IRREVOCABLE TRANSFERS AND A RECONVEYANCE OF POWER TO THE TRANSFEROR—SECTION 2038 OF THE INTERNAL REVENUE CODE OF 1954

Estate of Reed v. United States, 36 Am. Fed. Tax R.2d 75-6413, 75-1 U.S. Tax Cas. 87, 477 (M.D. Fla. 1975)

In 1960 decedent transferred stock in a family corporation[1] to his wife as custodian[2] for their minor daughter. When the daughter reached twenty-one, the stock was unconditionally reissued in her name. Shortly thereafter she executed an inter vivos trust agreement transferring her stock to a trust,[3] naming her parents as trustees and granting them absolute power to sell, exchange, assign, transfer, and vote the stock.[4] The Internal Revenue Service determined that the decedent's powers as trustee warranted inclusion of the value of the stock in his gross estate.[5] The estate paid the additional tax and initi-

1. The decedent formed A-B Distributors, Inc., in March 1960, and acted as president of the corporation from its inception until his death. His wife was secretary, and together they signed all stock certificates. Stock was issued to Mr. Reed, Mrs. Reed, and the three Reed children. Estate of Reed v. United States, 36 Am. Fed. Tax R.2d 75-6413, 75-1 U.S. Tax Cas. 87,477 (M.D. Fla. 1975).

2. Mrs. Reed served as custodian for their children under the Florida Gifts to Minors Act, FLA. STAT. ANN. § 710.01 *et. seq.* (1969). Section 710.04 makes gifts to minors irrevocable.

3. Although no transcript was made at the trial, both the government and plaintiff later filed briefs. The evidence at trial showed that decedent suggested the trust when his daughter was considering marriage. The daughter agreed to the creation of the trust in order that all shares, and thus control of the corporation, remain in the family. Brief for Defendant at 12, Estate of Reed v. United States, 36 Am. Fed. Tax R.2d 75-6413, 75-1 U.S. Tax Cas. 87,477 (M.D. Fla. 1975) [hereinafter cited as Brief for Defendant]; Plaintiff's Supplemental Brief at 2, Estate of Reed v. United States, 36 Am. Fed. Tax R.2d 75-6413, 75-1 U.S. Tax Cas. 87,477 (M.D. Fla. 1975) [hereinafter cited as Plaintiff's Supplemental Brief].

4. Plaintiff's Pre-Trial Brief at 4, Estate of Reed v. United States, 36 Am. Fed. Tax R.2d 75-6413, 75-1 U.S. Tax Cas. 87,477 (M.D. Fla. 1975) [hereinafter cited as Brief for Plaintiff]. These powers clearly bring the trust property within INT. REV. CODE OF 1954, § 2038(a)(1), if reserved by the transferor. This issue was undisputed. Brief for Defendant at 3, 5.

5. The deficiency notice provided:

> It is determined that the value of the . . . property . . . transferred by the decedent in his lifetime is includible in the gross estate pursuant to the provisions of the Internal Revenue Code of 1954, Section 2038, since the enjoyment of this property was subject at the date of his death to change through the exercise of a power by the decedent alone or in conjunction with any other person, to alter, amend, revoke, or terminate.

Estate of Reed v. United States, 36 Am. Fed. Tax R.2d 75-6413, 75-6414, 75-1 U.S.

ated suit for refund. The district court entered judgment for the taxpayer and *held*: Section 2038(a)(1) of the Internal Revenue Code of 1954[6] applies only when the power held by the decedent arises either from a direct reservation in the transferring instrument or from the conditions of the original transfer.[7]

Tax Cas. 87,477, 87,478 (M.D. Fla. 1975).

During his lifetime the decedent issued 384 shares of corporate stock to his daughter. When the trust was created, the daughter held 160 shares, all of which were placed in the trust. Thereafter, 224 shares were issued as stock dividends and 128 were removed from the trust and issued directly to the daughter. Thus, at the decedent's death there appeared to be 32 shares in the trust and 352 shares in the daughter's hands. The court followed this accounting. 36 Am. Fed. Tax R.2d at 75-6416, 75-1 U.S. Tax Cas. at 87,479.

