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Advantages of the *Gallenstein* Rule and How to Apply It

-by Neil E. Harl*

The advantages of the rule that has come to be known as the *Gallenstein* rule[1] are clear for many farm and ranch estates. That is almost a certainty for estates where real property was purchased after 1954 and before 1977 with title taken in joint tenancy or tenancy by the entirety (with that co-ownership maintained until the death of the first joint tenant to die), the joint tenant who was the first to die provided more than half of the consideration when the property was purchased and the mortgage, if any, was paid off and there would be an advantage in obtaining a higher basis at the death of the first joint tenant to die.[2]

However, recent discussions with some practitioners, including some who billed themselves as experts in farm and ranch estate and business planning, confirm that some are unfamiliar with the rule and reluctant to use the rule even where it would be advantageous to do so. This article discusses the rule and emphasizes how to apply the rule to an estate where the rule promises to be an advantage to the heirs in the form of a higher income tax basis for the property.

Facts of *Gallenstein*

The Gallensteins, husband and wife, purchased farmland in 1955 with title taken in joint tenancy. The evidence showed that Mr. Gallenstein provided all of the consideration for the purchase. Although it was possible for a gift to have been made to the non-contributing spouse, that was rarely done and was not done in the Gallenstein situation. Had Mr. Gallenstein died immediately following the purchase, the entire value of the property would have been included in his gross estate[3] and the entire property would have received a new income tax basis.[4] Under this "consideration furnished" rule, as described in publications by this author, joint tenancy property was (and still is for some situations as noted below) subjected to federal estate tax in the estate of the first to die *except to the extent it could be proved that the survivor contributed to its acquisition or contributed to the payment of debt secured by the property.*[5]

Mr. Gallenstein died in 1987. By that time, the federal estate tax treatment had been modified with amendments in years after 1976.[6] The revised rules governing the federal estate tax treatment of joint tenancy in real property went into effect for deaths after 1981.[7] Under those rules, which this author dubbed the "fractional share" rule, for property owned in joint tenancy (or tenancy by the entirety) by a husband and wife married to each other, for deaths after 1981 for federal estate tax purposes, half was included in the gross estate of the first to die and that half received a new income tax basis. It was immaterial, under that rule, as to who provided the consideration.

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In preparing the Form 706, the Gallenstein Estate reported the 1955 acquisition under the fractional share rule which they apparently thought was the proper reporting procedure. The result was that half of the value (which had increased substantially since 1955) was included in Mr. Gallenstein's gross estate and that half received a new basis. Some time later, Mrs. Gallenstein, by now the owner of the entire tract of land, received an offer for sale of the land, apparently for development, which she accepted. In reporting the gain on that sale, it was discovered that the one-half interest in the property included in Mr. Gallenstein's estate had received a new income tax basis at his death equal to fair market value, wiping out almost all of the gain *on his half of the property* but her half was not included in his gross estate and, thus, did not receive a new basis at his death. In filing the income tax returns for the sale of the real estate, Mrs. Gallenstein was advised that she had a substantial income tax liability on her half of the property (which did not receive a new income tax basis at Mr. Gallenstein's death). The income tax liability was a shock to Mrs. Gallenstein.

In family discussions with tax counsel after the income tax liability came to light, the family was advised to examine the "consideration furnished" rule which many thought had been repealed in 1976 as to husbands and wives (but not for other taxpayers) to see if there was any way to invoke the consideration furnished rule (which would cause inclusion of 100 percent of the value of the real property in Mr. Gallenstein's estate with 100 percent of the entire gain, not just the gain on one-half, wiped out. The law firm involved reported back that, from their research, it appeared that Congress did not repeal the consideration furnished rule for husbands and wives married to each other; Congress merely added another option – the "fractional share" rule. Therefore, since the estate was still within the time period for amendment of the Form 706, they promptly filed a revised Form 706 reporting the entire value in Mr. Gallenstein's estate with the entire property receiving a new basis at his death. Mrs. Gallenstein then proceeded to file amended income tax returns to reflect that outcome. The maneuver did not affect Mr. Gallenstein's federal estate tax liability inasmuch as the 100 percent federal estate tax marital deduction had become available for deaths after 1981.[8]

