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The decision, however, may not be as favorable to taxpayers as some might think. The circuit court panel split, with one of the three judges penning a spirited dissent that may cause other courts to approach the majority’s analysis with caution. Moreover, the appeals court couched some of its opinion in precatory language that gives the Tax Court leeway to hold to its original line on a key issue. Most importantly, the majority opinion leaves many questions unanswered, and it may establish a value apportionment regime that proves to be unworkable administratively.

This report examines Stewart, explores whether the Second Circuit reached the correct result, considers what the Tax Court should do on remand, and discusses the potential significance of the appeals court opinion for future cases, including some not involving undivided fractional interests in property. The report concludes that the discounts ultimately enjoyed by the taxpayer in Stewart may not be as great as some commentators assume.

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However, the Second Circuit’s opinion could alter in taxpayers’ favor the analysis under which section 2036(a) has been applied to family limited partnerships (FLPs), a popular estate planning technique.

I. Facts

The decedent, Margot Stewart, owned a brownstone on the East Side of Manhattan. She lived there with her son, Brandon. The two resided in the lower two stories of the building; the upper three floors

were rented to an unrelated commercial venture for $9,000 a month, under a lease entered into 14 months before she died.

The decedent and the son owned, as joint tenants with right of survivorship, property in the Hamptons, which they rented out to third parties. The joint tenancy in the Hamptons property had been created by the decedent by gift 11 years before she died. The two cotenants agreed to, and did, share the income and expenses from the Hamptons property equally.

In May 2000, four or five months after she had been diagnosed with pancreatic cancer, the decedent executed a deed that transferred to the son a 49 percent interest in the Manhattan brownstone, as tenant in common with the decedent. Despite this transfer, the decedent retained all the rent from that city property. She also paid most of the expenses relating to the brownstone before she died — $21,791 — whereas the son paid only $1,963 of expenses during that period. The expenses were abnormally high because repairs were necessary. The decedent’s share of those expenses worked out to 91.74 percent. After the brownstone gift and before she died, her son retained all the rental income from the Hamptons property, which was a departure from prior practice.

When Margot died in November 2000, the entire Hamptons property was includable in her gross estate under section 2040, and her interest as tenant in common in the Manhattan property was includable in her gross estate under section 2033. The IRS and the estate, however, disagreed on whether and to what extent the son’s interest in the Manhattan property should be includable in the decedent’s gross estate under section 2036(a). The estate took the position that none of the son’s interest was includable in his late mother’s estate — that only her undivided 51 percent interest was includable. The estate and the IRS stipulated that if this theory was correct, the estate could value the decedent’s undivided 51 percent interest at a 42.5 percent discount from its pro rata share of the brownstone’s underlying fair market value.

II. Tax Court

The Tax Court held for the government in a brief opinion.2 Judge Maurice Foley concluded that the decedent’s retention of the income stream from the brownstone was “very clear evidence” that she retained “possession or enjoyment” of that property.3 He rejected as “not credible” the son’s testimony that he and his mother agreed that they would share the income and expenses from the Manhattan and Hamptons properties “in a manner reflective of their ownership interests.”4 The son had testified that the pair intended at year-end “to perform a financial reconciliation” of the income and expenses, but there was no written agreement, and the son’s accountant “testified that he did not recall being informed about” such an agreement. The Tax Court found that no such agreement existed.5

III. Second Circuit Majority

The Second Circuit vacated and remanded the Tax Court’s decision. Judge Guido Calabresi, who once taught estate and gift taxation at Yale Law School, wrote the opinion for a majority of the three-judge panel. Judge Debra Livingston dissented with a forceful opinion. The majority concluded that it was a clear error for the Tax Court to hold that the decedent and son agreed that the decedent would enjoy all of the “substantial economic benefit” of the son’s 49 percent interest in the Manhattan property for purposes of section 2036(a). The appeals court said that the son, and not the mother, “manifestly enjoyed . . . the benefits of the residential portion of the 49 percent.”6 And as to the upper floors, the majority declared, “it seems likely that Decedent retained the benefits of less than the total 49 percent.”7

According to the appellate majority, the Tax Court’s findings concerning the mother’s retention of the brownstone rent and the absence of an agreement to reconcile the books of the two properties “do not provide a complete picture of the extent to which Decedent enjoyed the substantial economic benefit of” the son’s 49 percent interest. The court directed the IRS to “apportion” the interest under a 1979 revenue ruling in which a decedent was held to have retained only a portion of the economic benefit from a transferred residence, when he retained the right to use it or rent it out for only one month a year. By the same token, the Second Circuit said, the Tax Court should apportion the economic benefit of the brownstone between its lower and upper floors. Only the upper floors, it said, should be subject to section 2036(a).

