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Widow's Election — Amortizable Cost in the Purchase of a Life Estate

In community-property states many wills provide that a widow, in lieu of taking her one-half share in the community property, may receive the income for life from a trust consisting of the entire community estate. Under section 167(a)(2) of the Internal Revenue Code of 1954¹ widows have sought to amortize the cost of this exchange, claiming that it is a bargained-for sale and purchase.² The Commissioner, however, relying on section 273 of the Code,³ has refused to allow any deduction for amortization. His position is that the widow, having acquired her life estate by bequest from her husband's testamentary disposition of his property, has paid nothing for the income rights and has no cost or capital investment to recoup via amortization.⁴ He has also pointed out that gift tax returns have been filed in connection with the transfer of the widow's remainder interest to the trust, indicating a gift of the widow's property rather than a sale or purchase.⁵ The Commissioner, however, has only one case in support of this proposition.⁶ The Tax Court⁷ and Ninth Circuit⁸ have recently upheld the widow's right to amortize the cost of the purchase. However, the amortizable cost has been limited to the actuarially computed value of the life estate in the deceased spouse's community property.

I. WIDOW'S ELECTION—A PURCHASE

A gift tax case, *Commissioner v. Siegal*,⁹ has been cited often and generally followed in support of the proposition that the exchange of interests is a purchase for gift tax purposes.¹⁰ In *Siegal* the Commissioner contended that the widow received no consideration for making the election,

¹ This section allows as a "depreciation deduction a reasonable allowance for the exhaustion . . . of property held for the production of income." INT. REV. CODE OF 1954, § 167(a)(2).

² See, e.g., *Gist v. United States*, 296 F. Supp. 526 (S.D. Cal. 1968), *aff'd*, 423 F.2d 1118 (9th Cir. 1970); *Estate of Christ*, 54 P-H Tax Ct. Mem. ¶ 54.46 (1970).

³ INT. REV. CODE OF 1954, § 273, provides that "[a]mounts paid . . . as income to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be reduced or diminished by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time."

⁴ See *Gist v. United States*, 296 F. Supp. 526 (S.D. Cal. 1968), *aff'd*, 423 F.2d 1118 (9th Cir. 1970); *Estate of Christ*, 54 P-H Tax Ct. Mem. ¶ 54.46 (1970).

⁵ *Estate of Christ*, 54 P-H Tax Ct. Mem. ¶ 54.46, at 377 (1970).

⁶ *Helvering v. Butterworth*, 290 U.S. 365 (1933). While the primary question in *Butterworth* was whether the trustee was allowed a deduction for income distributed to the widow, there was dictum to the effect that the widow, by accepting the provisions of her husband's will in lieu of her statutory rights, was not a purchaser of the income for life, but occupied the position of beneficiary of the trust. The Supreme Court carried this further by stating: "When she makes her election the widow decides to accept the benefits of the will with the accompanying rights and liabilities. In no proper sense does she purchase an annuity." *Id.* at 370. The impact of this case is lessened, however, by the fact that it did not arise in a community-property jurisdiction. *Butterworth* arose in Pennsylvania, where the widow's statutory interests in the husband's estate arise only after his death. The holding was ultimately limited to the narrow issue of whether the widow was a beneficiary under the terms of the applicable statute.

⁷ *Estate of Christ*, 54 P-H Tax Ct. Mem. ¶ 54.46 (1970).

⁸ *Gist v. United States*, 423 F.2d 1118 (9th Cir. 1970).

⁹ 250 F.2d 339 (9th Cir. 1957).

¹⁰ See, e.g., *Estate of Vardell v. Commissioner*, 307 F.2d 688 (5th Cir. 1962); *Gist v. United States*, 296 F. Supp. 528 (S.D. Cal. 1968), *aff'd*, 423 F.2d 1118 (9th Cir. 1970); *Estate of Christ*, 54 P-H Tax Ct. Mem. ¶ 54.46, at 378 (1970).

and that the entire value of her community-property rights was a gift to the estate. By implication, this means that her acquisition of the life estate in all the community property was by bequest or inheritance rather than by purchase. The Ninth Circuit rejected this contention, stating that elections to take under a will by one of the spouses instead of property that he or she may be entitled to under state law have long been recognized as transactions in which the property surrendered is considered the consideration for the offer made in the will.¹¹ In all instances the effect of the election is determined by the law of the state.¹² Since under California law the interests of husband and wife in community property are declared to be "present, existing, and equal,"¹³ the court in *Siegal* ruled the widow had a vested interest in one half of the community property even before her husband's death. Thus, the value of the remainder interest surrendered was consideration for a life estate in the husband's community one-half which was received under the will.

