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ESTATE TAXATION OF JOINT TENANCY PROPERTY ACQUIRED BY SPOUSES WITH FUNDS GENERATED FROM THE FAMILY BUSINESS—THE "FAMILY PARTNERSHIP" EXCEPTION TO SECTION 2040

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INTRODUCTION

When a husband and wife hold property jointly with a right of survivorship and together participate in running a family business, the death of one spouse presents unique tax problems for the survivor. Problems arise because the federal estate tax provides that on the death of a joint tenant the entire value of the property owned in joint tenancy is included in the decedent's gross estate, except for the portion attributable to the consideration furnished by the survivor.[1] This Article addresses itself to the dilemma of the surviving spouse who is anxious to avoid the inclusion of the entire value of such jointly held property in the taxable estate of the decedent. This Article discusses those cases which have excluded a portion of the value of the jointly held business property on a partnership theory and also traces the development of the case law in which taxpayers have argued for application of the exception in section 2040(a) — that is, the "consideration furnished" exception. Further, this Article describes the evolution of the 1978 amendment to section 2040 which gives statutory recognition to the rights of surviving spouses in jointly owned and operated family businesses.

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1. Section 2040 of the Internal Revenue Code provides:

> (a) General Rule. —- 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 tenants by the entirety by the decedent and spouse, or deposited, with any person carrying on the banking business, in their joint names and payable to either or the survivor, 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.

I.R.C. § 2040.

EVOLUTION OF SECTION 2040

The broad statutory language that includes the full value of property held jointly with a right of survivorship[2] in the estate of the first spouse to die initially appeared in section 202(c) of the Revenue Act of 1916,[3] the forerunner of section 2040 in the Internal Revenue Code of 1954. The 1916 Act created a statutory presumption that the full value of jointly held property was to be included in the estate of the first to die but excepted any part of such property that could be shown to have belonged originally to the survivors and never to have belonged to the decedent.[4] Section 402(d) of the 1921 Revenue Act further refined the statute by adding two amendments. The first amendment closed a loophole that arose when the decedent made a gift of money or other property to his spouse which subsequently was used to purchase jointly held property The second amendment addressed the situation in which neither joint tenant furnished consideration and provided that when the property was acquired by gift, bequest, devise, or inheritance, only the decedent joint tenant's proportional part of such property was to be included in his gross

2. Section 2040 has no application to property held by decedent and any other person as tenants in common. Treas. Reg. § 20.2040-1(b); Estate of Trafton v. Comm'r, 27 T.C. 610, 617 (1956) (referring to former § 811(e), *acq.* at 1957-1 C.B. 5). All references to "joint tenants" or "joint interests" in the text refer to interests held as joint tenants with a right of survivorship or tenancy by the entirety as at common law.

3. The relevant provisions of the 1916 Act are as follows:

> Sec. 202. That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated:
>
> (c) To the extent of the interest therein held jointly or as tenants in the entirety by the decedent and any other person except such part thereof as may be shown to have originally belonged to such other person and never to have belonged to the decedent.

Revenue Act of 1916, ch. 463, § 202, 39 Stat. 756 (1916).

4. This exception gave rise to the judicial development of a "consideration furnished" test which requires the surviving spouse to trace his specific contributions made in money or money's worth toward the acquisition of the jointly held property in order to overcome the statutory presumption of full inclusion in the estate of the first to die. The difficulty in tracing consideration furnished over long periods of time, combined with disputes as to what constitutes consideration in money or money's worth, has frequently resulted in litigation wherein the complainant surviving spouse is without adequate records and then is unable to overcome the statutory presumption. *See, e.g.,* Phillips v. Dime Trust & Safe Deposit Co., 284 U.S. 160 (1931); Foster v. Comm'r, 90 F.2d 486 (9th Cir. 1937), *aff'd,* 303 U.S. 618 (1938); Bushman v. United States, 8 F Supp. 694 (Ct. Cl. 1934); Estate of Heidt v. Comm'r, 8 T.C. 969 (1947), *aff'd,* 170 F.2d 1021 (9th Cir. 1948).

estate. Except for minor revisions of language,[5] the statute remained unchanged until the Tax Reform Act of 1976.

The intention of the statute was to include in the gross estate the portion of the property that was traceable to an outlay of funds that originally were the decedent's own, in order to prevent the evasion of death transfer taxes on property passing by will or intestacy by the use of common law property devices that could transfer property outside the decedent's estate.[6] Although the statute has achieved this objective, its operational effect has been to place a heavy burden of proof on the surviving spouse to trace actual contributions. As a result, spouses without adequately documented evidence of contributions often fail to have their actual interest in the property recognized for estate tax purposes.[7] In the family business situation, in which both spouses enter into marriage and the business with little or no separate property, the entire value of the jointly owned business and other jointly owned property arguably is attributable to the energies and contributions of both spouses over the term of the marriage. Inclusion of the full value of such properties in the estate of the first to die is therefore inequitable.

CASE LAW DETERMINATION OF THE SURVIVING SPOUSE'S PROPORTIONATE INTEREST IN PROPERTY ACQUIRED FROM RESOURCES OF THE FAMILY BUSINESS

To determine the degree of ownership in jointly held property for purposes of death transfer taxation, a court initially must ascertain the substantive form in which such property is held by the spouses.[8] Courts have interpreted the federal estate tax concept of ownership as determined by all the surrounding facts and circumstances, not by the mere form of legal title evidencing ownership.[9] When the

5. The phrase "received or acquired from the decedent for less than an adequate and full consideration in money or money's worth" and all other references to "adequate and full consideration" were added by § 302(e) of the 1926 Revenue Act. Section 302(e) became § 811(e) of the Internal Revenue Code of 1939, which became § 2040 of the Internal Revenue Code of 1954, all without substantive changes. *See* 2 MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION § 15.01 (1959).

6. *See* Phillips v. Dime Trust & Safe Deposit Co., 284 U.S. 160 (1931); Estate of Peters v. Comm'r, 386 F.2d 404 (4th Cir. 1967); Stuart v. Hassett, 41 F Supp. 905 (D. Mass. 1941).

7. *See* note 4 *supra*.

8. *See* Hockey, *Wife's Services May Avoid Inclusion of Jointly Held Property in Husband's Estate,* 34 J. TAX. 174 (1971).

9. *See* Estate of Ensley v. Comm'r, 46 T.C.M. (P-H) ¶ 77,402 (1977). In *Ensley,* the court

joint owner-spouses have been able to prove the existence of a partnership agreement, the courts have not reached the question of the applicability of section 2040 or its exception. In such cases, the business property, along with all other properties acquired from business earnings, is included in the decedent's estate according to his proportionate interest in the de facto partnership.[10] When no partnership agreement is found and the property is not held as tenants in common or community property, courts apply the statutory presumption of full inclusion in the decedent's gross estate.[11] The surviving spouse, usually the wife, then must trace the adequate and fair considerations in money or money's worth that she has contributed toward the purchase of the property in order to exclude any portion of such property from her decedent husband's estate.

The Partnership Theory

Five cases decided between 1940 and 1978[12] excluded one-half of the value of business and most other property from the estate of the first spouse to die under the partnership theory. In *Estate of Waterman v. Commissioner,*[13] the husband died holding legal title to all properties in his name. The uncontradicted oral testimony of his wife established that the couple entered into their forty-year marriage with a nominal sum of separate property owned by the wife. During the course of their marriage, they entered into a number of business ventures in which both spouses took an active interest with the oral understanding that each spouse would own one-half of the businesses and that each would share equally in the success of their ventures. All income was reported on the husband's separate income

stated that "the Federal estate tax concept of ownership under section 2040 looks to the source of the consideration represented by the property and disregards legal title." *Id.* at 77-1625.

