Tax Dangers in Estates By the Entirety

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TAX DANGERS IN ESTATES BY THE ENTIRETY

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One of the favorite methods of acquiring title to real and personal property in Florida and certain other states is by use of the estate by the entirety where title is conveyed to a husband and wife jointly with right of survivorship. While this might be convenient from the common law standpoint, it often results disastrously as far as taxation is concerned. It is the purpose of this article to warn the general practitioner of the tax consequences of estates by the entirety.

The Supreme Court of Florida has defined an estate by the entirety as an estate held by husband and wife together as long as both live, and, after the death of either, by the survivor as long as the estate lasts.[1] At common law when land was conveyed to both husband and wife an estate by the entirety was created, neither could convey without the other; neither could devise the property, and upon the death of one the entire estate went to the survivor. This common law doctrine is still in force in Florida.[2]

For many years there was a statute stating that the right of survivorship in cases of real and personal property held by joint tenants should not prevail in Florida,[3] but the cases set forth in notes 1 and 2 and other decisions in effect held that the estate by the entirety was legal in Florida in spite of this statute. In 1941 this law was amended, and it now provides that the doctrine of the right of survivorship in cases of property held by joint tenants shall not prevail and that, except in cases of

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1 Bailey v. Smith, 89 Fla. 303, 103 So. 833 (1925).

2 English v. English, 66 Fla. 427, 63 So. 822 (1913).

3 Sec. 5482 C.G.L. (1927).

estates by the entirety, a transfer to two or more shall create a tenancy in common unless the instrument creating the estate shall expressly provide for the right of survivorship.[4] We may now have joint tenancies in Florida where the tenants are not husband and wife, if the instrument creating the tenancy provides for a right of survivorship, and we may still have estates by the entirety where property is conveyed to husband and wife.

A tenancy in common may be created by a conveyance to husband and wife which manifests an intent that they shall hold in this manner.[5] The Supreme Court of Florida by strong dicta has indicated in several cases that it will follow this rule.[6] Therefore if a deed should convey a one-half interest to the husband and a one-half interest to the wife and should clearly show that it was intended not to create an estate by the entirety or a joint tenancy, then the husband and wife would be tenants in common with no right of survivorship.

The obvious advantages of an estate by the entirety are that the property cannot be charged with the separate debts of either spouse,[7] and that no administration or probate proceedings are necessary upon the death of the first spouse to die since property held as an estate by the entirety is not subject to devise but belongs to the surviving spouse.[8] These advantages, namely, freedom from debt and freedom from administration or probate, have led many general practitioners of the law to advise their clients repeatedly for many years that an estate by the entirety is the most practical method in which to hold title to real and personal property. Unfortunately such advice has cost clients thousands of dollars in federal taxes. From the standpoint of taxation, estates by the entirety

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4 Sec. 689.15, Fla. Stat. 1941.

5 4 Thompson on Real Property, Sec. 1810 (Perm. Ed. 1939); 2 Tiffany, Real Property, Sec. 431 (3rd Ed. 1939); Hunt v. Blackburn, 128 U.S. 464 (1888).

6 Matthews v. McCain, 125 Fla. 840, 170 So. 323 (1936); Dixon v. Becker, 134 Fla. 547, 184 So. 114 (1938); Bailey v. Smith, 89 Fla. 303, 103 So. 833 (1925).

7 Ohio Butterine Co. v. Hargrave, 79 Fla. 458, 84 So. 376 (1920). However, in Stanley v. Powers, 123 Fla. 359, 166 So. 843 (1936), it was held that a judgment obtained in a tort action against a husband and wife jointly is a lien against property held by them by entireties.

8 Bailey v. Smith, 89 Fla. 303, 103 So. 833 (1925).

should very seldom be used.

