary interest arose in the settlor by operation of law,[17] but the possibility of any property ever passing to the dece-

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[9] Internal Revenue Act of 1916, § 202(b), Ch. 463, 39 Stat. 777 (1916).

[10] *See* Note, *Origin of the phrase, "Intended to take effect in Possession or enjoyment at or after . . . Death" (Section 811(c), Internal Revenue Code)*, 56 YALE L.J. 176 (1946), for a discussion of the historical development of this phrase prior to its adoption as § 202 in the Internal Revenue Act of 1916.

[11] Int. Rev. Code of 1939, § 811(c)

[12] Reinecke v. Northern Trust Co., 278 U.S. 339, 348-49 (1929).

[13] 281 U.S. 238 (1930); but note that this case was subsequently overruled by Commissioner v. Church, 335 U.S. 632 (1949).

[14] 283 U.S. 231 (1931); *but see* Helvering v. St. Louis Union Trust Co., 296 U.S. 39 (1935), which went the other way on a conveyancing nicety.

[15] 309 U.S. 106 (1940).

[16] 335 U.S. 701 (1949).

[17] A father 47 years old had created a trust for his three children who ranged in age from 22 to 12. There was no expres reversion but had the father outlived the children and his grandchildren, some of

dent was very remote. In spite of this, the court ruled that the trust corpus, valued at more than 1,000,000 dollars, must be included in the decedent's estate. In construing the "postponed-possession-or-enjoyment clause," the court said:

> [I]nclusion of a trust corpus under that provision is not dependant upon the total value of the reversionary interest.... The question is not how much is the value of a reservation, but whether after a trust transfer, considered by Congress to be a potentially dangerous tax evasion transaction, some present or contingent right or interest in the property still remains in the settler so that full and complete title, posession or enjoyment does not absolutely pass to the beneficiaries until or after the settlor's death.[18]

Statutory relief followed this case with the enactment of the so-called Technical Changes Act.[19] It provided that no trust created prior to 1949 in which the decedent had an interest valued at five per cent or less was to be included in the decedent's estate. Congress adopted a slightly amended form of this provision in the 1954 revision of the Internal Revenue Code.[20] The apparent purpose of this provision was to alleviate the undue tax burden which would be placed on many estates through the application of the *Hallock* rule.[21] This type of transfer is now covered by section 2037[22] which contains the five per cent test for valuing a reversionary interest to determine whether or not the value of the property transferred should be included in the transferor's gross estate for estate tax purpose.[23] The purpose of the five per cent provision in section 2037, then, is to relieve the estate from taxation based on a minimal reversionary interest.

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whom were born prior to the settler's death, he would have been entitled to the corpus by operation of law.

18 335 U.S. at 707.

19 Ch. 720, § 7, 63 Stat. 894 (1949).

20 INT. REV. CODE OF 1954, § 2037.

21 *See generally* Recent Developments, 66 COLUM. L. REV. 7976, 7996 (1966), for a presentation of the congressional discussion surrounding the enactment of § 2037.

22 *See generally* Moore, *Transfers Intended to Take Effect in Possession or Enjoyment at or After Death,* 40 TAXES 876 (1962) for a good explanation of the inclusion and exclusion of certain types of reversionary interests under § 2037.

23 The effect of § 2037 is to include in a decedents gross estate the total value of all property that the decedent (transferor) has transferred in trust or otherwise if 1) the property does not vest permanently in the transferee unles he outlives the transferor and 2) the value of the reversionary interest retained by the transferor exceeds 5% of the total value of the property. In other words, if the chances of the transferor outliving the transferee is 1 in 20 or more immediately before death and without regard to actual death, then the value of the transferred property is included in the transferors estate.

MORTALITY AND ACTURIAL TABLES AS AN EXCLUSIVE VALUATION TOOL

The primary consideration in determining the propriety of any type of taxation is the wording of the statute authorizing such taxation. The relevant provisions governing the taxation of a decedent's estate for an inter vivos transfer in which he has retained a reversionary interest allows inclusion of the whole value of an amount transferred by the decedent during his life if this reversion is worth more than five per cent of the value of the property transferred.[24] The method of valuing this reversionary interest is also provided for in the code,[25] but it does not specifically designate the mortality and actuarial tables[26] as the exclusive valuation tool for these reversionary interests.