The Commissioner sought inclusion of all 384 shares in decedent's gross estate, arguing that the trust had legal title to all shares and that the parties intended all shares to be placed in the trust. The trust instrument provided that the trustees were to consider all additional stock dividends as trust corpus. Brief for Defendant at 15-16. It was undisputed that all 224 shares issued after the creation of the trust were issued as stock dividends. At trial plaintiffs admitted that all stock was intended to be included in the trust. In fact, after the decedent died all 384 shares were called in and reissued to Mrs. Reed as trustee. Brief for Defendant at 3, 15-16.

6. INT. REV. CODE OF 1954, § 2038(a) provides:

(a) In general.

The value of the gross estate shall include the value of all property.

(1) Transfers after June 22, 1936.

To the extent of any interest therein of which the decedent has at any time made a transfer . . . by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate . . . .

(2) Transfers on or before June 22, 1936.

To the extent of any interest therein of which the decedent has at any time made a transfer . . . by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke . . . .

The main distinction between subsections (1) and (2) of § 2038 is the addition of the phrase "without regard to when or from what source the decedent acquired such power" to subsection (1) dealing with post-1936 transfers. Subsection (2) is essentially the same as § 302(d) of the Revenue Act of Jan. 1, 1924, ch. 234, § 302(d), 43 Stat. 304, *quoted in* note 13 *infra*.

Section 2038(a)(1) operates to bring the transferred interest into the decedent's gross estate under INT. REV. CODE OF 1954, § 2031. The predecessor to § 2038(a)(1) was held constitutional in Helvering v. City Bank Farmers Trust Co., 296 U.S. 85 (1935).

7. Estate of Reed v. United States, 36 Am. Fed. Tax R.2d 75-6413, 75-1 U.S. Tax Cas. 87,477 (M.D. Fla. 1975). There are several important issues which the court either decided without explanation or neglected to address. One concerned the amount of stock

Estate taxes are taxes on the transfer of property at death.[8] They can, however, be easily avoided if limited strictly to postdeath transfers.[9] To prevent one method of tax avoidance, Congress imposed an estate tax on inter vivos transfers when the decedent held at his death some "string" on the transferred property.[10] Congress reasoned that the decedent's death ended his control, thereby passing valuable assurance of title to the donee.[11] Since the donor by using the retained

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subject to decedent's control for purposes of § 2038. *See* note 5 *supra*. A second issue was plaintiff's constitutional attack on the application of the section to him. Plaintiff argued that if the means are inappropriate to the ends (prevention of tax avoidance), the statute violates the due process clause of the fifth amendment. Plaintiff maintained that operation of the statute in this fact situation would be an unreasonable means of preventing tax avoidance. *See* Brief for Plaintiff at 15-16. A third issue was whether the statutory language of § 2038(a)(1)—"which the decedent has at any time made a transfer"—operates in conjunction with or limits the parenthetical phrase "without regard to when or from what source the decedent acquired such power." The court's decision, requiring that decedent's power derive from the original transfer, implied that the first phrase does limit the second. A fourth issue was whether an express or implied agreement between the decedent and his daughter created liability under § 2038(a)(1). *See* notes 5 *supra* and 19 *infra*.

8. *See* New York Trust Co. v. Eisner, 256 U.S. 345, 346-47 (1921); Knowlton v. Moore, 178 U.S. 41, 57, 59 (1900); Revenue Act of Sept. 8, 1916, ch. 463, § 201, 39 Stat. 756, 777; Treas. Reg. § 20.0-2(a) (1958); C. LOWNDES, R. KRAMER & J. MCCORD, FEDERAL ESTATE AND GIFT TAXES §§ 1.1, 1.2 & 2.1 (3d ed. 1974); Lowndes, *An Introduction to the Federal Estate and Gift Taxes*, 44 N.C.L. REV. 1, 3-4 (1965).

9. A taxpayer could, for example, retain enjoyment of the property until death and escape taxation by making an inter vivos transfer and retaining a life estate or a power to alter, amend, revoke, or terminate. *See* C. LOWNDES, R. KRAMER & J. MCCORD, *supra* note 8, § 2.1, at 7-9; Lowndes, *A Day in the Supreme Court With the Federal Estate Tax*, 22 VA. L. REV. 261, 276 (1936); Lowndes, *supra* note 8, at 4.