Because the son was permitted to remain living in the downstairs portion of the building along with

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3 Id. at 6.
4 Id.
5 Id. at 7.
6 Estate of Stewart, 617 F.3d at 159.
7 Id.
the decedent, the majority concluded that inclusion of that portion under section 2036(a) was inappropriate:

Like other courts, we draw a distinction between cases where a decedent retains exclusive possession and withholds possession from the donee on the one hand, and “those cases where a residence jointly occupied by the donor and the donee has been held not includable in the donor’s gross estate” on the other. This case is of the latter sort. And despite the great burden faced by the taxpayer in all these cases, taxpayers have won in every case of which we are aware when those two crucial factors were favorable.8

As for the upper floors, the appeals tribunal instructed the Tax Court to re-examine a factual finding that it made, namely, regarding the payment of expenses by the pair. While the decedent’s payment of the lion’s share of the expenses supported the finding that the pair had an implied agreement that she would enjoy the economic benefit of the property, the circuit majority also declared that the expenses she paid decreased the economic benefit she received. Judge Calabresi explained:

For example, if A and B jointly own a rental property that generates $10,000 per month in rent and $5,000 per month in expenses, and A and B split the rent evenly but B pays all the expenses, then in substance A is getting the entire economic benefit of the property while B is getting nothing. Because ‘‘enjoyment’’ connote[s] substantial present economic benefit,” we think who paid what expenses must be taken into account in apportioning the 49 percent interest between the Estate and Brandon. In other words, the Tax Court must determine who received what portion of the net income from the 49 percent interest, rather than the gross income.9

In a footnote, the majority added:

As used in the preceding sentence, “income” includes not only the dollars generated by the rental portion of the 49 percent interest in the Manhattan property (less, in the case of net income, the expenses attributable to the 49 percent interest), but also Brandon’s imputed income from living in the residential portion of the property — that is, the fair market rental

value one would have paid to be Decedent’s housemate from May 9, 2000, to November 27, 2000.10

Lastly, the appeals court turned to the potential relevance of the Hamptons property. Although it accepted the Tax Court’s finding that there was no agreement that the income and expenses of the two properties would be reconciled, the Second Circuit declared that “it may be worth considering on remand where the net income from the East Hampton property went.”11 The majority noted that “consideration of other property may be useful to an accurate determination of who enjoyed the substantial economic benefit of a property.” It went on to give two examples of when that consideration might or might not be appropriate:

If, for example, Brandon and Decedent had formally split the rental income and costs of the Manhattan property 51 percent-49 percent but Brandon had allowed Decedent to take a portion of what should have been Brandon’s net income from the East Hampton property, and that amount equaled the income Brandon was entitled to from his 49 percent share of the Manhattan property, then consideration of the East Hampton property would be necessary to prevent an abusive transaction that would otherwise evade section 2036. At the other extreme, if Brandon and Decedent had jointly owned hundreds of other properties and there was no particular reason to think that the distribution of income from those properties was in any way related to the substantial economic benefit of the disputed property, then it would be incorrect to consider such other properties. We leave it to the Tax Court to determine, on remand, where this case falls along that spectrum and whether the distribution of net income from the East Hampton property is among the “facts and circumstances surrounding the transfer and subsequent use of the property,” all of which “must be considered.”12

In so holding, the Second Circuit rejected the IRS’s view that when one is determining whether section 2036(a) should apply to a particular asset, the use or enjoyment of other assets is never relevant.

IV. Dissent

Judge Livingston’s dissent was heated. She argued that the Tax Court was correct in holding that

8 Id. at 157 (emphasis in original; citation and footnote omitted).
9 Id. at 160-161 (emphasis in original; citation and footnote omitted).
10 Id. at 161, n.15.
11 Id. at 161.
12 Id. (citation omitted).
the decedent had retained “not only the income stream from the rent that was paid, but also the substantial economic benefits of residence” in the brownstone, because “her relationship to the property changed in not one significant respect from the period preceding transfer to the period after.” The dissent asserted that the majority misread precedent, and “turns the proper — and longstanding — construction of section 2036 on its head. It also opens up a loophole that will vitiate to a considerable degree the efficacy of this section.”

The dissent objected to the majority’s reliance on cases in which a decedent had transferred 100 percent of his interest in a family residence to a family member but continued to live in it himself. These cases, Judge Livingston said, held that the continued occupancy was not in and of itself sufficient evidence of an implied agreement that the decedent would enjoy the property to trigger application of section 2036(a). “The majority, conversely, takes co-occupancy as sufficient evidence to prove the absence of an implied agreement, at least with respect to the residential portion of the property,” she wrote.

The dissent also complained that the majority impermissibly focused on what the son received from the decedent, rather than what the decedent retained. Citing New York property law, the dissent observed: “As a tenant in common, Margot Stewart retained the right, even after the transfer, to possess and enjoy the whole of the Manhattan townhouse, subject only to Brandon Stewart’s right to do the same. It was thus wholly possible for her to retain substantially the same possession or enjoyment of the property that she had as the sole owner.” In some cases, the dissent reasoned, this retained right might be negated by other factors “because the tenancy interferes with the transferor’s subsequent desire to sell the property, because the transferee can himself file an action for partition, or simply because the co-tenants’ desires for the day-to-day use of an asset like a home are incompatible.” But the majority erred, Judge Livingston said, in holding that the pair’s co-occupancy of the lower floors, in and of itself, negated the application of section 2036(a) to those floors.