The *Hall* case held that the actuarial tables were not the exclusive tool for valuing a reversion under the code. The court found the language of the code to be of sufficient scope to prevent the harshness of a strict application of the actuarial tables, and to allow evidence of the decedent's health to be considered. This holding has prompted strange responses by some legal writers. For example, one writer likened it to a legalization of gambling.

> Transfers of property subject to a reversionary interest can represent, in effect, a form of wager in which the transferor plays the hope of avoiding estate taxes against his desire to control the ultimate disposition of his property at death. The effectiveness of Section 2037 as a weapon to discourage these estate tax sweepstakes will be vastly curtailed by the courts decision in the instant case [the *Hall* case].[27]

Another writer followed a more traditional approach and criticized the court's construction of the code on the basis of the underlying purpose of section 2037.

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24 The pertinent statutory language is as follows: "The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death . . . ." INT. REV. CODE OF 1954, § 2031(a). The extent to which the value is "provided for" is that the gross estate is to include the value of property transferred in trust or otherwise if "possession or enjoyment of the property can . . . be obtained only by surviving the decedent, and the decedent has retained a reversionary interest . . . and the value of such reversionary interest immediately before death exceeds 5 percent of the value of such property." INT. REV. CODE OF 1954, § 2037(a).

25 "The value of a reversionary interest immediately before the death of the decedent shall be determined (without regard to the fact of the decedent's death) by usual methods of valuation, including the use of tables of mortality and actuarial principles, under regulations prescribed by the Secretary or his delegate." INT. REV. CODE OF 1954, §2037(b).

26 United States Life Tables *supra* note 5.

27 Recent Developments, 66 COLUM. L. REV. 797, 801 (1966).

> [A] consideration of health frustrates the purpose of the statute. To the extent that a consideration of health produces a life expectancy figure which approaches the decedents actual life expectancy, a correspondingly fewer number of transfers than those actually contemplated will be taxed under the statute.[28]

Although this does not have the emotional appeal of the former argument, it meets on common ground with the position taken there, e.g., there is something basically wrong with a person attempting to keep his property from passing into the tax coffer.

The merits of this position are best evaluated through an exposition of the individual's responsibility as a taxpayer. Judge Learned Hand has had occasion to comment on his point a number of times. Some of his statements are apropos. "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[29] In discussing this same point in a later case, Hand stated that avoiding taxes is a purpose which "was legally neutral."[30] Finally, in relation to the burden of bringing a case within the statute, Hand felt that "in assessing a tax, the Treasury is not on the defensive; it has the affirmative, it must bring the case within the statute which imposes liability."[31] Hand's view would seem to be the better view since the application of a tax has always been looked upon as onerous by the citizenry. If the arguments in favor of exclusive use of actuarial tables in valuing a reversionary interest are based solely on increasing the amount of money the commissioner could realize under section 2037, then they lose much force in light of the true position of the taxpayer and his duty to pay taxes.

The statute provides that the value of the reversion is to be determined through "usual methods of valuation."[32] The actual life expectancy of a decedent would seem to be the most usual method available for a realistic evaluation of a reversionary interest and, hence, could not be dispensed with by the commissioner on any other basis than statutory authority.

A number of other arguments have been advanced in opposition to the use of actual life expectancies.[33] Probably the soundest of these is based on the words in section 2037 which direct that usual

[28] Note, 54 CALIF. L. REV. 2180, 2187 (1966).

[29] Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934).

[30] Chisholm v. Commisioner, 79 F.2d 14, 15 (2d Cir. 1935).

[31] Bennet v. Helvering, 137 F.2d 537, 539 (2d Cir. 1943).

[32] INT. REV. CODE OF 1954, § 2037(b).

[33] *See generally* Note, 54 CALIF. L. REV. 2180 (1966); and Recent Developments, 66 COLUM. L. REV. 797 (1966).

methods of valuation should be under "regulations prescribed by the Secretary or his delegate." The argument is that Treasury Regulation sections 20.2031-1 and 20.2031-7[34] can be read together to require actuarial computation in a valuation case.[35] The *Hall* court, however, construed these two regulations together and concluded that they did not require exclusive use of mortality tables in valuing a reversionary interest.[36] Which construction is preferable should ultimately depend on the wording of the statute.