10. INT. REV. CODE OF 1954, § 2038(a), *quoted in* note 6 *supra*; Helvering v. City Bank Co., 296 U.S. 85, 90 (1935). The powers to alter, amend, revoke, or terminate the enjoyment of the transferred property are often referred to as "strings." *See, e.g.*, Fidelity-Philadelphia Trust Co. v. Rothensies, 324 U.S. 108, 111 (1944); Trust Co. v. Allen, 164 F.2d 438, 442 (5th Cir. 1947), *cert. denied*, 333 U.S. 856 (1948); Estate of Edward E. Ford, 53 T.C. 114, 125 (1969), *aff'd*, 450 F.2d 818 (2d Cir. 1971).

11. H.R. REP. No. 179, 68th Cong., 1st Sess. 28 (1924) and S. REP. No. 398, 68th Cong., 1st Sess. 35 (1924) both state:

> Such property interests should therefore fairly be taxed as part of the decedent's estate, particularly since, by virtue of his death, the substantial interest which he had has been wiped out, and to the same extent the property interest of the legal title holder, his transferee, has been increased.

See also Porter v. Commissioner, 288 U.S. 436, 444 (1933); Mellon v. Driscoll, 117 F.2d 477, 478-79 (3d Cir.), *cert. denied*, 313 U.S. 579 (1941). In construing a predecessor of § 2038, the *Porter* Court stated:

> But the reservation here may not be ignored . . . it made the settlor dominant in respect of the other dispositions of both corpus and income, his death ter-

strings could revoke the transfer until his death, the transfer was in effect a substitute for a testamentary disposition and could be taxed as such.[12]

Section 302(d) of the Revenue Act of 1924 was the first statute to impose an estate tax on revocable transfers.[13] This statute focused on the control decedent retained "at the date of his death" over the transferred property and did not require that control be reserved at the time

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minated that control, ended the possibility of any change by him, and was, in respect of title to the property in question, the source of valuable assurance passing from the dead to the living. That is the event on which Congress based the inclusion of property so transferred in the gross estate . . . . Thus was reached what it reasonably might deem a substitute for testamentary disposition.

288 U.S. at 444.

Other federal estate tax statutes impose a tax on lifetime transfers testamentary in nature. *See, e.g.*, INT. REV. CODE OF 1954, §§ 2035 (transactions in contemplation of death); 2036 (transfers with retained life estates); 2037 (transfers taking effect at death); 2041 (powers of appointment); 2042 (proceeds of life insurance).

12. *See* Whitney v. State Tax Comm'n, 309 U.S. 530, 531 (1940); Estate of Sanford v. Commissioner, 308 U.S. 39, 43 (1939); Porter v. Commissioner, 288 U.S. 436, 444 (1933); Chase Nat'l Bank v. United States, 278 U.S. 327, 338 (1929); Mellon v. Driscoll, 117 F.2d 477, 478-79 (3d Cir.), *cert. denied*, 313 U.S. 579 (1941).

13. Revenue Act of Jan. 1, 1924, ch. 234, § 302(d), 43 Stat. 304, provides:

> The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—
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> . . . .
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> (d) To the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has at any time created a trust, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power . . . to alter, amend, or revoke . . . .

For the legislative history of § 302(d), see H.R. REP. No. 179, 68th Cong., 1st Sess. 28 (1924), and S. REP. No. 398, 68th Cong., 1st Sess. 35 (1924), *quoted in* note 11 *supra*. For the treasury regulations, see Treas. Reg. 68, § 302(d), T.D. 3683, 27 TREAS. DEC. INT. REV. 105 (1925).

Prior to the enactment of § 302(d) in 1924, revocable transfers were sometimes taxed as transfers "intended to take effect in possession or enjoyment at death." *See, e.g.*, Revenue Act of Sept. 8, 1916, ch. 463, § 202(b), 39 Stat. 777-78 (now INT. REV. CODE OF 1954, §§ 2036, 2037). More often, however, the state and federal courts allowed revocable transfers to escape taxation. This inconsistency of enforcement was the motivating force behind the enactment of § 302(d). *See In re* Miller's Estate, 236 N.Y. 290, 140 N.E. 701 (1923); C. LOWNDES, R. KRAMER & J. MCCORD, *supra* note 8, § 8.1, at 142; R. PAUL, FEDERAL ESTATE AND GIFT TAXATION § 7.06, at 301 (1942); Rottschaeffer, *Taxation of Transfers Taking Effect in Possession at the Grantor's Death*, 26 IOWA L. REV. 514, 531 (1941); Note, *The Federal Estate Tax and Revocable Trusts*, 30 ILL. L. REV. 361, 362 (1935). *But see* Reinecke v. Northern Trust Co., 278 U.S. 339, 345 (1929) (revocable transfers taxable as a transfer "intended to take effect in possession or enjoyment at death").