Mrs. Gallenstein's claim for refund of the federal income tax on the land sale was denied and action was taken in the United States District Court in the Eastern District of Kentucky which ruled in her favor. The case was appealed by the Internal Revenue Service to the Sixth Circuit Court of Appeals which affirmed the lower court decision.[9] Since that time, five more cases have been litigated,[10] all in favor of the taxpayer and none in favor of the Internal Revenue Service. The last case litigated, *Hahn v. Commissioner*,[11] was acquiesced in by IRS.[12] The *Hahn* case took the position that the "fractional share" rule did not apply to joint tenancy (and tenancy by the entirety interests in real property) after 1954 and before 1977 and the "*Gallenstein*" rule (which was essentially the original "consideration furnished" rule) *was mandatory* for real estate acquired after 1954 and before 1977. Moreover, the *Hahn* case provided "substantial authority" throughout the United States which meant that taxpayers in the states that had not had a case litigating the *Gallenstein* matter up to that point had authority to rely on the decision.

Relevance for estates

The question for estates where, at the death of the first joint tenant to die, real property was owned in joint tenancy or tenancy by the entirety) which had been acquired after 1955 and before 1977, and the death occurred after 1976, what rules govern? The answer, clearly, is that the "consideration furnished" rules at the time those rules governed husbands and wives owning joint tenancy or tenancy by the entirety property, apply. Thus, if as in *Gallenstein,* the husband died first, and the husband had provided all of the consideration, the entire value would be included in the gross estate and the entire value would receive a new basis.

If it could be proved that the husband (who was the first to die) had provided 75 percent of the consideration, for example, that percentage would apply to inclusion in the gross estate and also in determining the income tax basis after the death of the first of the spouses to die. That is well established in cases litigated over the years in which the consideration furnished rule was applied.

In conclusion

The *Gallenstein* decision does not apply in all instances but neither does any of the other estate planning tools. But in some instances it can deliver a significant advantage in terms of the income tax basis following the death of the first of a couple to die.

ENDNOTES

[1] Gallenstein v. United States, 975 F.2d 286 (6th Cir. 1992), *aff'g,* 91-2 U.S.Tax Cas. (CCH) ¶ 60,088 (E.D. Ky. 1991). See generally 5 Harl, *Agricultural Law* § 43.02[2][b][i] (2014); Harl, *Agricultural Law Manual* § 5.02[2] (2014); 1 Harl, *Farm Income Tax Manual* § 3.20[4][l][F][XV][CC] (2014 ed.).

[2] See Harl, "Taxing Joint Tenancy Property," 3 *Agric. L. Dig.* 181 (1992); Harl, "Basis for Joint Tenancy Property," 9 *Agric. L. Dig.* 49 (1998).

[3] I.R.C. § 2040(a).

[4] I.R.C. § 1014(a)(1).

[5] See note 1 *supra*.

[6] See 9 Harl, "Basis for Joint Tenancy Property," 9 *Agric. L. Dig*. 1998).

[7] I.R.C. § 2040(b). See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 403(c)(2), 95 Stat. 172, 302 (1981).

[8] I.R.C. § 2056(a).

[9] United States v. Gallenstein, 975 F.2d 286 (6th Cir. 1992).

[10] Patten v. United States, 96-1 U.S. Tax Cas. (CCH) ¶ 60,231 (W.D. Va. 1996), *aff'd*, 116 F.3d 1029 (4th Cir. 1997); Anderson v. United States, 96-2 U.S. Tax Cas. (CCH) ¶ 60,235 (D. Md. 1996); Baszto v. United States, 98-1 U.S. Tax Cas. (CCH) ¶ 60,305 (M.D. Fla. 1997); Hahn v. Comm'r, 110 T.C. 140 (1998), *acq*., 2001-2 C.B. 319, AOD CC-2001-06. See Wilburn v. United States, 97-2 U.S. Tax Cas. (CCH) ¶ 50,881 (D. Md. 1997) (tenancy by the entirety).

[11] 110 T.C. 140 (1998).

[12] 2001-2 C.B. 319, AOD CC-2001-66.