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FCG VALUATION CASE E-FLASH

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Issue 12:14

Stewart v. Commissioner, Cite as 106 AFTR 2d 2010-XXXX, 08/09/2010,Estate of Margot Stewart, Deceased, Brandon Stewart, Executor Petitioner-Appellant, v. Commissioner of Internal Revenue, Respondent-Appellee
United States Court of Appeals for the Second Circuit, Docket No. 07-5370-ag, August 9, 2010

The IRS argued and the Tax Court ruled that decedent retained enjoyment or possession of a 49-percent undivided interest in a five-story New York brownstone gifted to the decedent's son. Because the decedent did not enjoy full possession or enjoyment, however, the Second Circuit Court of Appeals ruled that the entire 49-percent interest was NOT includable in the gross estate and remanded the case to the Tax Court so that it could determine the includable percentage.

TAKEAWAY
In a split decision associated with an alleged IRC § 2036(a)(1) issue, the Second Circuit concluded that an implied agreement between mother and son prevented the mother from enjoying the entire economic benefit associated with her gift of a 49-percent undivided interest. More specifically, the majority ruled that IRC § 2036(a)(1) compliance is not an "all-or-nothing matter." In doing so, it relied on prior court rulings[1] which considered the following factors:

- Continued exclusive possession by the donor, and
- Withholding of possession from the donee.

Judge Livingston's vigorous dissent is also noteworthy. He fears the majority's decision will allow cohabitating family members to engage in sham transactions for tax avoidance purposes.

LACK OF FINANCIAL DISCIPLINE UNDERMINES PLANNING

Margot Stewart ("Decedent" or "Ms. Stewart") and her adult son Brandon ("Son"), collectively, "Parties," co-owned (as joint tenants with rights of survivorship) an East Hampton, New York, house which they rented during the summer. Instead of requiring tenants to write checks to each of them, either Ms. Stewart or Son would receive rental checks and would eventually pay the other for their portion. Additionally, the Parties evenly split the East Hampton maintenance expenses.

The Parties also lived in a five-story brownstone in Manhattan, which the Decedent had purchased in 1968. In October 1999, Ms. Stewart leased the upper three floors of the brownstone to an unrelated commercial tenant through July 2002.

At the same time the Decedent leased the upper three floors, the Parties met with an estate planning attorney. During the meeting, Ms. Stewart asked the attorney for strategies to mitigate the impact of the brownstone's appreciating value. The attorney suggested gifting part of the property to Brandon, a suggestion the Decedent accepted. The gift of a 49-percent interest to Son was completed in May 2000.

Between the time of meeting with the attorney and gift of the deed to Brandon, Ms. Stewart was diagnosed with pancreatic cancer. She underwent chemotherapy treatments.

[1] *Estate of Spruill v. Comm'r*, 88 T.C. 1197, 1225 (1987); *accord Guynn v. United States*, 437 F.2d 1148, 1150 [27 AFTR 2d 71-1653] (4th Cir. 1971).

The Parties continued to live in the brownstone after the gift. However, payments from the commercial tenant became erratic and, at the same time, the property incurred thousands of dollars of repair. The Parties' property management financial arrangements began to change as well. More particularly, Son received all of the income from the East Hampton property and did not share proceeds with the Decedent. At the same time, Son began to pay for a small but not insignificant portion of expenses for the Manhattan property, which he had not done before the gift.

ABSENT A WRITTEN AGREEMENT, SON'S TESTIMONY GIVEN LITTLE WEIGHT

Ms. Stewart died in November 2000. On the Form 706, the estate included a 100-percent interest in the East Hampton property but only a 51 percent interest in the brownstone. Because she had agreed to share the income from the commercial lease with her Son and shared the value of the bottom two floors of the property with Son, the estate argued the Decedent was entitled to include only the 51 percent interest in her estate.

Additionally, the estate argued that Ms. Stewart and Brandon intended to follow the income and expense arrangement with the Manhattan property that they had previously been using with the East Hampton property. Instead of forcing the tenants to write checks to the Decedent and to Son, the Parties planned on tracking the income and expense items of both properties and reconciling them at the end of the year.

