THE EFFECT OF GALLENSTEIN ON ELDER LAW PLANNING

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In planning for seniors, the ownership of the family residence is often a key issue. The decision in *Gallenstein v. Commissioner* and the cases that follow it will greatly affect the course our clients will take in their planning. In *Gallenstein*, the courts held that due to the changes enacted by the Tax Reform Act of 1976 (“TRA 76”) and the rules imposed by the Economic Recovery Act of 1981 (“ERTA 81”) for decedents dying after December 31, 1981, the law in effect prior to 1977 applied to joint tenancies between husband and wife. In order to understand the importance of the decision in *Gallenstein*, a brief review of the history of the applicable statutes is necessary.

Prior to 1976, Section 2040 of the Internal Revenue Code (“Code”) did not distinguish between spousal and non-spousal joint tenancies. It required that jointly owned property belonged in the estate of the first joint tenant to die unless the survivor could prove contribution. This is still the rule regarding joint tenancies other than spousal joint tenancies.

TRA 76, in an attempt to simplify the process added the concept of the Qualified Joint Interest for spousal joint tenancies. It provided that for estate tax purposes any joint tenancy or tenancy by the entirety created after December 31, 1976 was treated as owned 50% by each spouse. Therefore, there would be a 50% basis step-up available upon the death of the first spouse to die. Joint interests created before December 31, 1976 remained subject to the old rule.
In 1978 Section 2040 was again amended to allow for an election to treat pre-1977 joint tenancies as Qualified Joint Interests. This required an affirmative election on the part of the spouse providing the consideration for the real property. The typical case would require a spouse to file a gift tax return affirming the transfer to the spouse. Realize that this was before the unlimited estate and gift tax marital deduction. Making the required election could very well produce a gift tax liability.

ERTA 81 instituted the unlimited marital deduction and further amended 2040 to simply state that any tenancy by the entirety or joint tenancy with rights of survivorship between a husband and wife was a Qualified Joint Interest. The sections relating to the election instituted in 1978 were repealed and the new law was “applicable for the estates of decedents dying after 12/31/81.”

These differences in the effective dates of the statutory amendments were the basis of the taxpayer’s claim in *Gallenstein*. The IRS argued that even thought the various effective dates were inconsistent, the intent was to bring all spousal joint tenancies under the same rules. The IRS further argued the later statutes implicitly repealed the prior statutes. Both the District Court and the Court of Appeals for the 6th Circuit agreed with Mrs. Gallenstein that absent an explicit amendment, the pre-1977 rules apply to joint spousal tenancies created before 12/31/76. Furthermore, in several of the later cases cited above (*Patten* and *Anderson*) the taxpayer was awarded summary judgment. With the adoption of the ruling in *Gallenstein* by the Tax Court in *Hahn*, the principal set forth in *Gallenstein* has become viable law.
In dealing with seniors, there can be a great advantage of having the property subject to the pre-1977 rules. Where a husband and wife owned real property but only the husband (for example) provided consideration and was the first to die, the entire value of the property would be included in the husband's estate. This would qualify for the marital deduction (assuming it is passing to the surviving spouse) and 100% of the value of the property would receive a step-up in basis under Section 1014. Under the rules for property acquired after 1978, only 50% of such property would receive a step-up in basis.

Very often Elder Law planning requires the division of residential real property owned as tenants by entirety or an outright transfer to entire property to one's spouse. Before making such a transfer, the practitioner should carefully review the client’s tax position. Any such transfer of the real property would be viewed as the creation of a new estate in property subsequent to December 31, 1976. As a result, part of all of the accelerated basis step-up would be lost. Assume a house purchased in 1955 for $35,000.00 currently valued at $700,000.00 (common on Long Island) where the husband provided all of the consideration (again, common among the senior population). Retitling the house as tenants in common or outright to the wife, would result in the wife acquiring the husband’s basis in the interest transferred.iii If the husband is the first to die, and the house is subsequently sold, the surviving wife could face a substantial capital gain. The same result would result if the residence is transferred to a trust.

Another interesting off-shoot of the decision in Gallenstein is the option of the IRS to reverse the facts of on a taxpayer. For example, if the property was purchased jointly between husband and wife prior to 1977, the husband provided all of the consideration and the wife was the
first to pass away, none of the property would be included in her estate and the surviving husband would receive no basis step-up at all. This position is clearly consistent with the position adopted by the IRS in the final disclaimer regulations adopted on December 31, 1997 and EPTL Section 2-1.11(b)(1).

Elder Law and tax planning can often be mutually exclusive. While a transfer would be extremely advantageous for Elder Law planning purposes, it can result in adverse tax consequences. It is not to be inferred that the transfers should not be made, but the benefits of both sides of the transaction must be thoroughly reviewed prior to acting.

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i. 975 F 2d 286 (6th Cir. 1992)


iii. Code Section 1014