For purposes of federal estate and gift taxes, it appears that the exercise of a widow's election where the estate consists entirely of community property is considered to be a bargained-for sale or exchange made for consideration, even though the value of the remainder interest given up has generally greatly exceeded the value of the life estate received and a gift tax, in most instances, has been paid on this excess.¹⁴ The husband's life estate is viewed as "consideration in money or money's worth" which reduces the taxable amount of the wife's disposition of her interests for *gift and estate* tax purposes.¹⁵ The term "consideration in money or money's worth" appears in sections 2036(a)¹⁶ and 2043(a)¹⁷ (estate tax) and section 2512(b)¹⁸ (gift tax) of the Internal Revenue Code of 1954. Its purpose is to give a credit for the amount received against a taxable gift or transfer.

While the existence of such "consideration" for gift and estate tax purposes does not require a holding that there has been a sale or exchange for income tax purposes, it appears the Tax Court¹⁹ and Ninth Circuit²⁰ have extended this reasoning into the income tax field. The Tax Court reasoned that an exchange of interests is carried out primarily for the widow's own economic self-interest, and, therefore, considered it a bargained-for sale or purchase. The widow's election to transfer her share of the community property to the trust and to accept the benefits of the trust did not result from "charitable impulses or from a detached and disinterested generosity."²¹ It involved concern for her own economic well-

¹¹ 250 F.2d at 340-41.

¹² *Morgan v. Commissioner*, 309 U.S. 78 (1940).

¹³ CAL. CIV. CODE § 161a (West 1954).

¹⁴ See, e.g., *Estate of Vardell v. Commissioner*, 307 F.2d 688 (5th Cir. 1962); *Commissioner v. Siegal*, 250 F.2d 339 (9th Cir. 1957).

¹⁵ *Id.*

¹⁶ INT. REV. CODE of 1954, § 2036(a).

¹⁷ *Id.* § 2043(a).

¹⁸ *Id.* § 2512(b).

¹⁹ *Estate of Christ*, 54 P-H Tax Ct. Mem. ¶ 54.46 (1970).

²⁰ *Gist v. United States*, 423 F.2d 1118 (9th Cir. 1970).

²¹ 54 P-H Tax Ct. Mem. at 378.

being, which is the incentive for choosing to receive the income from the entire community. In response to the Commissioner's contention that gift tax paid by the widow is indicative of a donative intent and, therefore, constitutes a gift rather than a purchase, the Tax Court stated that it has long been recognized that donative intent is not a necessary element to subject a transfer to gift tax.²³

The Ninth Circuit,²³ having adopted the district court's reasoning, felt simply that it was illogical in light of *Siegal* and *Estate of Vardell v. Commissioner*²⁴ to conclude that the widow's election was not a purchase. It believed that the creation of the life estate upon the exercise of the widow's election did not alter the fact that the widow may be a purchaser for value, as would one to whom she sold her life estate for cash.

II. AMORTIZATION

If the widow's election is considered to be a bargained-for sale or exchange, the question then arises whether the purchaser is entitled to amortization deductions based on the cost of acquiring the life interest in the deceased's portion of the community property transferred to the trust. The right to amortize in situations where an interest in an estate has been purchased appears to be unquestioned.²⁵ In the leading case, *Bell v. Harrison*,²⁶ the taxpayer, who owned the remainder interest in a trust, purchased the life estate. The taxpayer contended that this was a capital expenditure wasting in value with time and that he should be entitled to recover his cost basis. The Government, however, took the position that the purchase of the life interest resulted in a "merger" of the two estates, and that for tax purposes, there was no life estate to amortize after the merger. Under this view the capital invested could only be recouped at the time of sale or other disposition. The Seventh Circuit, in deciding for the taxpayer, stated, "What he purchased . . . was a terminable estate and the termination of the estate will end all that he purchased."²⁷ In a similar situation, the Tax Court compared the problem to that of a purchaser of a lease, stating: "Nor can we perceive any difference in this respect between the purchase of a lease of a life interest and the purchase of the life interest itself. In both cases the interest is terminable and exhaustible for income tax-purposes."²⁸ The Internal Revenue Service acquiesced to amortization of the purchase price of a life estate after the decisions of *Commissioner v. Fry*²⁹ and *Bell*.³⁰ In its acquiescence, the Service noted that "the transactions in these cases appear to be bona fide and without a tax

²³ See, e.g., *Commissioner v. Wemyss*, 324 U.S. 303 (1945).

²⁴ *Gist v. United States*, 423 F.2d 1118 (9th Cir. 1970).

²⁵ 307 F.2d 688 (5th Cir. 1962).

²⁶ See Rev. Rul. 62-132, 1962-2 CUM. BULL. 73.

²⁷ 212 F.2d 253 (7th Cir. 1954).

²⁸ *Id.* at 254.

²⁹ *Keitel v. Commissioner*, 15 B.T.A. 903, 907 (1929).

³⁰ 283 F.2d 869 (6th Cir. 1960).