INCOME TAX ON RE-SALE BY SURVIVOR

Assume that A purchased a vacant lot for $20,000 in 1934, taking title in his own name. He died in 1946 leaving a will in which he devised the lot to his wife, B, and the fair market value of the property at the date of A's death was $45,000. If B sold it for $50,000 six months after receiving it from A's estate, the cost basis to B for income tax purposes would be the fair market value at the time of A's death or the sum of $45,000. This is true because the Internal Revenue Code[9] and the Regulations[10] provide that if property is acquired by bequest, devise or inheritance, the cost basis is ordinarily the value at the time of death.[11] In this example the capital gain would be the difference between the sale price of $50,000 and the cost basis of $45,000 or the sum of $5,000, and, since the maximum income tax on a long term capital gain is 25% of the gain,[12] the maximum income tax would be $1,250.

Now assume that A paid the same amount of $20,000 for the same lot in the same year 1934, but that the seller conveyed the title to A and B, his wife, as an estate by the entirety. If A died in the same year 1946 when the fair market value of the property was the same amount of $45,000, and if B survived A and sold the property six months after A's death for the same price of $50,000, the cost basis to B would be $20,000 (the original cost when the property was acquired as an estate by the entirety). This would be so because B did not receive the property by inheritance and consequently the cost basis for income tax purposes would be the original cost, according to a decision of the United States Supreme Court in the case of Lang v. Commissioner.[13] In this example

9 Sec. 113(a) (5) I.R.C.

10 Reg. 111, Sec. 19.113(a)(5)-1.

11 Under the section of the Code and the Regulations set forth in the last two footnotes, if the executor chooses the optional valuation date for estate taxes under Sec. 811(j)I.R.C., the cost basis for such property is the value one year after death or the value at any earlier date on which the property was sold, exchanged or distributed.

12 Under Sec. 117(b) I.R.C. only 50% of the gain would be recognized, and under Sec. 117(c)(2) I.R.C. the alternative tax would be 50% of the gain.

13 289 U.S. 109 (1933).

the capital gain would be the difference between the sale price of $50,000 and the cost basis of $20,000, or the sum of $30,000, and the maximum income tax on the long term capital gain is 25% of the gain, or $7,500 in this case. This would be true whether the consideration for the property had been furnished by the husband or the wife, or both of them.

If A had caused the title to be conveyed one-half to himself and one-half to his wife B, as tenants in common, and if A had died leaving a will devising this one-half interest in said lot to B, and if all of the other facts were the same as those in the last example, the cost basis to B would be the original cost of the one-half interest conveyed to her or the sum of $10,000 (½ of $20,000), plus the fair market value at the time of A's death of the one-half interest devised to B, or the sum of $22,500 (½ of $45,000), making a total cost of $32,500. Since the sale price after six months was $50,000, there would be a long term capital gain of $17,500 and a maximum income tax of $4,375 on the sale.

In the first example where title was taken in the husband's name alone, the income tax on the sale would be $1,250, in the second example where title was taken in the name of husband and wife as an estate by the entirety the income tax on the sale would be $7,500, and in the third example where title was taken one-half in the name of the husband and one-half in the name of the wife as tenants in common, the income tax on the sale would be $4,375. The examples given above deal with vacant property merely for convenience and in order to avoid the necessity of computing the adjusted cost basis by taking into consideration depreciation[14] and other items. However, the principle involved applies to improved

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[14] Since Sec. 114(a) I.R.C. states that the basis for depreciation shall be the adjusted basis provided in Sec. 113(b) I.R.C. for the purpose of determining the gain upon a sale, if A owns property in his own name and devises it to his wife the cost to the wife is ordinarily the value at the time of A's death, and the wife can start taking depreciation at a new rate just as though she had purchased the property. If the property is held as an estate by the entirety the wife does not take a new cost basis under the Lang case, *supra*, and the property might be almost fully depreciated so that there would be a very low rate of depreciation in the future.

as well as unimproved property, and to personal as well as real property.