10. United States v. Neel, 235 F.2d 395 (10th Cir. 1956); Singer v. Shaughnessy, 198 F.2d 178 (2d Cir. 1952); Rogan v. Kammerdiner, 140 F.2d 569 (9th Cir. 1944); Craig v. United States, 451 F. Supp. 378 (D.S.D. 1978); Estate of Waterman v. Comm'r, 9 B.T.A.M. (P-H) ¶ 40,519 (1940).

11. Berkowitz v. Comm'r, 108 F.2d 319 (3d Cir. 1939); Estate of Ensley v. Comm'r, 46 T.C.M. (P-H) ¶ 77,402 (1977); Estate of Ehret v. Comm'r, 45 T.C.M. (P-H) ¶ 76,315 (1976); Estate of Otte v. Comm'r, 41 T.C.M. (P-H) ¶ 72,076 (1972); Estate of Trafton v. Comm'r, 27 T.C. 610 (1956), *acq.* at 1957-1 C.B. 5; Estate of Awrey v. Comm'r, 5 T.C. 222 (1945); Estate of Fletcher v. Comm'r, 44 B.T.A. 429 (1941).

12. *See* note 10 *supra.*

13. 9 B.T.A.M. (P-H) ¶ 40,519 (1940).

tax returns in which the decedent frequently referred to the properties as "our" and used the term "we" in his explanations attached thereto. Although the Board of Tax Appeals noted that separate income tax returns were not filed by the wife, it concluded that the wife's oral testimony was sufficient to overcome the statutory presumption of full inclusion in the husband's gross estate and held that the wife "had, at the decedent's death, a one-half interest in all his assets derived from the payment of full consideration therefor."[14] In response to the Commissioner's contention that local law precluded either spouse from recovering any compensation for labor performed for the other, the court further found that "the spouses (were) working for themselves—treating the ventures as joint ventures. They did not act as principal and agent or employer and employee; they were, in a liberal sense of the word, partners."[15]

In *Rogan v. Kammerdiner,*[16] the government defeated the taxpayer by using the "partnership" theory to its advantage, thereby including one-half of the husband's separate property transferred to himself and his wife as joint tenants with right of survivorship in the estate of his wife. The husband, as the surviving joint tenant, claimed the entire property but insisted that the half interest vesting in him as the survivor of the joint tenancy was not taxable as part of his wife's estate for federal tax purposes because the property originally belonged to him and that he gave her the property for no consideration; therefore, when he later acquired it as her survivor, it was not taxable under section 302(e) of the Revenue Act of 1926.[17]

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14. *Id.* at 40-843.
15. *Id.*
16. 140 F.2d 569 (9th Cir. 1944).
17. The statute stated:

> Sec. 302 [as amended by Revenue Act of 1934, ch. 277, § 404, 48 Stat. 680]. The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated, except real property situated outside the United States.
>
> (e) 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, or deposited, with any person carrying on the banking business, in their joint names and payable to either or the survivor, 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.

Revenue Act of 1926, ch. 27, § 302, 44 Stat. 9 (1926). *See* note 5 *supra.*

After reviewing an agreement "to divide 50-50, win or lose"[18] the proceeds of an oil tool recovery business and the separate income tax returns filed by husband and wife as partners, the court agreed with the Commissioner's determination that a tax was due on the wife's half interest in the property held in joint tenancy with right of survivorship. The court relied heavily upon the husband's testimony that at the time of their marriage it was agreed that all property derived from their labors should be held in joint tenancy with the right of survivorship.[19] The court did not determine the wife's material participation in the business or capital contributions.

The controversy in *Singer v. Shaughnessy*[20] centered on the surviving wife's relationship to a small publishing company which the husband originally purchased and operated two years before the marriage; the wife took an active part in the conduct of the business during the subsequent eighteen years of their marriage. The facts revealed that the wife was primarily responsible for the operation of the business during the early years of the marriage while the husband worked as a salesman for a book publishing company Some time later, the husband left his job and joined the wife. Three months before his death, the husband executed a formal partnership agreement with his wife in which he sold her a one-half undivided interest. Other evidence, however, showed that both husband and wife understood that from the time the wife became associated with the business following her marriage she was to be a joint owner of the enterprise. In the district court[21] the jury found that a partnership existed from the date of the marriage. Affirming the jury's determination of fact on conflicting evidence, the Court of Appeals for the Second Circuit stated: "Since all the property held in their joint names was purchased with funds earned by them together and withdrawn from the business, it follows that only one half of the value of such property was includible in the decedent's gross estate."[22] This decision is unique because the district court jury decided in favor of the wife's contention that a partnership agreement existed from the date of the marriage despite evidence showing that no partnership returns were filed until after execution of the part-

18. 140 F.2d at 571.
19. *Id.*
20. 198 F.2d 178 (2d Cir. 1952).
21. 96 F Supp. 506 (N.D.N.Y. 1951).
22. 198 F.2d at 181.

nership agreement; separate income tax returns were filed by the wife for six years in which she received a salary from the business; confidential bank statements revealed that the husband listed himself as the sole owner of the business; and the subsequent partnership agreement itself denied any prior ownership by the wife.[23]

The Tenth Circuit's opinion in *United States v. Neel*[24] articulated the best definition of a partnership for federal estate tax purposes. The case involved a fact pattern similar to that stated above in that the spouses participated together in a number of businesses during the marriage which accounted for almost all of their accumulated joint wealth, the "classic family business" case. At the time of his death, the husband held most of the properties in his name. No evidence of income tax returns filed separately existed, and most of the factual evidence was established by the wife's testimony. The court affirmed the district court's holding that a general partnership existed and that only one-half of the property was therefore includible in the decedent's estate. In its opinion, the court stated that "a partnership is created by persons joining together their money, goods, labor or skill for the purpose of carrying on a trade, business, or profession, when there is a community of interest in the profits and losses."[25] Although courts will scrutinize closely a family arrangement, the absence of a formal agreement is not determinative: "Each case must rest on its own facts, but in determining the intent of the parties, the court will look at what the parties actually did to effectuate their avowed intentions."[26] Therefore, a partnership agreement even may be implied from the parties' conduct.

The most recent of the family partnership cases, *Craig v. United States,*[27] was decided by the United States District Court for South Dakota in 1978. This case involved a dispute over the ownership of a farm personalty which the Commissioner contended was fully includible in the husband's gross estate. The evidence showed that both spouses had entered into marriage with only nominal assets and had built a sizeable farming operation over a period of forty-three years. Based on evidence of capital contributions by both

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23. 96 F Supp. at 508.
24. 235 F.2d 395 (10th Cir. 1956).
25. *Id.* at 399.
26. *Id.* at 400, *citing* Eckhard v. Comm'r, 182 F.2d 547, 549 (10th Cir. 1950).
27. 451 F Supp. 378 (D.S.D. 1978).

parties, division of labor, arduous physical contributions by both parties in the operation of the farm, and equal participation by the spouses in all major decisions of the business, the court found that a family partnership did exist and that only one-half of the farm personalty was included in the husband's gross estate. The court did not consider the manner in which income tax returns were filed.