of the transfer.[14] In *White v. Poor*,[15] however, the Supreme Court held that section 302(d) applied only when the control held at death was reserved at the time of the original transfer.[16] To include the transferred property in the decedent's gross estate, *White* required a reservation of power at the time of the transfer by the terms of the transferring instrument,[17] by operation of law,[18] or by express or implied agreements.[19] In response to *White*, Congress in 1936 amended section

14. Revenue Act of Jan. 1, 1924, ch. 234, § 302(d), 43 Stat. 304, *quoted in* note 13 *supra.*

15. 296 U.S. 98 (1935). During her lifetime decedent conveyed property to herself and two others as trustees. The trustees, acting jointly, had the power to alter the trust and to fill trustee vacancies. The decedent served as trustee for one year and then resigned. The replacement trustee resigned after a year and the decedent was reappointed trustee. She served in this capacity until death. *Id.* at 100. The court held that § 302(d) was not applicable because the decedent acquired her powers solely by action of the other trustees, whereas the statute contemplated powers reserved at the time of the original transfer. *Id.* at 102.

The *White* decision was followed in two other cases involving pre-1936 transfers: Fabian v. United States, 127 F. Supp. 726 (D. Conn. 1954) and Estate of Franklin W.M. Cutcheon, 3 T.C. 636 (1944). For a discussion of the problems that *White* created in the operation of § 302(d), see Lowndes, *supra* note 9, at 276.

16. White v. Poor, 296 U.S. 98, 102 (1935). The Court also held that § 302(d) operated only when the grantor retained the powers as "settlor;" if the grantor retained powers as trustee the section would not apply. *Id.* at 102. When Congress amended § 302(d) in 1936, it provided that the statute operate on a power "in whatever capacity exercisable" by the decedent. *See* Revenue Act of June 22, 1936, ch. 690, § 805(a), 49 Stat. 1744-45, *quoted in* note 20 *infra.* The statute now operates even when the decedent holds powers as trustee. The regulations take the position that this change was declaratory of existing law. Treas. Reg. 80, § 805, T.D. 4729, 1937-1 CUM. BULL. 286-88, *quoted in* note 35 *infra.* The capacity in which the powers are exercisable is now irrelevant. *See* Union Trust Co. v. Driscoll, 138 F.2d 152, 154-55 (3d Cir. 1943), *cert. denied,* 321 U.S. 764 (1944); Welch v. Terhune, 126 F.2d 695, 697 (1st Cir.), *cert. denied,* 317 U.S. 644 (1942).

17. White v. Poor, 296 U.S. 98, 102 (1935).

18. *Id.*; Howard v. United States, 125 F.2d 986, 989 (5th Cir. 1942).

19. White v. Poor, 296 U.S. 98, 102 (1935); Treas. Reg. § 20.2038-1(c) (1958) provides:

> The phrase [reserved at the time of the transfer] also has reference to any understanding, express or implied, had in connection with the making of the transfer that the power would later be created or conferred.

This regulation is titled "Transfers made before June 22, 1936" and states that an agreement to return control of the property to the transferor will be treated as a reservation at the time of the transfer. If an agreement has this effect, it should cause § 2038 to apply to both pre- and post-1936 transfers. Thus, although the regulation refers to pre-1936 transfers, its application should not be limited to those transactions. No cases have relied on this regulation, but a similar provision appears in the regulations for § 2036, *see* Treas. Reg. § 20.2036-1(a)(ii) (1958), and has been cited in several cases to support the finding that the transferor reserved a life estate at the time of the transfer.

302(d) to include the phrase "without regard to when or from what source the decedent acquired such power,"[20] which was intended to negate this requirement.[21] The 1936 amendment was codified in the

See Estate of Skinner v. United States, 316 F.2d 517 (3d Cir. 1963); Estate of McNichol v. Commissioner, 265 F.2d 667 (3d Cir.), *cert. denied*, 361 U.S. 829 (1959); Atkinson v. United States, 231 F. Supp. 933 (E.D.S.C. 1964); Fitzsimmons v. United States, 222 F. Supp. 140 (E.D. Wash. 1963).