TWO ESTATE TAXES WITHIN FIVE YEARS

If A should purchase a parcel of property in his own name and should die leaving a will in which the property is devised to his wife, and if four years laters the wife should die leaving a will devising the same property to her son, the property is not taxed twice for estate tax purposes. The Internal Revenue Code[15] permits a deduction from the gross estate for property which has been subjected to an estate tax within five years prior to the decedent's death where the property can be identified as having been received from the prior decedent by bequest, devise or inheritance, the entire value of the prior taxed property not being deductible but only that portion which remains after allocating against it its pro rata share of the exemption and other deductions in the first estate. The reason for this Estate Tax Rule is to prevent the same property from being taxed more than once within a period of five years.

Suppose that title is conveyed to A and his wife B as an estate by the entirety and A dies, and within four years after his death B dies leaving a will devising the property to her son. There is an estate tax on the property in A's estate calculated in the manner set forth later in this article. Is there another estate tax based on this same property in B's estate? In the year 1932 the Circuit Court of Appeals of the Seventh Circuit, in the case of Commissioner v. Fletcher Savings & Trust Co.,[16] held that where there was an estate by the entirety the surviving spouse took by inheritance and that consequently the property should not be subjected to two estate taxes within a period of five years. However, the Supreme Court in the case of Lang v. Commissioner[17] in the following year decided that where there is an estate by the entirety the surviving spouse does not take by inheritance,

15 Sec. 812(c) I.R.C.

16 59 F.(2d) 508 (C.C.A. 7th 1932).

17 See Note 13.

and it would appear that the Lang case, in effect, might have overruled the Fletcher Savings & Trust Co. case, although there is a Regulation in force which seems to follow the Fletcher Savings & Trust Co. case.[18] It is therefore seen that if property is acquired as an estate by the entirety it may possibly be subjected to more than one estate tax within a period of five years (or at least there is danger that it will be until the point is definitely decided), while this would not be true if the property had been acquired in the name of one spouse alone.

If property is conveyed to A and his wife B, as tenants in common, and if A died devising his one-half interest to B, and if B died four years later devising to her son the one-half interest which A devised to her, this one-half interest would not be subjected to two estate taxes because B received it from A by devise. So here again in the matter of estate taxes on property taxed in a prior estate within five years, there might be a decided disadvantage in an estate by the entirety.

AMOUNT INCLUDED IN TAXABLE ESTATE

If property is held as an estate by the entirety and one spouse should die, the property might not be considered a part of the deceased spouse's estate for the purposes of administration under the laws of Florida, but it may be a part of the taxable estate for estate tax purposes. The Internal Revenue Code[19] provides, in effect, that there shall be included in the gross estate property to the extent of the interest therein held as tenants by the entirety by the decedent and spouse, except to the extent that the consideration is shown to have been furnished by the surviving spouse. The same rule applies to joint tenancies. In United States v. Jacobs[20] two cases were involved. In one case real estate in Illinois was conveyed to husband and wife as joint tenants, the wife contributed no part of the consideration, and the husband died. In the other case a joint tenancy in personal property was created by a man and his wife, a portion of the joint property was contributed to the tenancy by the wife, but the property which the wife transferred to the joint tenancy had been previously given to the wife by the husband, and the

[18] Reg. 105, Sec. 81.41(a), as Amended by T.D. 5239 and T.D. 5408.
[19] Sec. 811(e) I.R.C.
[20] 306 U.S. 363 (1939).

husband died. In both cases the entire value of the property was included in the gross estate.

It is therefore seen that if title to property is acquired individually, or if the same property is acquired as an estate by the entirety for the same price, the husband furnishing all of the consideration, the result is exactly the same for the purpose of determining the amount of the gross estate of the husband for estate tax purposes. Nothing is therefore to be gained in this respect by the use of an estate by the entirety. However, if title to the property should be transferred to the husband and the wife as tenants in common, and if the husband died, then there would be included in the husband's gross estate only one-half of the value of the property even though the wife furnished no part of the consideration. This is true because the rule set forth in Sec. 811(e) I.R.C. and in the Jacobs case, supra, applies only to joint tenancies and tenancies by the entirety and not to tenancies in common. Therefore the gross taxable estate can be minimized by the acquisition of the title by the husband and wife as tenants in common.