From these cases, it appears that whenever the court finds a partnership business relationship based upon equal capital contributions and services of both spouses, some, usually one-half, of the business property and any other property acquired with the proceeds of the business will be excluded from the estate of the first to die regardless of how the parties held legal title. The taxpayer thus avoids the burdensome "consideration furnished" and tracing tests required to invoke the exception to full inclusion in section 2040(a)

The partnership argument, however, is not the panacea for all family businesses. The determination of whether such a business relationship was a de facto partnership is a question of fact, and different courts undoubtedly will assign differing weights to the factual elements. To the extent that uncertainty exists for each factual situation, taxpayers have little guidance in showing that a partnership existed without testing their individual fact patterns in court.

The Section 2040(a) "Consideration Furnished" Exception

If the partnership argument fails or is inapplicable, the surviving spouse is confronted with section 2040's presumption of full inclusion, unless the spouse can trace into the property in question an adequate consideration in money or money's worth. In the eight cases in which the wife has shown material participation in a family business setting by the performance of non-domestic services and the existence of an agreement with her husband to share the profits of the business or ownership of assets purchased with such profits, the courts have allowed at least a partial exclusion of assets from her husband's gross estate.[28] This judicial doctrine was first enunci-

28. Berkowitz v. Comm'r, 108 F.2d 319 (3d Cir. 1939); Richardson v. Helvering, 80 F.2d 548 (D.C. Cir. 1935); Estate of Ensley v. Comm'r, 46 T.C.M. (P-H) ¶ 77,402 (1977); Estate of Ehret v. Comm'r, 45 T.C.M. (P-H) ¶ 76,315 (1976); Estate of Trafton v. Comm'r, 27 T.C. 610 (1956), *acq.* at 1957-1 C.B. 5; Estate of Giuliani v. Comm'r, T.C.M. (P-H) ¶ 52,207 (1952); Estate of Porteous v. Comm'r, 11 T.C.M. (P-H) ¶ 42,557 (1942); Estate of Fletcher v. Comm'r, 44 B.T.A. 429 (1941).

ated by the Court of Appeals of the District of Columbia in *Richardson v. Helvering.*[29] The evidence showed that the wife had given her husband certain separate property and salaries paid to her from the husband's business in order that the husband might invest in parcels of real estate, with the understanding that "if the money invested 'came back,' it would come back to both of them."[30] Based on this oral agreement and proof of the amount contributed to the husband, the court rejected the Commissioner's contention that exact tracing of the funds from property to property was required and held that only one-half of the investment property was includible in the husband's gross estate.[31] In dictum, the court further stated that because the wife was entitled to and could have compelled recognition of her right to an equal interest in the property, such property was subject to her claims, and the statutory exception was met.[32]

Berkowitz v. Commissioner[33] resembled the classic family business relationship more closely than *Richardson v. Helvering.* Here, the husband and wife started a retail grocery business with equal contributions of $150.00 and for forty-three years devoted all their skill and labor to operating the store. The Court of Appeals for the Third Circuit reversed the lower court's determination that failure to prove the existence of a partnership agreement resulted in the full inclusion of jointly held properties in the husband's estate. The Third Circuit held that while profit sharing might be an attribute of a partnership relationship, profits can be, and often are, shared by persons who are not partners.[34] The court stated: "The controlling question is whether the profits are those of the petitioner, and not how they are characterized . . . ."[35] Finding a genuine agreement to share profits, free of any scheme of tax avoidance

29. 80 F.2d 548 (D.C. Cir. 1935).

30. *Id.* at 549.

31. *Accord,* Estate of Porteous v. Comm'r, 11 T.C.M. (P-H) ¶ 42,557 (1942).

32. Note, however, that in common law jurisdictions that do not recognize the wife's right to profits from jointly held property, a *Richardson* argument might not prevail. *See* General Explanation of the Revenue Act of 1978, H.R. 13,511, Pub. L. No. 95-600, 95th Cong., 2d Sess. 287 (Comm. Print 1979) (prepared by the Staff of the Joint Committee on Taxation); S. REP. No. 95-1263, 95th Cong., 2d Sess. 215, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6761, 6978.

33. 108 F.2d 319 (3d Cir. 1939).

34. *Id.* at 321.

35. *Id.*

(because of the wife's contribution of capital and material participation), the court excluded one-half of the property from the husband's estate.[36]

In another "family store" case, *Estate of Trafton v. Commissioner*,[37] the Tax Court was confronted with an oral agreement between husband and wife that subsequent to their marriage, "whatever was earned or accumulated through their joint efforts was to belong to them jointly."[38] In this case, the spouses married when the decedent had a one-half interest in a drugstore. Later, they borrowed money from the wife's father and bought out the other half interest. The wife worked in the store for eight years, while the loan was paid off and other properties were acquired with the proceeds of the business. To effectuate the agreement, the decedent transfered and purchased securities in their joint names. Finding that the wife had provided capital and actively participated in the business, the Tax Court held that she had contributed money's worth consideration toward the transfer and purchase of the securities and was entitled to an exclusion of one-half of their value from the husband's estate.[39]

While these cases demonstrate the effectiveness of a profit sharing agreement for purposes of tax recognition of a wife's one-half interest in joint properties, not all surviving spouses have experienced a like degree of success. In *Estate of Ehret v. Commissioner*,[40] the court found an oral agreement between the spouses to "pool their efforts to make their marriage successful,"[41] but the wife was only partially successful in excluding jointly owned property from her husband's estate. An explanation for this result may be the variance of the facts in this case from those in the more classic family busi-

36. *Accord*, Estate of Giuliani v. Comm'r, 21 T.C.M. (P-H) ¶ 52,207 (1952). In this case, one-half of the value of a jointly owned and operated store was excluded from the husband's estate because the court found "substantial evidence to support [a] finding that decedent and his wife agreed that she should have a one-half interest in the business and property." *Id.* at 52-608.

37. 27 T.C. 610 (1956).

38. *Id.* at 612.

39. *Accord*, Estate of Fletcher v. Comm'r, 44 B.T.A. 429 (1941). The facts of this case were almost identical to those in *Trafton*, except that the spouses agreed to an oral partition of property just before the husband's death. The court found that the wife's contributions of capital and services were adequate consideration for the agreement and excluded the wife's share of property under the agreement from her husband's gross estate.

40. 45 T.C.M. (P-H) ¶ 76,315 (1976).

41. *Id.* at 76-1409.

ness cases discussed above. Instead of the husband and wife starting and developing a business, this case involved a business which the wife's in-laws had established years before the marriage. Rather than providing services from the inception of the marriage in an equal capacity with the husband, the wife worked as a salaried employee during only the last eight years of a forty-year marriage. On these facts, the Commissioner excluded twenty percent of the value of jointly owned properties purchased after the wife became a salaried employee. The Tax Court noted that the wife was fortunate to obtain that much because she could not trace her salary into any of the jointly owned property

In *Estate of Ensley v. Commissioner,*[42] the wife assumed operational control over a business already owned by her husband. From the evidence presented, the Tax Court concluded that her services were at least equal in value to those of the husband and were rendered pursuant to an agreement to share profits. But the court also found that almost all of the consideration furnished for the purchase of jointly held assets was traceable to the husband's large premarital estate. This situation is clearly distinguishable from classic family business cases, which typically involve a husband and wife entering into the marriage with assets of nominal value. In addition, the business in which the wife participated was not profitable until the two years immediately prior to the husband's death, so few profits were available for contribution to jointly held property The Tax Court held that unless the exact tracing requirements could be met, the statutory presumption of full inclusion could not be overcome. Nonetheless, the court did arrive at a small estimated amount of the wife's profits for the last two years, less living expenses, which was excluded from the husband's estate.[43] *Ehret* and *Ensley* suggest that an oral profit sharing agreement is most effective in excluding property from the husband's estate when com-

42. 46 T.C.M. (P-H) ¶ 77,402 (1977).