The *Reed* court required that decedent's powers derive either from a direct reservation at the time of the transfer or "from the conditions of the original transfer." 36 Am. Fed. Tax R.2d at 75-6416, 75-1 U.S. Tax Cas. at 87,480. Though the court never defined "conditions," it probably meant some mechanism in the original transferring instrument that would allow the transferor to regain control of the property. For example, a provision allowing the grantor to appoint himself trustee at any time would be a condition resulting in taxation. The court did not mention Treas. Reg. § 20.2038-1(c) (1958). Agreements to return control should be conditions, but since the court did not inquire into the presence of any such agreements, it implied that such agreements will not create § 2038(a)(1) liability.

Arguably, there were such agreements between the decedent and his daughter. The original gifts of stock are suspect because they involved intrafamily gifts of stock in the family corporation. For a description of how the stock was issued, see note 5 *supra*. But even if there were no implied agreements at the time of the original gifts, there was an express agreement in the trust instrument that all future stock dividends would be part of the trust corpus. *See id.* This should suffice to bring the 224 shares issued as stock dividends into the decedent's estate. Two problems arise: 1) are stock dividend transfers from a decedent who controlled the issuing corporation, and 2) are such agreements sufficient to cause § 2038(a)(1) to apply after the *Reed* decision? If such agreements are insufficient to bring transferred property into the decedent's estate, *Reed* has provided a clear method of tax avoidance.

20. Revenue Act of June 22, 1936, ch. 690, § 805(a), 49 Stat. 1744-45, *amending* Revenue Act of Feb. 26, 1926, ch. 27, § 302(d)(1), 44 Stat. 71, provided:

> (a) Section 302(d)(1) of the Revenue Act of 1926, as amended, is amended to read as follows:
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> "(d)(1) To the extent of any interest therein of which the decedent has at any time made a transfer . . . by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent . . . (*without regard to when or from what source the decedent acquired such power*), to alter, amend, revoke, or terminate . . . ."

Id. (emphasis added).

By the Revenue Act of June 22, 1936, Congress made three major amendments to § 302(d). First, it added the phrase "in whatever capacity exercisable." *See* note 16 *supra*. Second, Congress added the word "terminate" to the powers included in § 302(d). This amendment also responded to *White*, which had raised the question whether a power to terminate is the equivalent of a power to revoke. Congress, the Treasury, and the courts considered the amendment to be declaratory of existing law. *See* H.R. REP. No. 2818, 74th Cong., 2d Sess. 9 (1936), *quoted in* note 34 *infra*; Treas. Reg. 80, § 805, T.D. 4729, 1937-1 CUM. BULL. 286, 287, *quoted in* note 35 *infra*; Commissioner v. Estate of Holmes, 326 U.S. 480, 488-89 (1946). Third, Congress added the phrase "without regard to when or from what source the decedent acquired such power."

21. *See* H.R. REP. No. 2818, 74th Cong., 2d Sess. 9 (1936), *quoted in* note 34 *infra*.

Internal Revenue Code of 1939,[22] and then renumbered as section 2038(a)(1) in the Internal Revenue Code of 1954, without material change.

In *Estate of Reed v. United States*[23] the court confronted the question whether section 2038(a)(1) extended to all after-acquired powers or only those arising from the conditions of the original transfer.[24] The court determined that the issue turned on the interpretation given the phrase "without regard to when or from what source the decedent acquired such power."[25] Although recognizing that this phrase was added in response to *White*,[26] the court stated that both before and after 1936 the statute applied to transfers in which the decedent's power was reserved at the time of the original transfer.[27] Absent con-

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See also Treas. Reg. § 20.2038-1(a) (1958), *quoted in* note 35 *infra*; Rev. Rul. 70-348, 1972-2 CUM. BULL. 193; 3 J. MERTENS, THE LAW OF FEDERAL GIFT AND ESTATE TAXATION §§ 25.18-.19 (1959); Note, *Section 2038: Present Economic Benefit v. Technical Vesting of Title or Estates*, 13 W. RES. L. REV. 737, 740 (1962).

22. INT. REV. CODE OF 1939, ch. 3, § 811(d), 53 Stat. 121-22 (now INT. REV. CODE OF 1954, § 2038).

23. 36 Am. Fed. Tax R.2d 75-6413, 75-1 U.S. Tax Cas. 87,477 (M.D. Fla. 1975).

