

# Estate Taxation: Valuation of Mutual Funds for Estate Tax Purposes

St. John's Law Review

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## Recommended Citation

St. John's Law Review (1972) "Estate Taxation: Valuation of Mutual Funds for Estate Tax Purposes," *St. John's Law Review*: Vol. 47 : No. 2 , Article 27.

Available at: <https://scholarship.law.stjohns.edu/lawreview/vol47/iss2/27>

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Petitioner might have avoided his tax problem by allowing NBC to make \$300,000 worth of lease-hold improvements which are not taxable as rent.<sup>79</sup>

In the alternative, petitioner could have waived his right to restoration and entered into a new lease for 1 or 2 years. Shortly thereafter NBC could have given the petitioner three notes for \$300,000 for the cancellation of the new lease thus coming within section 1241 of the Code and also entitling the petitioner to elect the installment method of reporting income under section 453.

It is apparent from this case that the decision in *Ferrer* will not change the long-standing rule that taxpayers will only be allowed the use of section 453 when the sale includes the release of rights which can be sold.

#### ESTATE TAXATION

##### *Valuation of Mutual Funds for Estate Tax Purposes*

Most mutual funds (Funds) have both "bid" and "asked" prices.<sup>80</sup> The "bid" price is the net asset value of the Fund.<sup>81</sup> The Fund is required by law<sup>82</sup> to redeem its shares at this "bid" price. Except for a negligible few, Fund shareholders liquidate their investments by the redemption method.<sup>83</sup> The "asked" price is the amount at which the Fund's marketing agency will sell a share to the public and consists of the "bid" price plus a commission of approximately eight percent for the marketeers.<sup>84</sup>

Treasury regulations require a Fund to be valued at its "asked"

<sup>79</sup> INT. REV. CODE of 1954, § 109. But the improvements may not be a sham in an attempt to conceal the payment of rent. Treas. Reg. § 1.109-1 (1972).

<sup>80</sup> See *Wells v. Commissioner*, 50 T.C. 871 (1968), *aff'd sub nom.*, *Ruehlmann v. Commissioner*, 418 F.2d 1302 (6th Cir. 1969), *cert. denied*, 398 U.S. 950 (1970), citing the *Scudder, Stevens and Clark Common Stock Fund, Inc.*, as an example of a mutual fund having the same "bid" and "asked" price.

<sup>81</sup> *Cartwright v. United States*, 457 F.2d 567 (2d Cir. 1972), *cert. pending*, defines the net asset value as follows:

The "net asset value" is computed daily as of the close of trading on the New York Stock Exchange. The total assets are valued and the total outstanding liabilities, including all reserves and accrued expenses, are subtracted. The resulting net worth is divided by the number of shares outstanding to determine the "net asset value" per share of capital stock. This is generally described as the "bid" price in the financial pages.

*Id.* at 568 n.1.

<sup>82</sup> Investment Company Act of 1940, 15 U.S.C. § 80a-22 (1970).

<sup>83</sup> See *Wells v. Commissioner*, 50 T.C. 871, 873 (1968). See also *Howell v. United States*, 414 F.2d 45, 47 (7th Cir. 1969).

<sup>84</sup> The commission covers the marketing agencies' expenses and profit but does not provide for the Fund's management. *Cartwright v. United States*, 323 F. Supp. 769, 771 (W.D.N.Y. 1971). The management expenses are paid from the Fund's dividends. Brief for Petitioner at 33, *Cartwright v. United States*, 457 F.2d 567 (2d Cir. 1972).

price for estate tax purposes.<sup>85</sup> In *Cartwright v. United States*<sup>86</sup> the Second Circuit found the regulations to be unreasonable and required Funds to be valued at their "bid" price. Both the Sixth<sup>87</sup> and Seventh<sup>88</sup> Circuits had previously found the regulations reasonable.