43. *See also* Estate of Bruderman v. Comm'r, 10 T.C. 560 (1948). In this case, the wife asserted an oral agreement entered into at the time of the marriage, wherein husband and wife would hold all after-acquired properties as tenants in common. All properties arose from the efforts and earnings of her decedent husband; the widow neither rendered services nor invested her separate property. The Tax Court held that a mere agreement, without more, was insufficient to satisfy the test of adequate and full consideration in money or money's worth where the property is traceable to the decedent or his efforts. *Accord,* Estate of Loveland v. Comm'r, 13 T.C. 5 (1949) (wife's services in the home not recognized as consideration furnished for jointly held property).

bined with factual findings that all jointly held assets resulted from the earnings of family businesses which were started from scratch and in which the wife materially participated from the time of the marriage until her husband's demise (i.e., the classic family business case)

Three cases, with differing results, have been decided in which the courts have not expressly found a partnership business relationship or an agreement to share profits.[44]

In *Bushman v. United States,*[45] the wife contended that a portion of the value of jointly held real estate should be excluded from her husband's estate because of money's worth consideration furnished by her in the form of services provided in managing family real estate investments and performing clerical duties for her husband's law practice. Because the wife could not show any form of interspousal agreement or salary paid, the court concluded that her services were never considered, valued, or estimated by either the decedent or the wife during the more than four decades of their married life. The court acknowledged that such services may have been of inestimable value to the husband but held that the only compensation in her mind was the love and affection of her husband.[46]

In *Estate of Awrey v Commissioner,*[47] the husband and wife started from scratch and worked together intermittently in a bakery business for the first twenty years of the marriage. The wife demonstrated material participation and capital contributions to the business for this twenty-year period but was unable to prove a partnership or profit sharing agreement. During the second twenty years of marriage, the wife took no part in the business, and it was during this period that the business experienced the bulk of its growth. The wife was never paid for her services nor did she ever file an income tax return. The court held that the wife's contribution of capital and services in the early years of the business "is not sufficient basis for considering the wife as owner of an interest in her husband's partnership interest, but is rather to be ascribed to her general interest as a wife in the family welfare."[48] The court noted

44. Estate of Otte v. Comm'r, 41 T.C.M. (P-H) ¶ 72,076 (1972); Estate of Awrey v. Comm'r, 5 T.C. 222 (1945); Bushman v. United States, 8 F Supp. 694 (Ct. Cl. 1934).

45. 8 F Supp. 694 (Ct. Cl. 1934). *See also* Estate of Silvester v. Comm'r, 46 T.C.M. (P-H) ¶ 77,439 (1977) (property fully includible in husband's gross estate because of wife's failure to prove profit sharing agreement, mutual efforts, and a pooling of resources).

46. 8 F Supp. at 698.

47. 5 T.C. 222 (1945).

that a finding that the wife was the owner of such a large capital interest would be unsupportable because the business she left was worth only a small amount compared to its value at her husband's death.

The Tax Court decided *Estate of Otte v. Commissioner*[49] in favor of the wife even though the facts showed neither a partnership nor a profit sharing agreement. In many other respects, however, the case was similar to the classic family business case. The husband and wife entered into marriage with few assets and worked together "as a 'husband and wife team,' each [contributing] their services in managing and operating their farming enterprise."[50] They pooled all of their earnings and virtually all of the real and personal property purchased during the marriage was acquired with these earnings. Because all assets were purchased from joint funds, the court rejected the strict tracing requirement test, held that the wife's contributions represented an adequate and full consideration in money or money's worth, and excluded one-half of the value of all property from the husband's gross estate.

The cases discussed above lead to the conclusion that courts have recognized a wife's services in the family business as money's worth consideration whenever the facts show the main elements of the classic family business case. Variations from the standard fact pattern have led some courts to disregard the value of services rendered. But those surviving spouses who have shown a material participation in the growth and prosperity of the family business pursuant to an agreement, either express or implied, to form a business partnership or share in the profits of the business have obtained relief from taxation in the estates of their deceased spouses.

The Proposals For Change in Existing Statutory Law to Give Recognition to the Wife's Contributions to the Family Business

Although the original justification for federal estate taxation was the necessity of raising revenue, the current rationale is to "prevent or moderate the unreasonable accumulation of wealth and its transmission from generation to generation."[51] The transfer of a reasona-

48. *Id.* at 239.
49. 41 T.C.M. (P-H) ¶ 72,076 (1972).
50. *Id.* at 72-318.
51. *Estate and Gift Tax Hearings Before the Comm. on Ways and Means,* 94th Cong., 2d Sess. 2 (Comm. Print 1976) [hereinafter cited as *1976 Hearings*] (March 22, 1976) (statement

ble inheritance to one's spouse and children has been recognized as a necessary incentive to encourage full utilization of individual productive resources.[52] Underlying the application of the federal estate tax statutes is the notion of horizontal equity In the case of the family business, horizontal equity means equal application of the statutes to both spouses, equality of treatment between residents of different states (community property versus common law states), and equality of treatment between those couples who can afford estate tax avoidance advice and those who cannot. As inflation caused an increasing number of moderate estates to be subject to taxation, the pressures for estate tax reform incorporating these objectives became greater.[53] Finally, in 1976, Congress was forced to re-evaluate laws which had remained fundamentally unchanged since the 1940's.[54] Congress enacted new statutes and amended old ones in order to achieve some degree of congruity between the estate tax policy objectives and the actual operation of the statutes.

To understand and evaluate the various proposals for reform, a review of the pre-1976 status of estate tax laws having the most direct impact on family businesses is necessary

As noted earlier, section 2040's predecessor appeared with the first estate tax laws in 1916.[55] At that time, there was no gift tax statute. Therefore, the transfer tax on estates could be avoided entirely by making gifts which would take effect at death, leaving the decedent with nothing in his estate to pass by will or intestacy Had Congress omitted the predecessor of section 2040, a taxpayer could have avoided estate taxes completely by inter vivos transfer of all properties into joint tenancy with the spouse or someone else while simultaneously maintaining absolute control over at least one-half of the property during his lifetime. In the case of spouses holding as tenants by the entirety, the transferor spouse could maintain full lifetime control.

Without regard to the propriety of taxing transfers between

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of William E. Simon, Sec. of Treas., presented by Charles W Walker, Ass't Sec. of Treas. for Tax Policy).

52. *See* Eisenstein, *The Rise and Decline of the Estate Tax,* 11 TAX L. REV. 223, 229 (1956), *quoting* 17 WORKS OF THEODORE ROOSEVELT 432-34 (memorial ed. 1925).

53. *See* notes 64-95 *infra* & accompanying text.

54. *1976 Hearings, supra* note 51, at 1 (statement of William E. Simon, Sec. of Treas., presented by Charles W Walker, Ass't Sec. of Treas. for Tax Policy).