The majority’s division of the property between the rental floors and the residential floors was incorrect, according to the dissent, because the decedent’s retention of the rent from the upstairs portion may have created an inference that she and the son also considered her to have the right to possess and enjoy all of the downstairs portion. The majority impermissibly placed the burden of proving the existence of an implied agreement on the IRS, the dissent said, when in fact the burden of disproving the existence of an agreement was on the estate. Moreover, the dissent did not buy the majority’s conclusion that the son’s payment of some of the expenses relating to the brownstone supported the existence of an implied agreement; although he was a 49 percent owner, he paid only 8.26 percent of the expenses.

The dissent concluded:

It is not the job of this Court, of course, to close loopholes that Congress has left in the tax code. Here, however, the majority inexplicably reopens a loophole that the legislature has, in unmistakable terms, long since commanded shut.

Evidence demonstrating the existence of a genuine post-transfer tenancy in common certainly could weigh against the conclusion that the transferor and transferee had an implied agreement that the transferor would continue to possess or enjoy the whole of a property. But since in this case there is not only an absence of such evidence, but the record actually shows that the parties to the transfer did not behave as though a tenancy in common had been created and the transferor’s relationship to the property did not, in substance, change, I cannot see how it was clear error for the Tax Court to find that the estate failed to carry its burden to disprove the existence of an implied agreement favoring the transferor with regard to both the commercial and residential aspects of this Manhattan townhouse. The majority’s reasoning, by focusing solely on Brandon Stewart’s residence at the townhouse as a tenant in common as dispositive, not only departs from prior case law and contravenes the text of section 2036, but also thoroughly undermines the statute, inviting inequitable disparities among those subject to the estate and gift taxes due to easy dodges by future tax avoiders.

V. Analysis

A. Apportionment of Manhattan Property

In the course of the majority’s ruling that the Manhattan property must be apportioned for purposes of inclusion under section 2036(a), it became
apparent that the Manhattan property was in fact divided in three different ways: legal, physical, and economic. The property was legally divided by the tenancy in common into a 51 percent undivided interest and a 49 percent undivided interest. Physically, it was divided into the lower floors, which the decedent and the son continued to occupy, and the upper floors, which were rented out to a business. And economically, the majority divided the property into the net income retained by the decedent and the net income enjoyed by the son, taking into account that calculation (according to the footnote) both the rental income from the upper floors and the imputed income of living in the lower floors. To understand fully the implications of Stewart, all three planes of apportionment are worth considering.

1. Physical apportionment. The fundamental question on which the majority and the dissent disagreed was whether the physical division of the property into upstairs and downstairs portions was relevant for purposes of applying section 2036(a). As the dissent pointed out, the decedent “created a tenancy in common that guaranteed the transferor continued access to the entirety of her property.” In other words, unlike the decedents in most of the other cases involving continued occupation of residences and section 2036(a), the decedent in Stewart retained an interest as tenant in common in the Manhattan brownstone. Should that fact alone not have caused the entire Manhattan property to be included in the gross estate — her own 51 percent interest under section 2033 and the son’s 49 percent interest under section 2036?

Section 2036(a) is notorious for including property in the gross estate if the decedent retains the right to determine who should possess or enjoy the property, even if that right can be exercised only with the consent of an adverse party. Under property law, a tenant in common typically has the right to possess and enjoy the co-owned property as completely as if she were the sole owner, provided that such possession or enjoyment is not inconsistent with possession or enjoyment of the property by the other co-owner. In most jurisdictions, each cotenant must share with the other cotenant any income actually derived from the property, but a cotenant need not pay any rent or other amount to the other cotenant in order to enjoy personal occupancy, as long as the other cotenant is not ousted or excluded. Thus, as tenant in common, the decedent in Stewart had the right to use the entire brownstone, as long as her son did not object. And her need to obtain his consent to use the property exclusively did not limit her right to enjoy the property in a manner that should make any difference under section 2036(a).

This question was discussed but not completely resolved in a 1992 Tax Court decision, Estate of Powell v. Commissioner. There, a decedent gave undivided tenancy-in-common interests in her residence to her children, retaining a 40 percent tenancy-in-common interest for herself. She moved out of the residence and into a retirement facility shortly after the first of the gifts; neither she nor the children lived in it thereafter. The Tax Court held that the children’s interests were not includable in the mother’s gross estate, on the ground that the IRS had conceded the issue in a 1980 revenue ruling.

As the Powell court acknowledged, however, the 1980 ruling did not even mention section 2036(a). It said simply that under section 2033, a husband’s gross estate included only his own tenancy-in-common interest, and not that of his ex-wife, when the tenancy in common resulted from a tenancy by the entirety that had originally been created by the decedent when he purchased real property with his own funds. The ruling seemed more concerned with the possible application of section 2040(a), governing joint interests with rights of survivorship, than any other estate tax issue. It also dealt with former section 2515, now repealed, having to do with gift tax. Nonetheless, the court in Powell declared that the IRS had ruled out application of section 2036(a) to the tenancy in common.