Before examining the Second Circuit's reasoning, it is helpful to trace briefly the Treasury's attitude regarding the valuation of Funds prior to the enactment of the current regulation governing the matter. After the enactment of the Investment Companies Act of 1940<sup>89</sup> and until 1961, the Internal Revenue Service (IRS) accepted returns valuing Funds at the "bid" price.<sup>90</sup> From 1961 through 1963, the IRS attempted to value the Funds at the "asked" price but, when met with taxpayer resistance, it allowed the old method of "bid" valuation.<sup>91</sup> Only after October 10, 1963 did the IRS fight taxpayers who valued at the "bid" price.

To prevail in the instant case, the IRS did not have to prove that

<sup>85</sup> Treas. Reg. § 20.2031-8(b) (1963) reads:

(b) Valuation of shares in an open-end investment company. (1) The fair market value of a share in an open-end investment company (commonly known as a "mutual fund") is the public offering price of a share, adjusted for any reduction in price available to the public in acquiring the number of shares being valued. In the absence of an affirmative showing of the public offering price in effect at the time of death, the last public offering price quoted by the company for the date of death shall be presumed to be the applicable public offering price. If the alternate valuation under section 2032 is elected, the last public offering price quoted by the company for the alternate valuation date shall be the applicable public offering price. If there is no public offering price quoted by the company for the applicable valuation date (e.g., the valuation date is a Saturday, Sunday, or holiday), the fair market value of the mutual fund share is the last public offering price quoted by the company for the first day preceding the applicable valuation date for which there is a quotation, adjusted for any reduction in price available to the public in acquiring the number of shares being valued. In any case where a dividend is declared on a share in an open-end investment company before the decedent's death but payable to shareholders of record on a date after his death and the share is selling 'ex-dividend' on the date of the decedent's death, the amount of the dividend is added to the ex-dividend quotation in determining the fair market value of the share as of the date of the decedent's death. As used in this paragraph, the term "open-end investment company" includes only a company which on the applicable valuation date was engaged in offering its shares to the public in the capacity of an open-end investment company.

<sup>86</sup> 457 F.2d 567 (2d Cir. 1972).

<sup>87</sup> *Ruehlmann v. Commissioner*, 418 F.2d 1302 (6th Cir. 1969), *cert. denied*, 398 U.S. 950, *rehearing denied*, 400 U.S. 856 (1970).

<sup>88</sup> *Howell v. United States*, 414 F.2d 45 (7th Cir. 1969), also found the following companion gift tax regulation reasonable:

Valuation of shares in an open-end investment company.

(1) The fair market value of a share in an open-end investment company (commonly known as a 'mutual fund') is the public offering price of a share, adjusted for any reduction in price available to the public in acquiring the number of shares included in the particular gift.

Treas. Reg. § 25.2512-6(b) (1968).

<sup>89</sup> 15 U.S.C. § 80a-22 (1970).

<sup>90</sup> See *Cartwright v. United States*, 457 F.2d 567, 571 (2d Cir. 1972).

<sup>91</sup> See, e.g., *Davis v. United States*, 306 F. Supp. 949, 953 (C.D. Cal. 1969), *aff'd*, 460 F.2d 769 (9th Cir. 1972) (2-1 decision).

the regulation was the best possible method of valuation. All that had to be proven was that it was reasonable since, where several methods of valuation are possible, that chosen by the IRS cannot be set aside.<sup>92</sup> The court's role is to determine if the chosen method is consistent with the statute sought to be interpreted<sup>93</sup> and to decide if the interpretation is reasonable.<sup>94</sup>

The reasonableness of valuing Funds at a price about eight percent higher than the estate can realize when it redeems the shares is an issue that was litigated often in cases prior to the Second Circuit's *Cartwright* decision with resultant diverse rulings on the reasonableness of the "asked" method of valuation.<sup>95</sup> In all cases, the IRS has advanced two main theories. The first is that valuation of Funds at the "asked" price is consistent with the general method of valuation found in the regulations. The pertinent regulation states that the general criterion for valuation is the fair market value of the property at the time of decedent's death.<sup>96</sup> Fair market value is defined as the price a

<sup>92</sup> *Howell v. United States*, 414 F.2d 45, 48 (7th Cir. 1969).