³¹ 212 F.2d 253 (7th Cir. 1954).

avoidance motive. These cases will be followed in the disposition of other cases in which the facts are substantially the same.³¹

Until recently the valuation of amortization cost in the purchase of a life estate through the widow's election method has been untested in court.³² However, in *Estate of Christ*³³ and *Gist v. United States*³⁴ this is specifically defined. In *Christ* the widow claimed as the cost of the life estate the difference between the value of the remainder interest surrendered and the life estate received, while in *Gist* the widow tried to use the value of the entire life estate. The Ninth Circuit and the Tax Court held that the cost should be limited to the value of the spouse's life estate received by the widow. The amount by which the widow's remainder interest exceeds this value is considered a gift and is not used in computing the cost. In *Christ* the Tax Court reasoned that the remainder value of the widow's community interest should not be included in her cost, since at her death the remaindermen would be entitled to it. The remainder interest would not be reduced or exhausted by the widow, because she has no control over it under the terms of the election agreement. The district court in *Gist* felt that the taxpayer was resorting to a legal fiction in assuming that she had sold all of her community-property interest in return for a life interest in all the community property. The district court stated that "[w]hile it is true that plaintiff could have purchased a commercial annuity with her share of the community and amortized its cost over her lifetime, this she did not do."³⁵ The taxpayer already owned the life estate in her own community property and in no way could it be said she exchanged it and re-purchased it.³⁶

III. CONCLUSION

A look into this area cannot be made without reference to the related gift and estate tax problems that arise whenever this election method is used.³⁷ Briefly, in community-property states such as Texas³⁸ and California, the widow's-election estate plan has become popular because of the possible estate tax savings at the time of the widow's subsequent death. A well-drafted widow's election may allow the wife's community-property interest to pass at her death with a reduced estate tax or with no estate tax, according to the facts in each case.³⁹ Such a will may also permit the

³¹ *Id.* at 254.

³² *Gist v. United States*, 296 F. Supp. 526 (S.D. Cal. 1968), *aff'd*, 423 F.2d 1118 (9th Cir. 1970).

³³ 54 P-H Tax Ct. Mem. ¶ 54.46 (1970).

³⁴ 423 F.2d 118 (9th Cir. 1970).

³⁵ 296 F. Supp. at 529.

³⁶ The value of the life estate and remainder interests are computed by the use of Table 1 of Treas. Reg. § 20.2031-7(f) (1971). To compute the annual amortization deduction, the actuarial value of the life estate transferred to the taxpayer is divided by the remaining life expectancy of the taxpayer in terms of years.

³⁷ For a thorough discussion of estate and gift tax problems involving the widow's election, see Comment, *The Widow's Election—A Study in Three Parts*, 15 Sw. L.J. 85, 144-65 (1961).

³⁸ The effect in Texas of the widow's election on the community property will be the same as in California, since each spouse has a vested interest in one half of the community property. *Dakan v. Dakan*, 125 Tex. 305, 83 S.W.2d 620 (1935).

³⁹ See Comment, *supra* note 37, at 156.

life estate in the husband's community interest that passes to the wife to escape the second estate tax at her death.

Generally, the widow's election results in a gift to the trust taxable to her, but the value of the gift for tax purposes is only the value of the property relinquished by the electing spouse, less the value of the consideration received (the value of the life estate in the husband's half of the community property).⁴⁰ Since the values of the interests are determined by actuarial tables, the age of the widow will determine the amount of gift tax liability.⁴¹ When the widow is fairly young and the actuarial value of the life estate is fifty per cent or more of the total value of her community one-half, no gift tax will result.⁴²

Prior to *Gist* and *Christ*, there had been no income tax cases holding that the widow could amortize the cost of her life estate in a widow's election situation.⁴³ Although the courts have limited the amortization deduction to the value of the life estate in the deceased spouse's community property, up to this time it was not clear whether any deduction was allowable at all. These decisions will aid the practitioner in determining the possible worth or benefit of a widow's-election type of estate plan in community-property states. Through the determination of possible trust income to the widow, income tax liability can be determined with reasonable accuracy. The amortization deduction could be a substantial tax-saving tool in light of the fact that other deductions such as depreciation or depletion may still be available to the widow through section 167(h) of the Internal Revenue Code.⁴⁴ The *Gist* and *Christ* decisions also emphasize the necessity of handling the widow's election agreement in the will as a purchase and sale agreement rather than a transfer that could be construed as a gift. This will insure the use of the amortization deduction, the feature which makes the plan so attractive.

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⁴⁰ For methods on how to avoid the gift tax problem, see *id.* at 150-51.

⁴¹ *Id.* at 150.

⁴² Provision should be made for payment of gift taxes by the trust, since in the normal case the wife, after her election, has no assets from which the gift tax can be paid.

⁴³ *Gist v. United States*, 296 F. Supp. 526 (S.D. Cal. 1968), *aff'd*, 423 F.2d 1118 (9th Cir. 1970).

⁴⁴ INT. REV. CODE of 1954, § 167(h) provides:

In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allowable to each.