The plain meaning of the provisions in section 2037(b) is that the Secretary may prescribe regulations to control the usual methods of valuation, which could include the use of mortality and actuarial tables. The fact that the statute mentions "including" the use of these tables indicates that the Secretary has no power to make the use of mortality tables the "exclusive" method of valuation. What the statute does, then, is to give the Secretary the power to prescribe when actual life expectancies are so vagarious as to require actuarial computation. It appears, then, that the construction of the Treasury Regulations by the *Hall* court was the proper one.

The Treasury Regulations do not contain a section purporting to fulfill the function reserved to them by the code. The only section which approaches this is section 20.2031-7(e) which only shows how actuarial computations are to be made once it is determined that they are the proper method. It is submitted that even if the Treasury Regulations are changed to prescribe the proper application of actuarial computations, that they would still be subject to review by the courts. Barring any statutory change, the court would be free to determine whether or not the Secretary has extended actuarial computation into a case where another method of valuation would provide a more realistic valuation.

One other argument which merits attention is the assertion that administrative ease would require the exclusive use of actuarial tables. The merits of this argument are apparent on its face. Whether or not the commissioner could assess taxes easier would be a proper consideration for legislative change but it should not be allowed as a method of reading out a provision in the Internal Revenue Code.

The *Hall* case was decided in conformity with the provisions in the Internal Revenue Code and the Treasury Regulations as here

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34 Treas. Reg. § 20.2031 (1958).

35 Note, 54 CALIF. L. REV. 2180, 2183 (1966).

36 353 F.2d at 503-04.

interpreted. Unless a change is made in the wording of the code, it seems that even a change in the regulations could not require the exclusive use of mortality tables in valuing reversionary interests under section 2037. Except for cases requiring actuarial valuations for lack of other evidence, the use of actual life expectancies seems to be the proper valuation tool for reversionary interests.

There are a number of situations in which evidence of actual life expectancies or special circumstances have been recognized by the commissioner for tax purposes.[37] The use of actual life expectancies was approved for valuation of a transferee's life or remainder interests for the purposes of allowable credit for tax on prior transfers under section 2013 of the Internal Revenue Code of 1954.[38] Evidence of a life tenant's actual life expectancy and special circumstances affecting possibility of issue has been allowed as a substitution for mortality tables in valuing charitable remainders.[39]

The commissioner, however, is not willing to agree with this approach to section 2037 valuation problems. Here the Treasury Department takes the position that in section 2037 "Congress has provided a rule of administrative convenience which requires the application of actuarial tables notwithstanding the facts of the decedent's death or the facts surrounding his death."[40] The refusal of the Treasury Department to accept the rule of the *Hall* case, however, should not be the final word in these situations. Since this is contrary to a proper reading of the code and since courts are willing to listen to evidence of actual life expectancies,[41] an attempt must be made to determine when the use of actual life expectancies is practical.

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37 *See generally* C.L.B. LOWNDES & R. KRAMER, FEDERAL ESTATE AND GIFT TAXES § 18.41 (2d ed. 1962); which describes a number of exceptions to valuation by actuarial tables.

38 *See* Rev. Rul. 66-307, 1966-2 CUM. BULL. 429; but note that this ruling makes it clear that the service does not approve of this method of valuation being applied to section 2037(b).

39 *See* Hamilton National Bank v. United States, 236 F. Supp. 1005 (E.D. Tenn. 1965), *aff'd*, 66-2 U.S. Tax Cas. ¶ 12,430 (6th Cir. 1966). This case is interesting because a 54 year old bachelor's possibility of having isue was based on his personal habits and offensiveness to women in addition to his bad physical condition when valuing the charitable remainder.

40 Rev. Rul. 66-307, 1966-2 CUM. BULL. 429, 430.

41 *See generally* El Paso National Bank v. United States, 65-2 U.S. Tax Cas. ¶ 12,360 (W.D. Texas 1965); *and* Chaucey Stillman, 1965 P-H Tax Ct. Mem. ¶ 65,094, for some recent decisions involving actuarial valuation.