<sup>93</sup> *Id.*

<sup>94</sup> *Wells v. Commissioner*, 50 T.C. 871 (1968), *aff'd sub nom.*, *Ruehlmann v. Commissioner*, 418 F.2d 1302 (6th Cir. 1969), *cert. denied*, 400 U.S. 856 (1970).

<sup>95</sup> *See, e.g.*, *Ruehlmann v. Commissioner*, 418 F.2d 1302 (6th Cir. 1969), *cert. denied*, 400 U.S. 856 (1970); *Howell v. United States*, 414 F.2d 45 (7th Cir. 1969) (reasonable); *Davis v. United States*, 306 F. Supp. 949 (C.D. Cal. 1969), *aff'd*, 460 F.2d 769 (9th Cir. 1972); *Hicks v. United States*, 335 F. Supp. 474 (D. Colo. 1971) (unreasonable).

<sup>96</sup> *Treas. Reg. § 20.2031-1(b)* (1965) reads in pertinent part:

(b) Valuation of property in general. The value of every item of property includible in a decedent's gross estate under sections 2031 through 2044 is its fair market value at the time of the decedent's death, except that if the executor elects the alternate valuation method under section 2032, it is the fair market value thereof at the date, and with the adjustments, prescribed in that section. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account location of the item wherever appropriate. Thus, in the case of an item of property includible in the decedent's gross estate, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail. For example, the fair market value of an automobile (an article generally obtained by the public in the retail market) includible in the decedent's gross estate is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public and not the price for which the particular automobile of the decedent would be purchased by a dealer in used automobiles. Examples of items of property which are generally sold to the public at retail may be found in §§ 20.2031-6 and 20.2031-8. The value is generally to be determined by ascertaining as a basis the fair market value as of the applicable valuation date of each unit of property. For example, in the case of shares of stock or bonds, such unit of property is generally a share of stock or a bond. Livestock, farm machinery, harvested and growing crops must generally be itemized and the value of each item separately returned. Property shall not be returned at the value at which it is

willing buyer and a willing seller agree upon and the regulation notes that this is generally found in the retail market. The IRS argued that, since mutual funds are required by law to redeem shares,<sup>97</sup> then they are not a willing buyer within the meaning of the regulation.<sup>98</sup> The IRS also argued that the only applicable example of a willing buyer and seller is found in the retail situation in which the Fund is sold by a willing broker to a willing purchaser at the "asked" price.<sup>99</sup>

The Second Circuit refuted this argument by concurring with the district court's opinion<sup>100</sup> which had relied upon the theory that there are two market places for Funds: the first market is the transaction between the purchaser and the broker and the second is the redemption of the shares by the Fund from the original purchaser. This theory concludes that use of the first market place because it more exactly fits the definition of retail would create "an artificial value that cannot possibly be obtained by the estate in any readily accessible, realistic market."<sup>101</sup>

In addition, the court attacked the Government's retail concept by noting that the Regulation invites examination of all relevant facts, thereby not requiring that the retail price be the sole value determinant.<sup>102</sup> Indeed, the court pointed out, IRS has availed itself of those other "relevant facts" by valuing bonds at their par, not retail market value, when the estate could apply them at par value for payment of the decedent's estate tax.<sup>103</sup> Treasury Regulations also provide for deviating from the usual retail valuation technique when the sale of corporate stock is subject to a restricted agreement. In this situation the specified price rather than the stock's market price is used for valuation.<sup>104</sup> The Second Circuit concluded that facts relevant to

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assessed for local tax purposes unless that value represents the fair market value as of the applicable valuation date. All relevant facts and elements of value as of the applicable valuation date shall be considered in every case.

<sup>97</sup> Investment Company Act of 1940, 15 U.S.C. § 80a-22 (1970).

<sup>98</sup> See *Wells v. Commissioner*, 50 T.C. 871, 876 (1968). See also *Howell v. United States*, 414 F.2d 45, 48 (7th Cir. 1969).

<sup>99</sup> See *Ruehlmann v. Commissioner*, 418 F.2d 1302 (6th Cir. 1969), cert. denied, 400 U.S. 856 (1970), which upheld this contention while noting that "logical argument can be made for either the bid price or asked price." 418 F.2d at 1304.