55. *See* notes 2-4 *supra* & accompanying text.

spouses,[56] the Revenue Act of 1916 closed this obvious loophole in the law through use of the statutory presumption of full inclusion of jointly held property in the estate of the first to die. In 1924 Congress enacted the first gift tax statute,[57] which the Treasury Department interpreted as imposing a transfer tax applicable to the creation of joint tenancies.[58] Nothing was done to coordinate the estate tax statute on joint tenancies with the gift tax interpretation of the Treasury. The result was that one spouse could make a gift to the other of an interest in entirety property, pay the gift tax, and still be subject to full inclusion of the entirety property in his estate at death. Although the statute did provide a credit to the estate for gift taxes paid, the net effect of the gift and estate taxes was to deny spouses any method of avoidance of transfer taxation on the appreciation in value of the properties from the time of the gift. The gift tax on creation of joint tenancies also had an interesting corollary effect in operation: it was overwhelmingly disregarded, presumably as a result of ignorance of its existence, by persons making lifetime transfers in joint tenancy. Such a huge number of estates were delinquent in filing a return and paying tax on the creation of a joint tenancy that Congress made the gift tax section elective in 1954.[59] Thus, the lack of awareness of a gift tax and the impotency of the completed gift in reducing transfer taxes on appreciation in value made it unwise for spouses conscious of estate tax consequences to hold property in this form. Unfortunately, this operation of the statute was known to only a few. The vast majority of spouses in common law states continued to hold property in joint tenancy with right of survivorship or as tenants by the entirety.[60]

As an adjunct to and possibly in mitigation of the harsh results

56. Only recently has this topic come to the forefront in tax reform proposals. *See* ALI, Federal Estate and Gift Taxation Recommendations and Reporter's Studies 32-3 (1969); Tax Reform Studies and Proposals, U.S. Treas. Dept., House Comm. on Ways and Means and Senate Comm. on Finance, Joint Publication, 91st Cong., 1st Sess., pt. 3, at 358 (Comm. Print 1969).

57. Revenue Act of 1924, ch. 234, §§ 319-24, 43 Stat. 253.

58. U.S. Treas. Reg. 79, Art. 2(2), 19(8) (1939).

59. *See* I.R.C. § 2515(a).

60. *See* Campfield, *Estate Planning for Joint Tenancies,* 1974 DUKE L.J. 669, 671 n.3 (discussion of non-tax advantages of joint tenancy with right of survivorship); Hines, *Real Property Joint Tenancies: Law, Fact, and Fancy,* 51 IOWA L. REV. 582 (1966) (popularity of joint ownership as a fairly recent phenomenon developing since the 1930s); Riecker, *Joint Tenancy: The Estate Lawyer's Continuing Burden,* 64 MICH. L. REV. 801 (1966) (popularity of joint tenancies may be due to encouragement by lawyers).

extracted by the joint tenancy statutes on transfers between spouses, Congress, in 1948, enacted the estate and gift tax marital deductions.[61] The legislative purpose of the marital deduction was the equalization of tax treatment of couples in common law and community property states.[62] Community property states automatically attributed all property acquired after the marriage, except by gift, bequest, or devise to an individual spouse, as belonging one-half to each spouse under the theory that each spouse has contributed equally to the marriage. Surviving spouses in such jurisdictions were given automatic recognition of their contributions, in whatever form, toward building the marital estate. Unfortunately, such was not the case in common law states, the laws of which found their origin in an era when women were not recognized as legally competent to hold property Though the stated objective of the marital deduction was equalization of tax treatment, the operative result was to recognize the contributions of spouses in common law states by excluding one-half of the marital property left to such spouses from the taxable estate of the first spouse to die. This result was largely disregarded by those reformers who sought changes in section 2040, as well as by the courts in post-1948 decisions recognizing the exclusion of portions of jointly held property from the husband's estate *before* application of the marital deduction. Thus, any recognition of jointly held property as belonging to the surviving spouse apparently operated to duplicate the effect of the marital deduction. For example, if the wife were successful in arguing for exclusion of one-half of jointly owned property from the estate of her husband and were allowed a fifty percent marital deduction on the one-half left in his estate, the net effect was to recognize only twenty-five percent of the value of the property as being owned by him at death. The only policy justification for such a result was the view, held by many, that interspousal transfers, whether during life or at death, should be totally exempt from taxation, that is, a 100% marital deduction.[63]

61. Revenue Act of 1948 ch. 168, 62 Stat. 110, *reprinted in* 1948-1 C.B. 211, 216-20.

62. H.R. REP. No. 1274, 80th Cong., 2d Sess. 4 (1948), *reprinted in* 1948-1 C.B. 241; S. REP. No. 1013, 80th Cong., 2d Sess..1 (1948), *reprinted in* 1948-1 C.B. 285.

63. Since 1969, both the Treasury Department and the American Law Institute have advocated the total abolition of taxation on interspousal transfer. *See* ALI, Federal Estate and Gift Taxation Recommendations and Reporter's Studies 32-33 (1969); Tax Reform Studies and Proposals, U.S. Treas. Dept., House Comm. on Ways and Means and Sen. Comm. on

Substantive reform of estate and gift tax statutes relating to the family business began with the American Law Institute Recommendations[64] and the Department of Treasury proposals[65] for tax reform in 1969. These studies recommended the complete elimination of taxation on interspousal transfers whether property was passed to a spouse inter vivos or at death. Such a measure, it was felt, would simplify the tax laws while simultaneously providing equality of treatment to all surviving spouses.[66] The effect of a 100% marital deduction on the jointly held family business is clear. As between spouses, the operation of section 2040 would have no application and the entire subject matter of this Article would be relegated to its place in tax history.[67]

The 1976 Department of Treasury proposals also clearly outlined why the laws were in need of reform. Citing statistical data collected by the Treasury Department, the proposal noted that in the thirty years between 1945 and 1975, the percentage of estates required to

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Finance, Joint Publication, 91st Cong., 1st Sess., pt. 3, at 358 (Comm. Print 1969); Hearings Before the Comm. on Ways and Means on Tax Reform, 91st Cong., 1st Sess., pt. 11, at 4038 (March 27, 1969) (statement of Earl M. Colson).

64. ALI, Federal Estate and Gift Taxation Recommendations and Reporter's Studies (1969).

65. Tax Reform Studies and Proposals, U.S. Treas. Dept., House Comm. on Ways and Means and Senate Comm. on Finance, Joint Publication, 91st Cong., 1st Sess., pt. 3 (Comm. Print 1969).

66. The American Law Institute gave five reasons for dissatisfaction with the 50% limit:

> First, it does not achieve complete equality of tax treatment as between community and noncommunity property states because the marital deduction for lifetime transfers is limited to 50% of the value of each gift to the donee spouse; Second, it still results in the imposition of a transfer tax on the movement of property from spouse to spouse and forces them into an unnatural recordkeeping of interspousal transfers if the law is to be complied with; Third, frequently the tax that has to be paid as a result of an interspousal transfer comes at the death of a spouse, a time when significant sources of income may disappear, and hence not a time when a further economic adjustment should be required to pay taxes on the transfer; Fourth, very complex dispositions are necessary to give the surviving spouse on the donor spouse's death the exact 50% that is the maximum marital deduction; and Fifth, in small estates, the 50% marital deduction is frequently inadequate to provide the surviving spouse with an adequate tax free amount.

ALI, Federal Estate and Gift Taxation Recommendations and Reporter's Studies 32-33 (1969) (footnote omitted).