It has been stated that when one of the tenants by the entirety dies, it is not necessary to have administration or probate proceedings in order for the survivor to become vested with the complete title. For practical purposes this does not mean that the property can be sold immediately after the death of one of the spouses. If one of the tenants by the entirety should die owning other substantial assets, administration or probate proceedings will be necessary. It is incumbent upon his executor or administrator to obtain a complete discharge from estate tax liability or a release of all the property from the lien of estate taxes, both federal and state. The entire value of the property held as an estate by the entirety is included in the gross taxable estate of the spouse first dying if the other spouse furnished no part of the consideration although the property is not, under the state law, subject to being administered. Even if the surviving spouse furnished part of the consideration a portion of the value of the property held as an estate by the entirety is included in the gross taxable estate of the spouse who dies first. Under these circumstances the property originally held as an estate by the entirety cannot generally be released from the lien of estate taxes until an estate tax return has been filed including therein all property included in the gross taxable estate. Therefore in estates of any size no time and very little trouble is saved by the use of tenancies by the entirety. There may, however, be some savings in executor's fees and commissions. Freedom from administration in the case of an estate by the entirety also means a corresponding lack of freedom to dispose of property freely by will and is therefore not an unmixed blessing.

INCOME TAX ON RENTS

If the property produces rent it is obviously desirable for tax purposes to have the ordinary income represented by the rent divided between the husband and the wife instead of having the entire amount taxed to the husband. It would appear that the same result is accomplished in this respect whether the property is conveyed to the husband and wife as tenants in common or as tenants by the entirety. In either event one-half of the rent would probably constitute income to the husband and the remaining one-half, income to the wife.[21] If the property is likely to produce substantial revenue, the use of a tenancy in common is preferable to having the title vested in one spouse for income tax purposes. For estate tax purposes and for the purposes of income tax on the resale of property after the death of one spouse, a tenancy in common generally has distinct advantages over one by the entirety, as previously illustrated.

THE GIFT TAX

If either a husband or a wife pays the purchase price for property and title is conveyed to both husband and

[21] The income of property owned one-half by the husband and one-half by the wife as a tenancy in common should on principle be equally divided between the spouses for tax purposes, since each owns an undivided one-half interest therein. The Treasury has ruled that in Florida the income of property held as an estate by the entirety is considered income to the spouses equally. See I.T. 3235, Cum. Bull. 1938-2 page 160, and also the case of Edwin F. Sandberg, 8 T.C. No. 52 which arose in Oregon. In E. M. Godson, P-H 1946 TC Mem. Dec. Serv. Par. 46182 (TC 1946), the Tax Court did not follow this Treasury ruling where Florida real estate was owned by the husband's corporation, an advantageous lease was negotiated and the title was juggled around, being conveyed to the husband, then to his attorney, and then by unrecorded deed to the husband and wife as an estate by the entirety. Nothing herein is intended to apply to family partnerships operating a business.

wife as an estate by the entirety, this constitutes a gift from the spouse who furnishes the consideration. The value of the gift, according to the Regulations,[22] is "the value of such property less the value of the right, if any, of the donor spouse to the income or other enjoyment of the property or share thereof, during the joint lives of the spouses, and the value of the right of the donor spouse to the whole of the property should he or she be the survivor of them. The value of each of such rights is to be determined in accordance with the Actuaries' or Combined Experience Table of Mortality, as extended." In one case[23] the Board of Tax Appeals originally held that no gift tax is payable by the donor spouse on the creation of an estate by the entirety, but this case was reversed.[24] If title is taken by husband and wife as tenants in common, and if the husband pays the purchase price, then the husband has made the wife a gift equal to the value of the property at the date of the gift,[25] which would presumably be an amount equal to one-half the purchase price of the property.