A 1956 decision, Estate of Trafton v. Commissioner, had more squarely rejected application of the predecessor of section 2036(a) to a one-half tenancy-in-common interest that the decedent had given to his wife in securities, with the decedent retaining the other half. The decedent in fact received and “used . . . as he pleased” all the income from the securities. Nonetheless, the court held that the spouse’s half-interest was not includable in his gross estate, because his possession and enjoyment of the funds was “wholly dependent on her consent” and subject to partition on her demand.

Estate of Trafton, if not simply incorrect, can be distinguished on the ground that the assets at issue were securities, whose only attribute subject to

22 See, e.g., Daly v. Shepherd, 645 S.E.2d 485, 486-487 (Va. 2007); Barrow v. Barrow, 527 So.2d 1373, 1375-1377 (Fla. 1988); Rasmussen v. Thomas, 644 P.2d 1030, 1033 (Nev. 1982).
25 T.C. 610 (1956).
enjoyment is income, for which tenants in common are always accountable to each other. When real property is involved, and when the cotenants have rights of personal occupancy, there is no obligation to account to each other for personal use of the property. Section 2036(a) is phrased to cover either the income from the property or the right, alone or in conjunction with any other person, to designate who gets to enjoy or possess the property. Tenants in common clearly possess the latter right for real property for which there is no lease or rental arrangement involving a third party — exactly the situation with the downstairs floors in Stéwart. Thus, it seems that section 2036(a) should have applied in Stéwart.

In a 2000 case, Estate of Wineman v. Commissioner,26 the IRS and the Tax Court assumed that the decedent’s retained tenancy-in-common interest was not, in and of itself, sufficient to trigger section 2036 inclusion when she died, and the court held that the facts of the case did not warrant inclusion, either. The decedent had given her three children undivided interests in some cattle farm property; their interests totaled 24 percent. The decedent retained a 51 percent undivided interest, and a testamentary trust established by her late husband held the other 25 percent. After the gifts to the children, the decedent continued to live in the larger of two houses on the property, and she continued to use the garden and small orchard next to her house. The smaller house was occupied by one of the children rent-free, and the children’s farm corporation leased most of the rest of the property from the co-owners — including barns, a granary, a shop, cattle scales, and corrals — at below-market rent, which the decedent apparently retained. The Tax Court held that no inclusion under section 2036(a) was warranted.

The Wineman court’s discussion of section 2036(a) is open to some question, however. It began by noting that the IRS was attempting to include in the decedent’s gross estate only the value of a life estate in the 24 percent interest held by the children.27 If section 2036(a) applied, one would have thought that the entire value of the 24 percent interest would be included. The court’s ruling also rested heavily on its perception that the decedent held a “controlling interest” and the children held only a “minority” interest in the property,28 whereas the rights of tenants in common to occupy personally the co-owned property are ordinarily equal. Nonetheless, the court clearly held that section 2036(a) was inapplicable, in large part because of the decedent’s limited actual use of the property in question.

The dissent in Stéwart conceded that tenancy in common alone was not enough to trigger section 2036(a) inclusion. It suggested that section 2036(a) would not apply if the cotenants were in disagreement about the day-to-day uses of the property, or if either filed an action to partition the property and terminate the cotenancy. But that concession seems to have been misplaced. Section 2036(a) focuses on what the decedent had the right to do, as well as on what she actually did; and as noted earlier, it does not matter whether an adverse party’s consent to the decedent’s exercise of those rights must be obtained. Thus, the better rule — the rule that seems most consistent with established law involving section 2036(a) as it applies to trusts — would be that with any retained tenancy in common in real property, the decedent has kept a forbidden interest that triggers section 2036(a) inclusion.

The code reaches this result with a retained interest as joint tenant with right of survivorship under section 2040(a),29 and it seems logical to reach it in the case of a retained tenant-in-common interest under section 2036(a) as well. After Stéwart, however, that clearly is not the prevailing rule, at least not in the Tax Court and the Second Circuit. And with no automatic inclusion of the entire property, the door is left open for the type of physical apportionment in which the appeals court engaged.

2. Economic apportionment. The second plane on which the Second Circuit majority concluded that an apportionment was necessary was an economic one. The court instructed the Tax Court to construct a partial inclusion of the brownstone based on the decedent’s and her son’s respective shares of the “net income” from the property, including the imputed income that the son enjoyed by living in the downstairs quarters as his mother’s roommate.30 The appeals court gave the lower court little guidance on the algebra or other mathematics of the calculation that it desired.