<sup>100</sup> 323 F. Supp. 769, 772 (W.D.N.Y. 1971).

<sup>101</sup> Compare *Davis v. United States*, 306 F. Supp. 949 (C.D. Cal. 1969) with *Hicks v. United States*, 335 F. Supp. 474 (D. Colo. 1971), which reached the same conclusion regarding the unreasonableness of Treas. Reg. § 20.2031-8(b) (1963) by treating the purchase of shares from the broker and eventual redemption of the shares by the Fund as one contract in which the Fund is a willing buyer of the redeemed shares.

<sup>102</sup> See note 96 *supra*.

<sup>103</sup> *Bankers Trust Co. v. United States*, 284 F.2d 537 (2d Cir. 1960), cert. denied, 366 U.S. 903 (1961), holding that the market value does not reflect the full value of the bond to the estate.

<sup>104</sup> Treas. Reg. § 20.2031-2(h) (1958).

Funds require their valuation at the "bid" price since the estate can only expect to receive this price for its Fund shares.<sup>105</sup>

The Government's alternative argument was that a Fund is worth the amount it would cost to replace it (replacement cost) which is the retail "asked" value, not the redemption value. This premise was supported by analogy to single premium life insurance policy situations in which the value of the policy is found to be its replacement cost, not its surrender or redemption value.<sup>106</sup> The Government argued that Funds should also be valued at their replacement cost, not redemption value. However, the court did not agree. The district court distinguished between single premium insurance policies and Funds by pointing out that an insurance policy contains many rights, with the surrender value being only one. The other principal rights are entitlement to face value upon death and the periodic payment of dividends while alive.<sup>107</sup> Thus, the district court found that the difference between the replacement and surrender costs of a single premium life insurance policy represented additional rights while the difference between the "asked" and the "bid" price was only the broker's commission which did not increase the Fund's worth.<sup>108</sup> On appeal to the Second Circuit, the IRS argued, "[F]und shares have a value beyond the redemption price and . . . the value is reasonably measured by the . . . load charge (eight percent).<sup>109</sup> The Government claimed that the extra value referred to is "the possibility of capital gains and dividends that may be used to purchase additional shares at less than the public offering price . . . diversification of investment for a small outlay, and expert management."<sup>110</sup> The Second Circuit found that other corporations on the stock exchange provided similar services without including brokerage commissions in their stocks' valuation.<sup>111</sup>

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<sup>105</sup> 457 F.2d at 572.

<sup>106</sup> *Guggenheim v. Rasquin*, 312 U.S. 254 (1941), wherein the taxpayer, an elderly woman, paid a single premium of approximately \$852,000 for a life insurance policy with a face value of \$1,000,000. For gift tax purposes the taxpayer valued the gift at its surrender value of about \$717,000. The Supreme Court decided that the replacement cost of the policy, \$852,000, was the true measure of the value, not the \$717,000 surrender value.

<sup>107</sup> 323 F. Supp. at 773. *See also* *Guggenheim v. Rasquin*, 312 U.S. 254, 257 (1941), stating that the surrender of the policy represents only one of the insured or beneficiaries' rights as they can also retain for investment purposes and eventually receive the policy amount when the insured dies. *See also* *United States v. Ryerson*, 312 U.S. 260 (1941), holding that the replacement cost is the one criterion that reflects both the insurance and investment value of life insurance policies.

<sup>108</sup> 323 F. Supp. at 773.

<sup>109</sup> 457 F.2d at 570.

<sup>110</sup> *Id.*

<sup>111</sup> *Id.* *See also* Treas. Reg. § 20.2031-2 (1965).