67. It is interesting to note that these proposals did not die with the 1960's but were reintroduced by the Treasury Department as proposals for tax revisions in the Tax Reform Act of 1976. *1976 Hearings, supra* note 51, at 9-11 (statement of William E. Simon, Sec. of Treas., presented by Charles W Walker, Ass't Sec. of Treas. for Tax Policy).

file returns increased from approximately one percent to just over eleven percent of all estates.[68] The proposal noted that the effect of this increase was a "ten-fold increase in the impact of the estate tax in terms of the percentage of estates affected. No longer does the tax impact principally on the relatively larger estates. Rather, the estate tax has shifted to a more broadly-based tax on the private capital accumulations of more moderate estates."[69] Reiterating the policy objectives of the estate tax, the proposal further stated that:

> [T]he estate tax has the limited function of restraining the undue accumulation of wealth. It should not be viewed as a device to raise revenue nor to achieve progressivity in the tax system, per se. It is inappropriate, therefore, to continue down the present path to a broad-based estate tax that imposes heavy burdens on moderate estates at a time when financial demands on the widow and children of a decedent may be most heavy and when the chief revenue producer has been lost to the family[70]

The impact of estate taxation and its policy objectives on the family business was placed even more clearly in perspective by witnesses who appeared before the House Ways and Means Committee. Setting the tax policy considerations in the framework of the family business, Senator Gaylord Nelson of Wisconsin stated:

> The ultimate question posed by estate tax policy is whether the country wishes to preserve a climate where family enterprise can survive a transfer from one generation to another, or whether we are going to destroy most existing family firms and weaken the incentive to establish new ones by continuing the present limitations.[71]

Testifying on the confiscatory nature of the tax, Alice Heyman, appearing on behalf of the National Women's Political Caucus noted that:

> In recent years I have become distressed by the steady decrease in small family-owned businesses as well as the decline in the number of family farms
>
> Simply stated, the gradual but nonetheless steady disappear-

68. *Id.* at 2.
69. *Id.* at 3.
70. *Id.*
71. *Id.* at 2 (statement of Senator Gaylord Nelson).

> ance of the family farm and other small businesses has been fostered by high estate taxes, which leaves the wife as heir and after payment of the estate tax—often through the sale of part of the farm—with a farming unit that is often not economically viable and one that is eventually sold. In many situations, the wife is actually forced to sell the farm or the small business in order to secure the necessary funds to pay the applicable tax.[72]

Though the witnesses were decidedly in agreement on the discriminatory effect of the estate tax on the surviving widow of the joint family enterprise,[73] recommendations for a solution to the problem divided them into two groups. The first group, in alignment with the proposals of the Treasury Department and the American Law Institute,[74] advocated the recognition of the wife's services and relief from the "widow's tax"[75] through an increase in the estate tax marital deduction. The second group, focusing on the immediate source of their concern, advocated an amendment to section 2040 to eliminate either the consideration furnished test or to recognize the wife's contributions of services as money's worth consideration to satisfy the test.

72. *Public Hearings & Panel Discussions Before the Comm. on Ways & Means on the General Subject of Federal Estate and Gift Taxes*, 94th Cong., 2d Sess., pt. 2, at 918 (1976) (statement of Alice Heyman).

73. Illustrative of the vehemence of women testifying on the discriminatory effect of the Service's application of § 2040 is a quote from the letter of a Wisconsin woman:

> Some of my points are: 1. When property is owned jointly — yet a wife must pay inheritance tax on both halves, she is denied the right to own property. 2. Taxes are paid by joint return therefore she has already paid the tax on her half of income — how can she inherit what is already hers? 3. If labor is not a contribution then her husband's labor should not count either. If his does, then this constitutes slavery. Slavery was abolished in 1865, therefore the law is illegal.

Hearings on H.R. 10612 Before the Comm. on Finance (Part 4 of 4), 94th Cong., 2d Sess. 156 (1976); *1976 Hearings, supra* note 51, at 156 (March 17, 1976) (quotes from letters received by Mrs. Lloyd Royal on estate taxation).

74. *See* notes 63-66 *supra* & accompanying text.

75. The phrase "widow's tax" was first coined by Ms. Laura Lane in an article appearing in the September, 1975 *Farm Journal*, entitled *Let's Get Rid of the Widow's Tax*. In this article, Ms. Lane explains the application of the § 2040 statutory presumption by I.R.S. agents who refused to recognize a wife's contributions of labor on the farm as money's worth consideration. She concludes by urging readers to support a Nebraska campaign led by Doris Royal and three other women to "get rid of the widow's tax." From this article and the efforts of Mrs. Royal, the campaign spread across the entire United States with petitions gathered from 48 states for presentation to Congress. *See 1976 Hearings, supra* note 51, at 165-68 (March 17, 1976).

Curiously, the group advocating an increase in the marital deduction to recognize the spouse's contributions did not lobby for the total abolition of interspousal transfer taxes; rather, this group confined its request to the enactment of a 100% marital deduction up to the $100,000-$250,000 level, with the fifty percent rule applying thereafter. Representative of the reasoning of this group was the statement of the American Farm Bureau Federation which recommended:

> a substantial increase in the marital deduction to minimize the problem of the so-called "widow's tax" [by raising] the maximum marital deduction from 50 percent of the value of the adjusted gross estate passed to a surviving spouse to $100,000 plus 50 percent of the total value of the adjusted gross estate. This would recognize the importance of partnerships between husbands and wives, and the special problems of wives who are widowed at an early age.[76]

Similar proposals were advocated by the National Farmer's Union,[77] the United Farm Wives of America,[78] and Senator Gaylord Nelson in his introduction of Senate Bill 2819 on the floor of the Senate.[79] The emphasis on an increased marital deduction by this group seems to confirm the writer's earlier hypothesis that relief for surviving spouses in common law states historically has been tied to the marital deduction, which applies to the common law states the community property notion of marital property being owned equally by both spouses.[80] The efforts of this group were ultimately recognized in the Tax Reform Act of 1976, which allowed a 100% marital deduction up to $250,000, with the fifty percent rule apply-

76. *1976 Hearings, supra* note 51, at 165-68 (March 17, 1976) (statement of the American Farm Bureau Federation, presented by Allan Grant, President).

77. *Public Hearings & Panel Discussions Before the Comm. on Ways & Means on the General Subject of Federal Estate & Gift Taxes,* 94th Cong., 2d Sess., pt. 2, at 970-72 (1976) (proposing a 100% marital deduction up to $240,000).

78. *Id.* at 1709 (proposing a 100% marital deduction up to $100,000 with the 50% limit applicable thereafter).

79. 121 CONG. REC. 41526 (1975) (proposing a transfer of the first $240,000 of business and other property to a surviving spouse free of tax at death). It is interesting to note that while Senator Nelson began his campaign against the widow's tax by recommending an increased marital deduction, he was ultimately responsible for enactment of the § 2040(c) amendment in the Revenue Act of 1978. *See* text accompanying note 98 *infra.*

80. *See* notes 61-63 *supra* & accompanying text.

ing thereafter.[81] It would seem, then, that this would have settled the issue of the "widow's tax." Such was not the case, however, as the second group ultimately prevailed on its proposals as well.[82]

Spearheaded by the efforts of Doris Royal and an article in the September 1975 issue of the *Farm Journal*,[83] the second group lobbied for a direct amendment to section 2040 which would recognize the wife's contributions of service to the family business as money's worth consideration. No mention was made of the recent case law in favor of spouses who materially participated in the business.[84] This group focused its attention on the law as applied by revenue agents in the field. In answer to the question whether a wife contributed by driving a tractor, sorting cattle, and doing the book work, one Internal Revenue Service attorney replied that "[t]he wife renders all these services as a part of her marriage contract,"[85] implying that such services are not money's worth consideration furnished for jointly held property. Alice Heyman, speaking on behalf of the National Women's Political Caucus, blasted the Internal Revenue Service, stating:

> While the Internal Revenue Code may not contain any flagrant de jure discriminatory provisions, it is, nevertheless, the NWPC's position that the application of those provisions or certain regulations, as well as the application of IRS regulations by its revenue agents across the country, operates, in fact, as de facto discrimination against women who have significantly contributed to the economic and financial well-being of their families. . . . [S]uch discriminatory application of the IRS Code and regulations is as reprehensible as if the tax laws contained specific provisions mandating that an inordinate tax burden be placed not merely on women as a class, but particularly widows left to manage small farms in the Midwest and small businesses, such as the traditional "Mom and Pop" grocery stores. . . .[86]

81. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2002(a), 90 Stat. 1854 (codified as I.R.C. § 2056(c)(1)(A)).