24. The issue could be stated whether Congress intended the 1936 amendments to negate entirely the *White* requirement that the decedent's power be reserved at the time of the original transfer.

25. 36 Am. Fed. Tax R.2d at 75-6416, 75-1 U.S. Tax Cas. at 87,480. Although never stating the issue directly, the court did recognize that the outcome of the case turned on this phrase.

26. The court cited the facts of *White* incorrectly, 36 Am. Fed. Tax R.2d at 75-6416, 75-1 U.S. Tax Cas. at 87,480, in stating that decedent was not an original trustee of her trust. *See* note 15 *supra*. Although the Supreme Court would probably have reached the same result on these facts, the error indicates the sloppiness of the *Reed* opinion.

27. The court stated:

> At all times prior and subsequent to the statutory amendment of 1936 . . . the provision relating to revocable transfers has been applied to bring into the gross estate of a transferor . . . the values of property interests over which the transferor *retained* or *reserved* certain powers or control at the time of the original transfer.

Id. at 75-6416, 75-1 U.S. Tax Cas. at 87,480 (emphasis original). The court implied that its search produced many § 2038 cases dealing with reserved powers, but no cases involving after-acquired powers. This interpretation is supported by the court's reliance on Estate of Skifter v. Commissioner, 468 F.2d 699 (2d Cir. 1972). The *Skifter* court stated bluntly that it found no cases dealing with after-acquired powers:

> The emphasized language [without regard to when or from what source the decedent acquired such power] would appear to indicate that § 2038 would ap-

trary authority, the court reasoned that Congress intended the 1936 amendment merely to alter the outcome of the specific *White* situation in which after-acquired powers had arisen from the conditions of the original transfer.[28] Because this decedent's powers did not so arise, the court excluded the transferred stock from his gross estate. The court ignored the legislative history of the statute and instead relied on the interpretation given section 2038(a)(1) by three circuit court decisions dealing with estate taxation of insurance proceeds.[29]

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ply even when the power was acquired under circumstances such as are present here. However, there is no indication that the Commissioner has ever made such an argument and we have been able to find no case applying § 2038 in this manner.

. . . However, this language appears never to have been applied to a power other than one that the decedent created at the time of the transfer in someone else and that later devolved upon him before his death. In essence, the language has been applied strictly to change the result in White v. Poor.

468 F.2d at 704.

The decedent in *Skifter* had irrevocably transferred life insurance policies on his life to his wife. The wife predeceased her husband, and her will made the decedent trustee of a trust containing the insurance policies. 468 F.2d at 701. The court held the policies nontaxable. *Id.* at 705.

28. 36 Am. Fed. Tax R.2d at 75-6416, 75-1 U.S. Tax Cas. at 87,480. *See* note 27 *supra*. For a discussion of the fallacy in this reasoning, see note 39 *infra* and accompanying text.

29. 36 Am. Fed. Tax R.2d at 75-6416 to 6417, 75-1 U.S. Tax Cas. at 87,480. The court cited three cases comparing the insurance tax section to § 2038, each of which commented on the scope of § 2038:

1) Under § 2036 Congress specifically levied the estate tax upon interests *retained* by a decedent in connection with an incomplete transfer; and § 2038 is similar in effect.

Rose v. United States, 511 F.2d 259, 264 (5th Cir. 1975) (emphasis original) (footnotes omitted).

2) The only significant distinction between §§ 2036 and 2038 on the one hand and § 2042 on the other is that under the former there must be an incomplete transfer by the decedent whereas under the latter a transfer is unnecessary. Thus under §§ 2036 and 2038 the decedent must have *retained* some control over the property he initially transferred while under § 2042 it is enough if at death the decedent merely *possessed* an incident of ownership, the means by which he came into possession being irrelevant.

Estate of Lumpkin v. Commissioner, 474 F.2d 1092, 1097 (5th Cir. 1973) (emphasis original) (footnote omitted).

3) The emphasized language [without regard to when or from what source the decedent acquired such power] would appear to indicate that § 2038 would apply even where the power was acquired under circumstances such as are present here. However, there is no indication that the Commissioner has ever made such an argument and we have been able to find no cases applying § 2038 in this manner.