The Supreme Court is presently considering the government's request that certiorari be granted. It is probable that the request will be granted to resolve the diverging appellate decisions. If the regulation in question is found unreasonable, the estate tax loss to the Government will be mitigated by income tax increases resulting from lower bases to the estate's beneficiaries. This income tax increase will only be realized if the recipient of the Fund shares from the purchaser's estate sells in his lifetime<sup>112</sup> and the market price of the Fund increases. A bill accomplishing by statute what taxpayers are attempting to do judicially is currently in the House of Representative's Ways and Means Committee.<sup>113</sup> The bill will be pushed by its author, Representative C. Hosmer of California, if the Supreme Court either denies certiorari or reverses the Second Circuit.<sup>114</sup>

### *Marital Deduction — Terminable Interest Rule*

Section 2056(a) of the Code allows a deduction from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.<sup>115</sup> This marital deduction is limited by sections 2056(b), (c), and (d). Section 2056(b)(1) denies the deduction where the interest passing or passed is "terminable."<sup>116</sup>

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<sup>112</sup> If the purchaser's heirs don't redeem the Fund in their lifetimes and the Fund is passed on to their heirs, it is doubtful that the eventual increase in income tax due to a lower basis for the Fund at the time of transfer will offset the inheritance tax loss on not taxing *two* commissions.

<sup>113</sup> H.R. 844, 91st Cong., 1st Sess. (1969), provides:

(2) SPECIAL RULE FOR SHARES IN AN OPEN-END INVESTMENT COMPANY.—

In the case of shares in an open-end investment company (commonly known as a 'mutual fund'), and in securities trust agreements, the value thereof shall be the price at which such company would redeem such shares on the date of the decedent's death.

<sup>114</sup> Telephone interview with Mrs. Finlayson, legislative assistant to Rep. Hosmer, October 11, 1972.

<sup>115</sup> INT. REV. CODE OF 1954, § 2056(a). The person receiving the decedent's property for which a marital deduction is claimed must qualify as a surviving spouse at the date of the decedent's death. A legal separation which has not terminated the marriage at the time of death does not change the status of the surviving spouse. *Eccles v. Commissioner*, 19 T.C. 1049, *aff'd*, 208 F.2d 796 (4th Cir. 1953). If an interest in property passes from the decedent to a person who was his spouse but was not married to the decedent at the time of his death, the interest is not considered as passing to the surviving spouse. If a decedent's divorce from a prior wife is declared invalid by a state court having valid jurisdiction, no marital deduction will be allowed for the decedent's bequest of property to a subsequent wife. Rev. Rul. 442, 1967-2 CUM. BULL. 65, 66.

<sup>116</sup> The term "terminable interests" covers any interest in property which is subject to termination because of lapse of time, the occurrence of a contingency or the failure of a contingency to occur, if the following conditions are met:

(A) if an interest in such property passes or has passed (for less than a ade-

Section 2056(b)(5) provides an exception to this limitation by allowing the deduction where the interest passing or passed to the survivor is a life estate with an absolute power in the transferee to appoint that interest.<sup>117</sup>

In *Estate of Edward N. Opal v. Commissioner*,<sup>118</sup> the Second Circuit concluded that the widow neither overcame the limitation of section 2056(b)(1) nor met the exception of section 2056(b)(5), and was, therefore, not entitled to the deduction.

Decedent's will had been executed jointly with his wife. It provided in pertinent part:

We, EDWARD N. OPAL and MAE OPAL, his wife, both residing at 85-19 Avon Street, Jamaica, Queens County, New York, both of us being of sound and disposing mind and memory and mindful of the uncertainty of this life, do make, publish and declare this to be our joint LAST WILL AND TESTAMENT, hereby agreeing, each of us with the other in consideration of the dispositive provisions hereinafter set forth, that this Will shall be irrevocable by either of us without the written consent of the other, and hereby revoking any and all former Wills and Codicils by us or either of us at any time heretofore made.

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quate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse); and (B) if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse.

INT. REV. CODE OF 1954, § 2056(b)(1). It is not necessary that the contingency or event occur or fail to occur in order to make the interest terminable. Treas. Reg. § 20.2056(b)-1 (1958).