One uncertainty is that the court was not entirely clear about whether this second type of apportionment was distinct from, or the same as, the division between the residential and rental portions of the brownstone. Given the court’s conclusion that the downstairs was off limits to section 2036(a), one

27Id. at 15-16.
28Id. at 20.
29In addition to pulling jointly held property back into a decedent’s estate, section 2040 denies any discounts for the disadvantages of co-ownership, even though those disadvantages are essentially the same with joint tenancy as they are with tenancy in common. See Estate of Young v. Commissioner, 110 T.C. 297, 315-316 (1998), Doc 98-14934, 38 TNT 91-8.
30Estate of Stéwart, 617 F.3d at 161 n.15.
might have thought that the threshold calculation would have been an apportionment of the overall fair market value of the real property between the upper and lower floors, with only the upper portion’s allocation of value being subject to section 2036(a). If the Second Circuit’s required fraction is to be applied only to the value of that portion, it seems illogical to take the imputed rental value of the lower floors into account in determining the decedent’s retained portion of the upstairs. Alternatively, the appeals court may have been envisioning application of a fraction to the overall value of the entire building, in which case consideration of the imputed income from the lower floors would be more appropriate for purposes of deriving the fraction.

For example, assume that the upper floors had an FMV of $2 million, that the lower floors had an FMV of $3 million, that the fair rental value of the top floors was $9,000 a month, and that the fair rental value of the lower floors was $12,000 a month. One way of complying with the Second Circuit’s mandate would be to focus only on the $2 million of value attributable to the top floors. The decedent kept all the income from that portion of the building, gross and net, and so one might think that a 49 percent interest in the top floors would be includable under section 2036(a), with the other 51 percent of the top floors being included under section 2033. As for the downstairs, only section 2033 inclusion of the decedent’s 51 percent interest would be permissible. For ease of reference, one can label this method — physical apportionment of the fee by floors — as Method 1.

However, the Second Circuit’s insistence on consideration of imputed income from the bottom floors suggests that the threshold apportionment just made between the overall values of the upstairs and downstairs should not have been made. Instead, one should derive a fraction that would apply to a partial interest in an underlying property worth $5 million. A derivation of that fraction might be found in Table A.

For ease of reference, one can refer to this method — apportionment of the actual and imputed income from overall fee — as Method 2. In this approach, the actual rent from the upstairs floors would be the initial line item. Apparently, the tenant in the actual case did not make all of its required rent payments.

As mentioned earlier, the majority’s insistence on consideration of imputed income from the son’s use of the lower floors certainly seems misguided if the percentage derived from the calculation is supposed to be applied just to the rental floors. It may even be open to question as applied to the overall property. Section 2036(a) uses the terms “income” and “possession or enjoyment” in the alternative, indicating that Congress considers them two different attributes of property. The imputed income approach monetizes possession or enjoyment and then lumps it in with cash income, in seeming contradiction of the congressional vision.

Moreover, although the regulations under section 2036(a) contemplate only partial inclusion when a decedent retains “an interest or right with respect to a part only of the property transferred by him,”31 the type of income retention at play in Stewart may not be the sort of partial retention to which the regulation refers. In a case in which a decedent retains a specified percentage or fraction of the income from property, inclusion of only a “corresponding portion” of the property under section 2036(a) is appropriate. But in circumstances such as those in Stewart, with expenses being covered by the two cotenants in a haphazard fashion with no fraction or percentage to guide the sharing, it is debatable whether the estate can establish that the income “from a part only of the property” was retained. In an analogous setting involving spousal trusts and the marital deduction, Congress and the IRS have indicated that just because a dollar amount of income is less than all of the income from a specific asset, it does not necessarily constitute the income from a “specific portion” of that property.32

A potentially more serious problem with economic apportionment is its complexity. How Method 2 would be applied in a case in which the decedent lived for a long time after creation of the tenancy in common would be anyone’s guess. Would one use average annual figures for the many years in which the tenancy in common lasted? Only

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<tr>
<th>Item</th>
<th>Mother</th>
<th>Son</th>
<th>Total</th>
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<tbody>
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<td>Seven months’ upstairs rent at $9,000/mo</td>
<td>$63,000</td>
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<tr>
<td>Imputed income from seven months’</td>
<td>$42,000</td>
<td>$42,000</td>
<td>$84,000</td>
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<tr>
<td>occupancy at $6,000/month each</td>
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<td>Less expenses ($21,791)</td>
<td>($1,963)</td>
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<td>Net income</td>
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<td>$123,246</td>
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<tr>
<td>Percentage of net income</td>
<td>67.51</td>
<td>32.49</td>
<td>100</td>
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<tr>
<td>Less interest actually owned</td>
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<td>(49)</td>
<td></td>
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<tr>
<td>Percentage of overall property to be</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>included under section 2036(a)</td>
<td>16.51</td>
<td>0</td>
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</tr>
</tbody>
</table>

31Reg. section 20.2036-1(c)(1)(i) (second sentence).
32See section 2056(b)(10); reg. section 20.2056(b)-5(c).
the largest annual figures from the period? Total amounts over the entire period? Only the figures most in the government’s favor, because the taxpayer ordinarily bears the burden of proof?