Whether the gift tax would be greater in case of a tenancy by the entirety or a tenancy in common where the husband pays the purchase price, depends on the income of the property and the respective ages of the spouses. If the income is small, the husband old and the wife young, the gift tax would be greater, where the husband furnished the consideration, in the case of the estate by the entirety. In a great many cases there would be no gift tax at all because the first $3,000 of gifts made by a donor to any person during the calendar year is excluded,[26] and because there is a specific exemption of $30,000 in computing net taxable gifts.[27]

RECOMMENDATIONS

There is no general rule which will cover all cases in determining whether to acquire title in the name of one

22 Reg. 108, Sec. 86.19(h).

23 Commissioner v. Hart, 36 B.T.A. 1207 (1937).

24 Commissioner v. Hart, 106 F.(2d) 269 (C.C.A. 3rd 1939); See also Lilly v. Smith, 96 F.(2d) 341 (C.C.A. 7th 1938), Cert. Den. 305 U.S. 604; Gutman v. Commissioner, 41 B.T.A. 816 (1940).

25 Reg. 108, Sec. 86.17.

26 Sec. 1003 (b)(3) I.R.C.

27 Sec. 1004(a) (1) I.R.C.

spouse alone or of two spouses as tenants in common, or of two spouses as tenants by the entirety. No ready-made legal garment will fit all situations but special tailoring is required. If the property produces considerable revenue and the parties are persons of substantial means, it is probably desirable to take title in the husband and wife as tenants in common, in which event the income will be divided between the spouses equally while they are alive, only one-half of the value of the property will be in the gross taxable estate of the spouse first dying, there will be no double estate taxation of the one-half interest of the spouse first dying if the surviving spouse should die within five years, and on resale after the death of one spouse the cost basis of one-half of the property will be the value at the time of the death of the spouse first dying. However, if the parties are of very modest means and the property is of small value and has very little or no income, it might be best to take title in the name of the husband alone because then the cost basis on resale after the husband's death would be the value at the time of his death and there would be no estate tax; and this would be particularly true if the property involved in the last-mentioned situation happened to be a homestead because the property would then be exempt from levy for debts.[28] If a person has judgments against him or owes many obligations or is engaged in very speculative transactions, freedom from debt might be the first consideration and then an estate by the entirety would be the best means of protection, no matter what tax disadvantages might result.

Since this article is being written for the general practitioner and the law student and not for the tax expert, let us, at the risk of being repetitious, attempt to lay down a few guiding principles: (1) If the end sought to be accomplished is the saving of income tax on a sale after the death of one spouse, title should be taken in the name of one spouse alone because then the cost basis of the entire property would be the value at the time of the death of the spouse first dying, and to meet this situation the second best plan is to use a tenancy in common

28 Art. 10, Sec. 1, Fla. Constitution.

and a poor third would be the estate by the entirety; (2) If the goal sought for is minimizing the tax on the rent of the property while both spouses are alive and also minimizing the amount of the estate subject to estate taxes, without paying the maximum amount of income tax on the sale of the property after the death of one spouse, then a tenancy in common should be created; (3) If the greatest consideration is to save the property from claims of creditors, then by all means use the estate by the entirety, unless the property is a homestead, in which event practically the same result can be accomplished by taking title in the individual spouse who is the head of the family. These principles are based primarily on tax considerations. But there may be other important elements present. One man might not want his wife to have an interest in a particular parcel of property after his death, while another might want the property to be free from control by his children after his decease. Still a third man might desire the privilege of conveying the property during his lifetime without the consent of his wife, in which event title should be taken in the name of a corporation. The method of acquiring title should be dictated by the needs of each individual client.

In any event attorneys should no longer advise clients to use estates by the entirety in all purchases of property. Such advice is archaic in view of the principles of federal taxation which have just been discussed. The estate by the entirety might be the solution to the problems of some clients, but, as a general rule, it has outlived its usefulness. The tenancy in common should be used more frequently, particularly for clients of substantial means. There are still a number of cases where individual ownership is most satisfactory. A capable attorney can be of much service to his clients by recognizing these problems, studying them carefully, and giving proper advice as to the manner in which real estate should be acquired.