<sup>117</sup> Section 2056(b)(5) of the Code provides that:

In the case of an interest in property passing from the decedent, if his surviving spouse is entitled for life to all the income from the entire interest, or all the income from a specific portion thereof, payable annually at or more frequent intervals, with power in the surviving spouse to appoint the entire interest, or such specific portion (exercisable in favor of such surviving spouse, or of the estate of such surviving spouse, or in favor of either, whether or not in each case the power is exercisable in favor of others), and with no power in any other person to appoint any part of the interest, or such specific portion, to any person other than the surviving spouse—

(A) the interest or such portion thereof so passing shall, for purposes of subsection (a), be considered as passing to the surviving spouse, and

(B) no part of the interest so passing shall, for purposes of paragraph (1)(A), be considered as passing to any person other than the surviving spouse. This paragraph shall apply only if such power in the surviving spouse to appoint the entire interest, or such specific portion thereof, whether exercisable by will or during life, is exercisable by such spouse alone and in full events.

The terminable interest rule is designed primarily to prevent the allowance of a marital deduction with respect to property which, by the terms of the transfer, is likely to escape inclusion in the gross estate of the surviving spouse. It also applies to transfers which, by reason of the various conditions imposed, can be kept out of her estate by subsequent acts. However, when a decedent gives his spouse an interest for life, together with a general power of appointment, the possibility of exclusion from the surviving spouse's gross estate is substantially removed. Therefore, such transfers are permitted to qualify for the marital deduction as exceptions to the terminable interest rule.

<sup>118</sup> 450 F.2d 1085 (2d Cir. 1971).



Second: In the event Edward N. Opal predeceases Mae Opal,

A. We direct that his just debts and funeral expenses be paid as soon after his decease as may be practicable;

B. All the rest, residue and remainder of the estate of Edward N. Opal, real, personal and mixed, and wheresoever the same may be situate, is hereby given, devised and bequeathed unto the said Mae Opal, absolutely and forever;

C. Thereafter and upon the death of said Mae Opal, and after the payment of her just debts, and funeral expenses, all the rest, residue and remainder of the estate of said Mae Opal, real, personal and mixed, and wheresoever the same may be situate, is hereby given, devised and bequeathed unto our beloved son Warren Ian Opal, absolutely and forever.<sup>119</sup>

By an application of New York law<sup>120</sup> to the specific language of the will, the court found that the effect of the contractual nature of the document<sup>121</sup> was to vest an interest in the property both in the widow and the decedent's son, thereby making her interest defeasible.<sup>122</sup> Despite the use of the words "absolutely and forever," the widow was obligated to bequeath to the son any remainder of the property which she had received from her husband, and which would not be expended at the time of her death.<sup>123</sup> If any possibility exists as of the date of the

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<sup>119</sup> *Id.* at 1085-86.

<sup>120</sup> Although federal law determines when an event will be taxed, it is state law which defines the nature of the interest created by the decedent and passing to the survivor. *See* *McGehee v. Commissioner*, 260 F.2d 818 (5th Cir. 1958); *Commissioner v. Estate of Ellis*, 252 F.2d 109 (3d Cir. 1958); *Estate of Julius Selling*, 24 T.C. 191 (1955).

<sup>121</sup> Although the Second Circuit held that the intent of the parties was so clear that it was not necessary to cite any New York law to establish that a binding contract existed (450 F.2d 1086), the Tax Court was not so easily convinced and went to great lengths to interpret New York law and apply it to the language of the will to ascertain whether or not there was, in fact, a contract which terminated the widow's interest. 54 T.C. 154, 156-61 (1970).

<sup>122</sup> 450 F.2d at 1087.

<sup>123</sup> While the court of appeals' decision was unanimous, there was a sharp difference on this point in the Tax Court. As did the majority in the Tax Court, the Second Circuit interpreted Clauses "B" and "C" of the will in such a way as to impress upon the widow the obligation to bequeath to the son both the remainder of any property she might still possess at the time of her death out of that left to her by her husband and whatever constituted her own estate. The court of appeals, agreeing with the Tax Court majority, stated that it "would be absurd to read these clauses as dictating the devolution of the property the surviving spouse owned of her or his own right, but not that which such spouse had received from the other." 450 F.2d at 1086. The dissenting opinion in the Tax Court of Chief Judge Drennen, joined by Judge Hoyt, disagreed vigorously on this point. It maintained that a careful reading of the will illustrated that what was actually promised by the widow was that, upon her death, the remainder of *her estate* was to be given to the son. Judge Drennen maintained that the will said nothing about the remainder of the decedent's estate. 54 T.C. 154, 169 (1970).