VALUATION THROUGH THE USE OF ACTUAL LIFE EXPECTANCIES

The first and most apparent situation in which the use of actual life expectancy should be used as a valuation devise is when the reversionary interest is incapable of valuation through the use of actuarial tables.[42] This situation does not present much of a problem because even those writers criticizing the *Hall* case agree that actual life expectancy should be used here;[43] and it is not unreasonable to expect that the commissioner would also allow it should the proper case arise.

The more difficult situation arises in the normal case. Undoubtedly the commissioner is going to object to the admission of any evidence of actual life expectancy for valuation of a reversionary interest under section 2037.[44] The next step, then, is to determine which of these situations are proper ones for court review.

At the outset, of course, the value of property sought to be included in the estate is an important consideration. The practical financial considerations are better left to individual attorney-client considerations, however, so the discussion here is limited to the merits of the position independent of any financial considerations.

Determination of whether a holder of a reversionary interest prior to death should have his actual life expectancy asserted should first depend on the nature of the physical infirmities of the decedent. If a physician could have determined with a good deal of accuracy how long an individual could be expected to live, without regard to the fact of death, then this would be more persuasive to a court. The need for preciseness of this determination on a minimum-maximum basis would, of course, bear a direct relationship to the life expectancy of an individual on actuarial tables. As the actuarial figure increased, the span between the minimum-maximum forecast of expected life would increase.

One argument which may be encountered at this point is that the statutory prohibition against considering the fact of death may preclude any consideration of the illnesses which caused the actual death.[45] Policy buttressing this position is that it would discriminate against persons who were presumably in good health prior

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[42] *See* C.L.B. LOWNDES & R. KRAMER, FEDERAL ESTATE AND GIFT TAXES § 7.7 (2d ed. 1962).

[43] Note, 54 CALIF. L. REV. 2180, 2182-83 (1966); Recent Developments, 66 COLUM. L. REV. 797, 798 (1966).

[44] *See* text accompanying note 38 *supra*.

[45] Recent Developments, 66 COLUM. L. REV. 797, 801 (1966).

to death as compared to a person who died after a lengthy illness.[46] The answer to this is that it would be manifestly unfair to the person who had a mortal affliction, not to allow this as a consideration when the statute can be construed to include such a consideration. As was noted before, the commissioner has the burden of bringing property within the statute.

With these arguments in mind, it would seem that the more persuasive case would exist when the decedent had died suddenly of some cause other than the factors which a physician would use in computing the actual life expectancy. However, just because a person dies of what would, immediately before his death, have been a prime consideration in figuring his actual life expectancy, it would not seem to take the case out of the statute. There is no reason why the reversionary interest cannot decrease in value as death approaches under the wording of the statute. If it were otherwise, the statute would have provided for valuation of the reversionary interest at the time of the transfer and not immediately before death.[47]

A final consideration may be the type of reversionary interest retained by the transferor. A more persuasive case could be presented where the reversionary interest arose as a matter of law rather than being expressly provided for. Since this type of reversionary interest is imposed on the transferor for estate tax purposes under section 2037 (when the transfer is made after October 8, 1949), the increased oppressiveness of not allowing the use of actual life expectancies could be asserted. This does not mean, however, that a situation in which the reversionary interest is expressly reserved by the transferor must be valued by actuarial tables. If the intent to avoid taxes is "legally neutral,"[48] there would seem to be no reason why this should be considered by the court under section 2037 so this type of reversionary interest should not be valued by the use of actual life expectancies.

CONCLUSION

It appears that section 2037 of the Internal Revenue Code of 1954 does not require actuarial tables as an exclusive valuation tool under the five per cent provision. Although the Commissioner of Internal Revenue may oppose any other valuation method, there are a number of situations in which assertion of actual life expect-

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[46] Note, 54 CALIF. L. REV. 2180, 2186-87 (1966).

[47] INT. REV. CODE OF 1954, § 2037(a)(2).

[48] *See* text accompanying note 28 *supra*.

ancies would undoubtedly fall on sympathetic ears if the commissioner's position were opposed.

The five per cent provision certainly should not be construed as an objective standard requiring exclusive use of actuarial tables. It is submitted that in a proper case, the use of a subjective standard considering the actual life expectancies under the five per cent provision is the preferable approach to the application of section 2037.

Steven D. Brumley, '68