The IRS argued that the Decedent retained possession or enjoyment of the 49-percent interest under IRC § 2036(a)(1). Accordingly, the IRS believed the entire interest should be includable in her estate.

Because there was no written agreement between the Parties, and because the Tax Court gave little weight to Brandon's assertion that an oral agreement existed, the Tax Court ruled there was no agreement which apportioned the brownstone's income and expense items. Instead, the Tax Court ruled there was an implied agreement between Ms. Stewart and Brandon that she would maintain the economic benefits of the full property, and the full value of the brownstone was therefore includable in her estate.

§ 2036 ANALYSIS

IRC § 2036(a)(1) states that a gross estate shall include property of which the Decedent retained "the possession or enjoyment" or from which it retained the right to income. In analyzing IRC § 2036(a)(1), the Second Circuit determined the property was the Son's 49-percent interest, not the entire Manhattan brownstone. Additionally, the Second Circuit found that the Decedent did not retain the right to income from the property because she had gifted a 49-percent interest to Son.

As a result, the issues considered by the Second Circuit were:

1) Did the Decedent retain the possession or enjoyment of any portion the 49-percent interest? [IRC § 2036(a)(1)]

2) If so, what portion of the 49-percent interest should be includable in the Decedent's estate? [IRC § 2036(c)(1)(i)]

The Second Circuit considered whether an implied agreement existed between Ms. Stewart and her Son for her to possess or enjoy the benefits of his 49-percent interest. Relying on analysis from prior rulings,[2] the Second Circuit considered whether the Decedent (donor) retained continued exclusive possession and withheld possession from her Son (donee). Based on their cohabitation, the Second Circuit could not find an implied agreement existed for their residential use of the brownstone.

In contrast, the Second Circuit upheld the Tax Court's findings of an implied agreement for the commercial use of the brownstone. Additionally, the Second Circuit upheld the Tax Court's findings that Brandon's testimony was not credible, and that all of the income from the commercial tenant went to the Decedent. Both of those factors weighed heavily in the determination of an implied agreement.

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[2] *Estate of Spruill v. Comm'r*, 88 T.C. 1197, 1225 (1987); *accord Guynn v. United States*, 437 F.2d 1148, 1150 [27 AFTR 2d 71-1653] (4th Cir. 1971).

APPORTIONING SON'S INTEREST TO MOTHER'S ESTATE

Citing IRC § 2036(c)(1)(i), the Second Circuit faulted the Tax Court for treating IRC "§ 2036(a)(1) as an all-or-nothing matter" without considering whether Ms. Stewart retained a right or interest in only a part of the property transferred. Because the Tax Court failed to consider all of the facts and circumstances, the majority in the Second Circuit vacated and remanded the lower court's decision.

When considering apportionment of the Son's 49-percent interest to the estate, the Second Circuit instructed the Tax Court to consider Revenue Ruling 79-109. In particular, the Tax Court "must determine how much of the substantial economic benefit generated by the 49-percent interest is attributable to the residential portion of the interest and how much is attributable to the commercial portion." More specifically, the Tax Court must determine what percentage of net income (not gross income) was received by each of the parties.

The majority in the Second Circuit also suggested that the Tax Court consider how the Parties treated the income and expenses of the East Hampton property when considering the Son's interest in the Manhattan brownstone.

DISSENT

Judge Livingston dissented from the majority decision. In particular, the judge believed the onus was on the estate to *disprove* the Tax Court's determination that an implied agreement existed between the Parties existed.

Additionally, Judge Livingston believed Ms. Stewart's relationship with the Manhattan property did not significantly change after the gift, that the majority erred in focusing on what the Son received (rather than what the Decedent retained), and that the majority's decision opened a loophole in § 2036(a)(1) by imparting new meaning to its longstanding construction.

Judge Livingston also objected to the majority's use of the factors in *Spruill* because the transferred interest in that case was a 100-percent interest, rather than a minority interest such as the present case.

Finally, the dissenting judge was concerned that the majority shifted the burden of proof from the taxpayer to the IRS.

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