This dissenting opinion, through a very fine and technical point, drew an interesting distinction. To be certain, whatever remained from the bequest of the husband upon the death of the wife, would necessarily become part of the survivor's estate and thereby pass, in accordance with the will, to the son. However, the distinction is that under the majority's ruling, the son's interest is derived directly from his father, while under the dissenting

testator's death that at some future date the survivor's interest will cease, the interest passing to the survivor is "terminable" and within the limitation of section 2056(b)(1).<sup>124</sup>

In essence, the interest which passed to the widow in *Opal* was that of a life estate<sup>125</sup> with broad powers of invasion. She was given wide latitude to assert her rights in relation to the property, but her interest was not absolute. On the lapse of time, or the occurrence of an event or contingency (in this instance, her death) any interest in her husband's property that remained would pass to the son by virtue of the binding contract embodied in the joint will. Her death would effectively terminate her interest in the property in precisely the manner in which the parties had contemplated.<sup>126</sup> She was therefore not entitled to the claimed deduction since her interest was clearly "terminable."

The court noted, however, that Congress sought to moderate the harshness of this rule with the exception contained within section 2056(b)(5).<sup>127</sup> To satisfy the requirements of this section, the surviving spouse must establish that he or she is entitled to all the income from the entire interest or all the income from a specific portion for life.<sup>128</sup> In addition, the power of appointment<sup>129</sup> over the property must be vested in the survivor alone<sup>130</sup> and in all events.<sup>131</sup>

The Second Circuit determined that the interest which passed from the husband to the surviving spouse did not meet this test. It was deficient in that she was unable to appoint the property to herself or her own estate.<sup>132</sup> In so holding, the court reasoned that she neither satisfied the Congressional intent behind the statute<sup>133</sup> nor met the

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view, no independent right to the property passed from father to son; whatever interest passed to the son passed from his mother, and that interest was a derivation from her own rights. The widow's interest, therefore, was not "terminable."

In either case, the result is the same. Whatever is left, upon the widow's death, passes to the son; only as to the tax consequences is there a variance.

<sup>124</sup> See *Jackson v. United States*, 376 U.S. 503, 508 (1964); *Allen v. United States*, 359 F.2d 151, 154 (2d Cir.), cert. denied, 385 U.S. 832 (1966).

<sup>125</sup> 450 F.2d at 1087.

<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

<sup>128</sup> The INT. REV. CODE OF 1939, § 812(e)(1)(F) required that the life interest created must be in the form of a trust. This limitation was abolished by INT. REV. CODE OF 1954, § 2056(b)(5), which extended the application of the exception to a legal life estate.

<sup>129</sup> INT. REV. CODE OF 1954, § 2056(b)(5). See also 90 A.L.R.2d 414, 431-43 (1963) for a discussion of the power of appointment.

<sup>130</sup> INT. REV. CODE OF 1954, § 2056(b)(5).

<sup>131</sup> *Id.*

<sup>132</sup> 450 F.2d at 1088.

<sup>133</sup> *Id.* citing H.R. REP. NO. 1337, 83d Cong., 2d Sess. (1954), reported in 3 U.S. CODE CONG. & ADMIN. NEWS 4017, 4118-19, 4461-62 (1954), and S. REP. NO. 1622, 83d Cong., 2 Sess. (1954).

statutory test defined in the Treasury Regulations.<sup>134</sup> Both require the survivor be established as *unqualified* owner with unlimited power to dispose of the property. The widow could not vest the property absolutely in herself since it would, in any event remain part of her estate and pass to her son under the terms of her will. A fortiori she could not dispose of it absolutely through her estate.<sup>135</sup> The court found that any rights passing to the son would have their origin in the decedent and not in the surviving spouse.<sup>136</sup> As such, the widow's ability to dispose of any remainder of the property at the time of her death was effectively cut off.