A third possible approach to the economic apportionment mandate — call it Method 3 — would be to treat the net income enjoyed by the decedent as akin to an annuity, and to determine how much “corpus” it would take to generate that annuity indefinitely. This is the approach taken under section 2036(a) when the grantor of a trust retains a fixed annuity payment right that does not in fact end before his death. Those cases often result in less than the full corpus of the trust being included in the gross estate.33

In the current example, using the hypothetical cash and imputed income combined, the decedent was enjoying $83,209 of periodic net income when her 51 percent share as tenant in common would have been only $62,855 ($123,246 times 51 percent). Thus, the portion of her son’s income that she retained was $20,354. Assuming an applicable rate under section 7520 of 7.2 percent (which is the rate actually in effect at her death), the amount needed to generate net income of $20,354 indefinitely would be a mere $282,694. No discount would be available for this amount,34 but it would be a considerably smaller inclusion under section 2036(a) than under either Method 1 or Method 2.

Here again, however, complexity rears its ugly head. Because the sharing of the income and expenses between mother and son was determined on the fly, selecting the appropriate dollar figures to be plugged into the calculations would be far more problematic — perhaps impossible so — if the decedent had lived a much longer life and operating results varied from year to year.

33See Rev. Rul. 82-105, 1982-1 C.B. 133; Estate of Pardee v. Commissioner, 49 T.C. 140, 150 (1967) (acq.) (inclusion under section 2036(a); fixed amount could be spent each month to discharge decedent’s support obligations); Estate of Sullivan v. Commissioner, T.C. Memo. 1993-531, Doc 93-11823, 93 TNT 236-11 (to same effect, based on estimate of needs of decedent’s spouse); United States Nat’l Bank v. United States, 188 F. Supp. 332, 339-340 (D. Ore. 1960) (section 2036 case; decedent was entitled to monthly payments of fixed amount for life); see also Northeastern Pa. Nat’l Bank v. United States, 387 U.S. 213, 224-225 (1967) (6-3 decision) (valuation of spousal annuity interest for purposes of old version of estate tax marital deduction under section 2056(b)(5)).

34Similarly, no discount is allowed in valuing successive interests, such as life estates and remainders, in the present-value-based valuations of such interests using the tables prescribed by section 7520. When those tables apply, the values of the various time-divided interests in a particular asset add up to the value of the underlying asset itself. See, e.g., reg. sections 20.2051-7T(d)(2)(ii) (penultimate sentence) and 25.2512-5T(d)(2)(ii) (penultimate sentence).

35See Estate of Fontana v. Commissioner, 118 T.C. 318 (2002), Doc 2002-7744, 2002 TNT 61-11 (block of stock included in gross estate under section 2033 aggregated for valuation purposes with block of same stock included under section 2041); Estate of Babbitt v. Commissioner, 87 T.C. 1270, 1277 (1986) (undivided interests includable under section 2035 and former section 2035 held, value of entire property was includable); Estate of Adler v. Commissioner, T.C. Memo. 2011-28, Doc 2011-2166, 2011 TNT 21-10 (no discounts for undivided one-fifth interests transferred to decedent’s children during his lifetime, where decedent retained possession and enjoyment of property until his death, triggering section 2036 inclusion); Rev. Rul. 79-7, 1979-1 C.B. 294 (closely held stock includable under section 2033 and former section 2035); LTR 9403002, 94 TNT 15-17 (closely held stock, sections 2033, 2038); TAM 9146002 (undivided interests in residence, sections 2036, 2035(d)(2), 2038), TAM 9140002 (undivided interests in real estate, sections 2033, 2044); TAM 8330004 (options to purchase closely held stock, sections 2033, 2041). But cf. Estate of Bonner v. United States, 84 F.3d 196 (5th Cir. 1996), Doc 96-16744, 96 TNT 111-13 (per curiam) (for valuation purposes, no aggregation of qualified terminable interest property included under section 2044 with surviving spouse’s own assets); Estate of Mellinger v. Commissioner, 112 T.C. 26 (1999), Doc 1999-3887, 1999 TNT 17-5 (acq.) (following Bonner); Estate of Lopes v. Commissioner, T.C. Memo. 1999-225, Doc 1999-23452, 1999 TNT 131-8 (same); Estate of Nowell v. Commissioner, T.C. Memo. 1999-15, Doc 1999-3888, 1999 TNT 17-7 (same).


3. Legal apportionment. The last type of apportionment to be considered is the legal division of the property into undivided tenancy-in-common interests, 49 percent transferred and 51 percent retained. The Second Circuit’s holding accepted this division, treating the cotenants’ interests as separate for purposes of the estate and gift taxes. Both the decedent’s lifetime transfer and the change of ownership brought about by her death were treated as transfers of undivided interests, making both susceptible to valuation discounts. In contrast, by including the 49 percent interest in the gross estate, the Tax Court negated the discounts. Property in the gross estate is generally aggregated for valuation purposes,35 and thus under the Tax Court’s view, the 51 percent included under section 2033 was merged with the 49 percent included under section 2036(a) and valued as outright ownership of the entire fee interest in the brownstone.