82. *See* notes 97-114 *infra* & accompanying text.

83. *See* note 75 *supra*.

84. *See* notes 8-50 *supra* & accompanying text.

85. *Public Hearings & Panel Discussions before the Comm. on Ways and Means on the General Subject of Federal Estate & Gift Taxes*, 94th Cong., 2d Sess., pt. 1, at 823 (1976), *citing Farm Journal*, September 1975.

86. *Id.*, pt. 2, at 918.

Recommendations by this group included repeal of the presumption against equal contributions, the establishment of a presumption in favor of the contributing wife, and amendatory legislation specifically recognizing a wife's contributions as money's worth consideration. Major political groups favoring one or more of the above proposals included American Agri-Women,[87] National Organization for Women,[88] Women's Lobby,[89] National Women's Political Caucus,[90] National Livestock Tax Committee,[91] American National Cattlemen's Association,[92] National Livestock Feeder's Association,[93] and the National Wool Growers Association.[94] Relief in the form of amendatory legislation recognizing the wife's material participation as consideration furnished was finally granted in the Revenue Act of 1978.[95]

From the analysis of the lobbying positions of these two groups, both of which sought the same objective—namely, recognition of the wife's contribution to the marital estate—it appears that relief was granted *twice,* once in the 1976 Act and again in the 1978 Act. Three possible explanations can be offered. First, the Congress may not have considered the relief granted to widows by the increased marital deduction sufficient to eliminate the problem and wished to confine any further relief to widows who were co-owners in family businesses, as opposed to granting an across-the-board increase in the marital deduction. A second explanation is that Congress at last was moving toward the American Law Institute and Treasury Department proposal of a 100% marital deduction. A third possibility is that Congress never even considered the 2040 amendment as an increased marital deduction, but rather as a provision to equalize the tax treatment between family businesses organized as partnerships or corporations and those with no formal business entity Per-

87. *Id.*, pt. 1, at 789.

88. *Id.*, pt. 2, at 861.

89. *Id.* at 915.

90. *Id.* at 917. This group advocated the total elimination of tax on interspousal transfers and in the alternative, requested recognition of the value of services performed by the spouse.

91. *1976 Hearings, supra* note 51, at 165 (Joint Statement of Nat'l Livestock Tax Comm., American Nat'l Cattlemen's Ass'n, Nat'l Livestock Feeder's Ass'n, and the Nat'l Wool Growers Ass'n).

92. *Id.*

93. *Id.*

94. *Id.*

95. Revenue Act of 1978, Pub. L. No. 95-600, § 511(a), 92 Stat. 2821 (codified as I.R.C. § 2040(c)).

haps Congress felt that the amendment would recognize the substance over form economic fact of the husband-wife partnership. The committee reports lend support to the latter conclusion.[96]

THE ORIGIN AND OPERATION OF THE SECTION 2040(C) AMENDMENT

The 1978 Internal Revenue Code amendment securing final relief from the widow's tax[97] came through the efforts of Senator Gaylord Nelson of Wisconsin, who, in 1976, had supported an increased marital deduction to recognize the contribution of the surviving spouse to the family business.[98] On April 10, 1978, Senator Nelson introduced Senate Bill 2865[99] as a floor amendment to the Internal Revenue Code to "provide a more equitable estate tax treatment of joint interests in farm and closely held business property "[100] In his statement on the Senate floor, Senator Nelson explained the operation of his proposal:

> In the event of death of a husband or wife who is a joint owner of property, and who has been working a farm jointly with his or her spouse, this proposal would deem the survivor, for estate tax purposes, to have "furnished consideration" for their joint property at the rate of 2 percent a year, up to a maximum of 50 percent of the portion of the property which has *not been paid for at the time of the marriage.*[101]

In effect, this meant that the surviving contributing spouse could "earn out" up to one-half of the amount of any "unpaid mortgages on, or any indebtedness in respect of"[102] the property existing at the time the joint tenancy was created. The surviving spouse would not be permitted to earn out any consideration furnished as a down payment by the deceased spouse. Thus, if the deceased spouse made fifty percent down payment, the surviving spouse would be permitted to "earn out" a maximum of one-half of the remaining fifty

96. General Explanation of the Revenue Act of 1978, H.R. 13,511, Pub. L. No. 95-600, 95th Cong., 2d Sess. 286 (Comm. Print 1979) (prepared by the staff of the Joint Comm. on Taxation); S. REP. No. 95-1263, 95th Cong., 2d Sess. 214, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6761, 6977-78.

97. *See* note 75 *supra* & accompanying text.

98. *See* note 79 *supra* & accompanying text.

99. S. 2865, 95th Cong., 2d Sess., 124 CONG. REC. S5188 (daily ed. April 10, 1978).

100. 124 CONG. REC. at S5190 (statement by Senator Nelson).

101. *Id.* (emphasis supplied).

102. *Id.* at S5191.

percent. If one of the spouses inherited the property unencumbered, no earn out would be permitted. The bill dealt only with earning out a portion of the mortgage indebtedness. No recognition was given to the wife for appreciation in value on her earned out percentage of the indebtedness. Apparently, this would leave the wife with an exclusion that equaled only her earned out portion of the original debt.[103]

In explaining the reasons for this amendment, the Senator appears to have relied heavily upon the tax policy argument of horizontal equity He argued that the distinction drawn by the law between proprietorships and other forms of doing business was unfair. If husband and wife formed a de jure partnership or corporation, the Internal Revenue Service would recognize the wife's ownership interest and exclude that portion from the deceased husband's estate. When the business was conducted in proprietorship form, however, the Revenue Service would not recognize any part of jointly held property as belonging to the wife based upon her participation in the business alone.[104] Thus, Senator Nelson explained, "it is only the smallest and least organized element of the business population that suffers from the problem. But 12 million of the total of 14 million U.S. enterprises, that is, 85 percent of the total, are unincorporated."[105] The Senator's second equity argument emphasized the disparity between sophisticated taxpayers who were aware of the tax problems of joint ownership and could afford expert legal advice and those less sophisticated who were unaware of the problems and could not retain expert counsel. The Senator noted that the joint tenancy gift tax election enacted in 1976[106] would solve the

103. *Id.*

104. The favorable estate tax effect of operating in the partnership form was recognized by the House Ways and Means Committee Reports accompanying H.R. 14844:

> In the case of certain trade or business activities conducted in the form of a family partnership, the partnership interest held by the surviving spouse will not be included in the deceased spouse's gross estate. The effect of this is that the services performed by the surviving spouse in connection with the family owned business are taken into account, by reason of the profit sharing ratio, as consideration furnished for the purchase of jointly owned property used in the trade or business if a partnership is used to conduct business.

H.R. REP No. 94-1380, 94th Cong., 2d Sess. 19, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3356-3373.

105. 124 CONG. REC. S5190 (daily ed. April 10, 1978).

106. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2002(c), 90 Stat. 1855 (codified as I.R.C. § 2040(b)).

widow's tax problem for those couples starting out who were aware of its provisions and had the benefit of expert legal advice, but it did not solve the problem of existing estates which had appreciated in value over the years and future estates of unsophisticated taxpayers who could not afford legal counsel. The proposed legislation would supposedly close this gap and provide equal treatment for all taxpayers.[107]

Senator Nelson's "Widow's Tax Bill" next appeared as number 104 of 106 amendments added to H.R. 13,511[108] by the Senate Finance Committee on September 11, 1978. In proposing the amendment, Senator Nelson, a member of the Senate Finance Committee, repeated the policy reasons for the bill and its operational effect previously discussed. The amendment was adopted by the Finance Committee and reported on October 1, 1978 as section 504 of H.R. 13,511.[109] The operational effect of section 504 remained the same as Senator Nelson's original proposal in Senate Bill 2865. There was, however, some minor modification of definitional terms.[110]

On October 9, 1978, after H.R. 13,511 had been reported to the floor of the Senate, an amendment was proposed by Senator

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107. The reasons for change in the law reported by the Senate Finance Committee and the Joint Committee on Internal Revenue Taxation echo Senator Nelson's arguments. *See* General Explanation of the Revenue Act of 1978, H.R. 13,511, Pub. L. No. 95-600, 95th Cong., 2d Sess. 286-87 (Comm. Print 1979) (prepared by the staff of the Joint Comm. on Taxation). S. REP. No 95-1263, 95th Cong., 2d Sess. 215, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6761, 6978.

108. H.R. 13,511 was enacted as the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, on November 6, 1978.

109. *See* 59 FED. TAX. REP. BULL. (P-H) 43, § 2 (October 5, 1978).

110. Three changes appear in the Senate Finance Committee version of the § 2040(c) amendment. First, instead of using the phrase "unpaid mortgages on, or any indebtedness in respect of, such property at the time the . . . joint interest was created. . . ." (appearing in S. 2865 to describe the portion of the property eligible for "earn out" under the statute), the Finance Committee version uses the term "acquisition indebtedness," which is defined as "indebtedness which is incurred or assumed by the decedent and the decedent's spouse in acquiring property . . . but only to the extent that such indebtedness is secured by such property." This change clarifies the statutory intent that only bona fide indebtedness of a commercial nature incurred to acquire property will be eligible for preferential treatment. Second, the term "eligible joint interest" is substituted in place of the term "qualified joint interest" used in S. 2865. Apparently, this change was made to avoid confusion with the present use of "qualified joint interest" appearing in I.R.C. § 2040(b). Third, the definition of "eligible joint interest" was expanded to include "property . . . used in any trade or business," whereas S. 2865 applied only to "property which . . . is devoted to use as a farm, or . . . constitutes, or is used in, a closely held business. . . ." *See* S. 2865, 95th Cong., 2d Sess. (1978).

Melcher from Montana which recognized the failure of Senator Nelson's bill to attribute any of the appreciation in value of property over the term of the marriage to the surviving spouse's interest therein.[111] Senator Melcher favored a statute that would allow the surviving spouse to earn out a percentage of the total fair market value of the property on the date of death, less any consideration furnished by the decedent spouse. He also proposed that when the deceased spouse inherited property, the value of the property at the time of inheritance should be regarded merely as consideration furnished by that spouse, not value precluding the surviving spouse from earning out a percentage of the appreciation in value over the term of the marriage. Senator Melcher's amendment also proposed an election procedure whereby the executor of the estate could elect to have section 2040(a) rather than section 2040(c) apply to the estate of the decedent.[112]

The Senate Finance Committee's version of section 2040(c), with Senator Melcher's amendment, was passed by the Senate on October 10, 1978 and sent to the Conference Committee, where the statute was rewritten by the Joint Committee on Internal Revenue Taxation in order to express more clearly the legislative intent of the Senate. The statute, as finally drafted, differed from the version reported out by the Senate Finance Committee in three material respects. First, the final version allowed the surviving spouse to share in the appreciation in value of the property, as proposed in the Melcher amendment, by allowing the estate to exclude an amount

> equal to the sum of the amount determined by applying a percentage rate of 2 percent for each year the surviving spouse materially participated in the business (not to exceed 50 percent) to the excess of the value of the joint interest (as determined for estate tax purposes) over the amount attributable to the original consideration furnished by both spouses and (plus) the amount attributable to the original consideration furnished by the surviving spouse.[113]

111. Amendment No. 2034, 95th Cong., 2d Sess., 124 CONG. REC. S17,757 (daily ed. Oct. 9, 1978).

112. The reasons for the election procedure, which appear in the final enactment of § 2040(c), are not explained, but its effect is apparently to allow the executor to rely on the family business case law in situations where the surviving spouse owns a greater than 50% interest in the business.

113. General Explanation of the Revenue Act of 1978, H.R. 13,511 Pub. L. No. 95-600, 95th

The final version provided that "adjusted consideration" will not be determined by the actual amount paid but will equal the actual amounts paid increased by simple interest of six percent per annum for each year since payment. The purpose of the six percent rule evidently was to recognize the appreciation in value of the original money consideration furnished by each spouse even though such recognition was at an artificially low rate. The Senate version contained the two percent earn out per year rule, but it was applied only to the property's acquisition indebtedness. The Melcher amendment proposed the earn out of appreciation in value but did not provide for the six percent interest on other consideration furnished.

Second, the statute placed a ceiling on the total amount that might be excluded from the decedent's estate: "The aggregate amount by which the value of the decedent's gross estate may be reduced . . . is $500,000 and the [amendment] may not result in the inclusion in the decedent's gross estate of less than 50 percent of the value of the eligible joint interest."[114] In other words, the combination of the wife's services plus any other consideration furnished by her can never total over fifty percent of the value of the joint interest under section 2040(c).

Finally, whereas the Melcher Amendment offered an option to an executor to elect out of section 2040(c), the final version of the statute required an executor to make an affirmative election to apply section 2040(c) by the due date of the estate tax return.[115]

V CONCLUSION

The present law provides two distinct options for achieving recognition of the widow's material participation as money's worth consideration furnished toward jointly owned property in the family business. Through the executor of her husband's estate, she can make an affirmative election to invoke section 2040(c)'s statutory relief or she can rely on existing case law to prove her ownership interest in the business under section 2040(a). Both options have

Cong., 2d Sess. 287 (Comm. Print 1979) (prepared by the staff of the Joint Comm. on Taxation). Expressed as a mathematical formula: Amount excludible = (2% × yrs. participation) × (fair market value at date of death — adjusted consideration furnished by both spouses) — adjusted consideration furnished by surviving spouse.

114. *Id.*

115. I.R.C. § 2040(c)(9).

drawbacks. A favorable result under the case law will require proof that the family business was conducted as a de facto partnership or that an oral agreement was made to share profits. These are both questions of fact, and the risk that a particular fact pattern may not fit into the classic family business case is high. Additionally, the time and expense required to pursue the case before the Service and in court must be considered.

The major problems with section 2040(c) are its limited scope and possible procedural problems in the interpretation and application of its provisions. When the widow owns a percentage of the business in excess of fifty percent, or when the dollar value of her interest exceeds $500,000, or when significant other jointly held property, e.g., investments, bank accounts, residence, was acquired with the earnings from the business, section 2040(c) provides no relief. In these situations, the wife will be forced to rely on the case law When the statute is applicable, computational problems may arise in calculating the adjusted consideration, both its actual amount and interest thereon, unless adequate records have been maintained showing both the amounts of such consideration and the date furnished. Another problem is determining when the significant services must be performed to gain recognition under the two percent rule. If the wife performs services for years prior to the acquisition of the jointly held property, does the statute apply? In other words, must the joint tenancy have existed from the time the wife began to perform the services? If, for example, the husband and wife work together for forty years but the joint tenancy is not established until several months before the husband's death, will the wife be permitted to rely upon the provisions of section 2040(c)? Also, how is material participation to be determined—on a year-by-year basis or in the aggregate? These and other questions await clarification by regulation or technical correction.