The stance taken by the Second Circuit when confronted with this type of problem has been approved and adopted by several of the other Circuits.<sup>137</sup> All maintain that the surviving spouse must possess the

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<sup>134</sup> Although Treas. Reg. § 20.2056(b)-5(g)(1) (1958) intimates by example that a power to appoint in one's own favor is equivalent to a power of absolute and unlimited consumption, Treas. Reg. § 20.2056(b)-5(g)(2) states that:

The power of the surviving spouse must be a power to appoint the entire interest or a specific portion of it as unqualified owner (and free of a trust if a trust is involved, or free of the joint tenancy if a joint tenancy is involved) or to appoint the entire interest or a specific portion of it as a part of her estate . . . that is, in effect, to dispose of it to whomsoever she pleases.

*Id.*

<sup>135</sup> Various equivalents have been held to constitute a power of appointment. For instance, a life estate, coupled with the power to sell and retain the proceeds of such sale, has been held sufficient. *Gever v. Bookwalter*, 193 F. Supp. 57 (W.D. Mo. 1961). Words transferring to the husband an estate "with full power to dispose of same and to use income and corpus thereof in such manner as he may determine without restriction or restraint" has also been held to confer a power of appointment. *McGehee v. Commissioner*, 260 F.2d 818 (5th Cir. 1958). In addition, the courts have held that an unlimited power to invade the corpus is the equivalent of a power of appointment. *Commissioner v. Estate of Ellis*, 252 F.2d 109 (3d Cir. 1958). But where the right to invade is restrained in such a way that the survivor, when disposing of the property, must take into consideration the rights of the remaindermen, the power to dispose of the property in those instances is limited and is not the equivalent of the statutory power of appointment as required by section 2056(b)(5). See *United States v. Lincoln Rochester Trust Co.*, 297 F.2d 891 (2d Cir.), *cert. denied*, 369 U.S. 887 (1962); *May's Estate v. Commissioner*, 283 F.2d 853 (2d Cir.), *cert. denied*, 366 U.S. 903 (1961); *Estate of Pipe v. Commissioner*, 241 F.2d 210 (2d Cir. 1957), *cert. denied*, 355 U.S. 814 (1957) (all arising under the old Code). See also *Allen v. United States*, 242 F. Supp. 687 (E.D.N.Y. 1965), *aff'd*, 359 F.2d 151 (2d Cir.), *cert. denied*, 385 U.S. 832 (1966) (arising under the 1954 Code). See generally 90 A.L.R.2d 414, 437 (1963).

<sup>136</sup> It is interesting to note, however, that the specific wording which defines the joint contract is somewhat different in *Opal* than that used in the other cases. In *Estate of Pipe v. Commissioner*, 241 F.2d at 212, the will read "on the death of my said wife . . . I give and bequeath all . . . to [certain named legatees]" and in *Allen v. United States*, 242 F. Supp. at 687, the will specifically provided that upon death of the surviving spouse she was obligated to transfer the contents of her own estate, "as well as the estate which she will inherit by . . . my will," to their children. Such pervasive use of the first person as the director of the interest which passes to the children is notably absent from the provision of the will in *Opal*. Nevertheless, the court held the effect to be the same.

<sup>137</sup> See *Estate of Semmes v. Commissioner*, 288 F.2d 664 (6th Cir. 1958); *Estate of Tarver v. Commissioner*, 255 F.2d 913 (4th Cir. 1958); *In re Reilly's Estate*, 239 F.2d 797 (3d Cir. 1957), *rev'd on other grounds sub. nom.*, *Meyer v. United States*, 364 U.S. 410

property free and clear of any and all other interests and as an owner in fee simple absolute, in order to establish that her interest is not "terminable." Where her interest is that of a life estate she must have absolute power of appointment over it. The decision reached by the court in *Opal* is a succinct statement of the Second Circuit's position on the terminable interest rule.

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(1959); *Shedds Estate v. Commissioner*, 237 F.2d 345 (9th Cir. 1956); *In re Sweet's Estate*, 234 F.2d 401 (10th Cir. 1956).