B. Discounts on Remand

What will become of the estate’s valuation discounts on remand? Some commentators assume that the 42.5 percent discount to which the parties stipulated will be applied to all of the interests in the property that wind up in the decedent’s gross estate.36 That happy result for the taxpayer, however, does not seem guaranteed.
First, the Second Circuit itself appeared to leave open the possibility that the IRS may back out of the stipulation now that the appeals court’s views of the case are known. "We express no view whether the 42.5 percent discount is a correct figure, or whether on remand the Government remains bound by its stipulation," the appeals court majority said in a footnote.37 Having held entirely for the IRS in its original opinion, and having received a seemingly new legal standard from the appellate tribunal, perhaps the Tax Court will be amenable to withdrawal of the stipulation in the second go-round.38

Moreover, depending on how the Tax Court performs the economic apportionment calculation discussed earlier, it may turn out that discounts apply only to the residential portion of the property. For example, assume that the Tax Court uses Method 1. In that case, the upstairs portion of the house would wind up in the gross estate in its entirety: 51 percent under section 2033 and 49 percent under section 2036(a). Under that characterization, the entire rental portion would be included, with no discount for undivided interests. Assuming as in the preceding example that the upstairs had an FMV of $2 million and the downstairs an FMV of $3 million, only the downstairs living space would be subject to a discount; the $2 million for the upper floors would be included in the gross estate without diminution for the legal division of the property. In other words, while the legal apportionment (undivided interests) results in discounts, the physical apportionment (upstairs and downstairs) may not.

Assuming a 42.5 percent discount on the downstairs portion, the overall amount included in the gross estate would be $2,879,750, computed as follows:

<table>
<thead>
<tr>
<th>Table B</th>
<th>Value</th>
<th>Upstairs</th>
<th>Downstairs</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base value</td>
<td>$2 million</td>
<td>$3 million</td>
<td>$5 million</td>
<td></td>
</tr>
<tr>
<td>Percentage included</td>
<td>100%</td>
<td>51%</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Pro rata value</td>
<td>$2 million</td>
<td>$1,530,000</td>
<td>$3,530,000</td>
<td></td>
</tr>
<tr>
<td>Discount at 42.5%</td>
<td>Not applicable</td>
<td>($650,250)</td>
<td>($650,250)</td>
<td></td>
</tr>
<tr>
<td>Amount included in gross estate</td>
<td>$2 million</td>
<td>$879,750</td>
<td>$2,879,750</td>
<td></td>
</tr>
</tbody>
</table>

Note that the discount’s inapplicability to the upstairs would result in an increase to the gross estate of 42.5 percent of 51 percent of $2 million, or $433,500. Viewed a slightly different way, the $650,250 discount would be only 18.42 percent of the total pro rata value of the combined interests included in the gross estate.

The IRS might seek to defeat or diminish the discount even if an economic apportionment is employed along the lines of Method 2. Recall that in that income-focused approach, a percentage was derived that would be applied to the overall value of the entire property. Because the value of the overall property is the base, it is not certain that the product of the percentage and the overall value should then be discounted to reflect undivided interests. For example, having decided that the proper inclusion percentages were as determined earlier, the Tax Court might apply them to the full FMV of the brownstone, without additional discounts, on the ground that the income approach is akin to the annuity calculation in Method 3, which does not allow for discounts. The result would be as follows:

<table>
<thead>
<tr>
<th>Table C</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage actually owned, included under section 2033</td>
<td>51%</td>
<td></td>
</tr>
<tr>
<td>Percentage of overall property included under section 2036(a)</td>
<td>16.51%</td>
<td></td>
</tr>
<tr>
<td>Total percentage included in gross estate</td>
<td>67.51%</td>
<td></td>
</tr>
<tr>
<td>Base value of brownstone</td>
<td>$5 million</td>
<td></td>
</tr>
<tr>
<td>Amount included in gross estate</td>
<td>$3,375,500</td>
<td></td>
</tr>
</tbody>
</table>

On the other hand, although Method 2 applies a single percentage to the overall value of the brownstone, perhaps the Tax Court could be persuaded to allow a discount against the resulting figure on the ground that less than the entire property is being included in the gross estate. Whether the 42.5 percent discount stipulated on account of the legal apportionment (undivided interests) truly represents the appropriate discount for the economic apportionment (income), however, would be open to serious question.

In any event, for the sake of illustration, if the 42.5 percent discount were allowed from the $3,375,500 result reached, the discount would amount to $1,434,588, and the total amount included in the gross estate under sections 2033 and 2036 would be $1,940,912 — a considerably better result for the estate than under Method 1.

