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Second Circuit Finds No Code §2036 Inclusion of Residence in Decedent's Estate

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Estate of Stewart is a new Second Circuit opinion addressing the application of Code §2036 to a situation where a decedent transferred a principal residence but continued to live in it.

In *Stewart*, the decedent owned a Manhattan brownstone. She and her adult son occupied the first two floors and leased the top three floors to a commercial tenant. In late 1999, the decedent was diagnosed with pancreatic cancer and saw an estate planning attorney. In May, 2000, she gifted a 49% interest in the Manhattan brownstone to her son. The decedent died in November, 2000, and the estate reported a 51% interest in the brownstone on the 706.

The IRS issued a notice of deficiency, claiming that 100% of the property was includible under Code §2036 because the decedent had continued to use and enjoy the property until her death. Code §2036 causes estate inclusion for any property to the extent of any interest of which the decedent made a transfer but retained for his or her life, the possession or enjoyment of, or the right to the income from, the property.

The Tax Court agreed with the IRS and found that the decedent and her son had an implied agreement as to her continued use and enjoyment of the property, making it 100% includible in her estate. However, the Second Circuit disagreed. As to the residential portion of the property,

the Second Circuit held that the decedent did not retain the exclusive use of the residence, nor did she withhold possession from the donee. Therefore, the gift should be respected. As to the commercial portion of the property, the Second Circuit remanded the case for the Tax Court to determine specifically to what extent the decedent retained an interest. Under the facts of the case and the holding of Revenue Ruling 79-109, the Tax Court could find a specific portion of the property (eg, half of the 49% gifted) to be includible.

What are the lessons of this case for estate planners and their clients?

1. If a donor makes a gift of a residence to children or others but continues to live in the residence, pay all expenses or does not change his or her relationship to the property in any way, the gift almost certainly will not be respected for tax purposes and the full value of the property will be includible in the donor's estate.

2. When the donee is a co-tenant with the donor, as was the case in *Stewart*, the chances are better that the gift will be respected for tax purposes. The legal and financial arrangement between the parties should be fully documented.

3. It is interesting to note that the parties in this case stipulated to a 42.5% discount for lack of control and lack of marketability.

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