Finally, Method 3 would treat the decedent as retaining for section 2036(a) purposes only the amount of corpus needed to generate the hypothetical annuity that she was drawing from the son’s interest. That would be added to the amount included in her gross estate under section 2033 on
account of her own 51 percent undivided interest in the brownstone. It seems appropriate to allow a discount for the decedent’s own 51 percent interest under this method, since the apportionment approach respects the legal division of the property into tenancy-in-common interests. As to the section 2036(a) inclusion of a portion of the son’s share of the property, however, in keeping with the precedents from which the annuity approach is drawn, no discount would be permitted. The result would be as follows:

| Table D |
|-------------------|------------------|
| Amount included under section 2036(a) | $282,694 |
| Pro rata value of 51% interest included under section 2033 ($5 million times .51) | $2,550,000 |
| Less discount on 51% interest at 42.5% | ($1,083,750) |
| Total amount included in gross estate | $1,748,944 |

Summing up all the approaches and comparing them with the estate’s originally desired outcome in Stewart, one reaches the following array of outcomes:

| Table E |
|-------------------|------------------|
| Method | Total Amount Included in Gross Estate |
| Method 1 (partial discount) | $2,879,750 |
| Method 2 (with no discount) | $3,375,500 |
| Method 2 (with full discount) | $1,940,912 |
| Method 3 (partial discount) | $1,748,944 |
| Taxpayer at trial ($5 million x 0.51 x 0.575) | $1,466,250 |

As can be seen, although the Second Circuit’s decision is a significant victory for the taxpayer (the IRS and the Tax Court would have included $5 million in the gross estate), it is likely not a total victory. And the remand could result in widely varying results, depending on the details of the apportionment method selected.

C. The Hamptons Property

As if the uncertainty of its apportionment holding were not trouble enough, the Second Circuit majority also left open whether the pair’s treatment of the Hamptons property should play a role in the section 2036(a) calculus. The appeals court said that the issue “may be worth considering on remand.” Given the brevity of the Tax Court’s original opinion in the case, it seems to be the last thing on earth that the trial judge would want to do.

What should the Tax Court think about in making that determination? As discussed earlier, the circuit court posed two hypotheticals, which it saw as being at opposite extremes. The first, in which the court thought that consideration of the Hamptons property would be relevant to the Manhattan property, was:

Brandon and Decedent had formally split the rental income and costs of the Manhattan property 51 percent-49 percent but Brandon had allowed Decedent to take a portion of what should have been Brandon’s net income from the East Hampton property, and that amount equaled the income Brandon was entitled to from his 49 percent share of the Manhattan property.10

Is there any chance that the facts of Stewart fit this fact pattern? They might, if the extra income (above his share) that Brandon kept from the Hamptons property “equaled” the extra income (above her share) that the decedent kept from the Manhattan property. Without knowing the amount of rental income derived from the Hamptons property, which neither court opinion supplied, it is impossible to make this call. But another important unanswered question is whether the Second Circuit is referring to exact equality, or something close to exactly equal. In any event, barring extraordinary, heretofore undisclosed agreements between mother and son, any equivalence in the two amounts would seem completely serendipitous.

The other extreme scenario, which seems clearly inapplicable, was: “Brandon and Decedent had jointly owned hundreds of other properties and there was no particular reason to think that the distribution of income from those properties was in any way related to the substantial economic benefit of the disputed property.” The brownstone and the Hamptons property appear to have been the only co-owned parcels that the pair had. Thus, the easiest case for keeping the properties separate in the estate tax analysis was not present. Nonetheless, it seems likely that on remand the Hamptons property will turn out to be irrelevant.

D. Effect on FLP Jurisprudence

Although the facts of Stewart may not be commonplace, the Second Circuit opinion may be significant in future application of section 2036(a) to a frequently used discount planning device: FLPs. In recent years, section 2036(a) has been the IRS’s most potent weapon for negating the valuation discounts that FLPs and similar family investment entities are designed to generate. In many, if not most, of the cases in which the Tax Court has held that section

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39 Estate of Stewart, 617 F.3d at 161.

40 Id. at 161.

41 Id.
2036(a) drew back into the gross estate the assets that a decedent had transferred during her lifetime to the FLP, the Tax Court has noted that the decedent’s “relationship to” the transferred assets “did not change” between the time of their contribution to the FLP and the decedent’s death.\footnote{See generally John A. Bogdanski, Federal Tax Valuation, paras. 4.03[4][c][viii]-[xii] (1996 and supps.).}

That is the same language the Tax Court used in Stewart, and indeed, as Judge Livingston’s dissent stressed, the facts of Stewart strongly supported that characterization. After the gift to her son, the decedent lived in the brownstone just as she did before, and she kept all the rent from the brownstone just as she did before. The only thing different that occurred following the gift was that the son paid some of the expenses attributable to the brownstone, in effect \textit{increasing} the decedent’s beneficial enjoyment of the property. Despite these damming facts, the Second Circuit majority held that not all of the brownstone should be included in the decedent’s gross estate. Under the same rationale, not all of the assets a decedent transferred to an FLP might properly be includable in the gross estate under section 2036(a).

\textbf{VI. Conclusion}

Exploring the Second Circuit’s decision in Stewart is not unlike peeling an onion. In addition to the physical apportionment issue on which the majority and the dissent faced off, the court raised many questions that the parties and the Tax Court must address on remand. Although out-of-court settlement of these issues would doubtlessly be welcomed by the trial judge, observers of the valuation scene will likely be rooting for another judicial opinion — or two.