. . . However, this language appears never to have been applied to a power other than one that the decedent created at the time of the transfer

The *Reed* court's opinion employed faulty logic and relied on weak precedent rather than looking to the clear language and legislative history of section 2038(a)(1). Traditional canons of statutory construction dictate that a court should first look to the language of the statute;[30] if this does not resolve the issue, the court should then look

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in someone else and that later devolved upon him before his death. In essence, the language has been applied strictly to change the result in White v. Poor.

Estate of Skifter v. Commissioner, 468 F.2d 699, 704 (2d Cir. 1972).

Although each court discussed § 2038, the primary concern was with § 2042. The statements on § 2038 in *Rose* and *Lumpkin* were plainly dicta; *Skifter*, while on point, relied on the same fallacious reasoning employed in *Reed*, *see* notes 39, 40 & 45 *infra* and accompanying text.

Similar considerations of "source" are involved in both §§ 2038 and 2042. Under § 2042, the proceeds of an insurance policy on the decedent's life which are payable to his estate are taxable to his estate. *See* INT. REV. CODE OF 1954, § 2042(1). If the proceeds are payable to beneficiaries other than the decedent, the decedent must hold "incidents of ownership" in connection with the policies before the proceeds are included in his estate. *Id.* at § 2042(2). Generally, incidents of ownership include the right to change the beneficiaries, or cancel or assign the policies, or a reversionary interest. *See* Treas. Reg. § 20.2042-1(c)(2-6) (1974). The statute does not state whether the source of the incidents of ownership is important to its operation. The courts thus must resolve whether § 2042 operates when a decedent unconditionally assigns his policies to another, but holds incidents of ownership at his death. *Skifter* answered this question in the negative, reasoning that § 2042 followed § 2038 which was interpreted as requiring a reservation of power at the time of the transfer. In *Lumpkin* and *Rose* the courts held that the source was irrelevant if decedent held incidents of ownership at death.

In Fruehauf v. Commissioner, 427 F.2d 80 (6th Cir. 1970), decedent's wife purchased insurance on the decedent's life with her own funds. *Id.* at 81-82. She predeceased him, devising the policies to a trust of which decedent was a life beneficiary and a co-trustee with the power to sell or assign the policies. *Id.* The court held the policies includible in his gross estate under § 2042. *Id.* at 86. The court's main concern was whether the decedent's trustee status would exculpate him from liability; it largely ignored the issue of whether a reservation of the incidents of ownership was required. The opinion is nonetheless instructive. The likelihood of collusive agreements is clearly less when decedent is not the original owner of the property than when he holds it initially, transfers it, then subsequently acquires it again. On public policy grounds, therefore, *Skifter* and *Reed*, which imposed no tax liability, present a stronger case for taxation than *Fruehauf*, which included the insurance in decedent's taxable estate. For a thorough analysis of these cases, see Eliasberg, *I.R.C. Section 2042—The Estate Taxation of Life Insurance: What is an Incident of Ownership*, 1973 INS. L.J. 7; *CA-5 Puts Insurance in Non-Grantor Trustee's Estate, Conflicts with CA-2 and CA-6*, 43 J. TAXATION 49 (1975); Note, *Estate Taxation of Life Insurance Policies Held by the Insured as Trustee*, 32 MD. L. REV. 305 (1972); Note, *Estate Tax—The Other View of Skifter*, 39 MO. L. REV. 258 (1974).

For the legislative history of § 2042, see H.R. REP. No. 1337, 83d Cong., 2d Sess. A316 (1954); S. REP. No. 1622, 83d Cong., 2d Sess., 124 (1954).

30. The plain meaning rule dictates that if language is clear and unambiguous it

to the legislative history of the statute to determine its purpose.[31] The *Reed* court did neither. The language of section 2038(a)(1) specifically directs that it operate "without regard to when or from what source the decedent acquired such power."[32] The court disregarded the ordinary interpretation of this language which clearly covers the

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must be given effect except when it would lead to absurd consequences or subvert the purpose of the statute. Commissioner v. Brown, 380 U.S. 563, 570-71 (1964); Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247, 249 (1940); Helvering v. Hammell, 311 U.S. 504, 510-11 (1940); Helvering v. City Bank Farmers Trust Co., 296 U.S. 85, 89 (1935); Thompson v. United States, 246 U.S. 547, 551 (1918); Hamilton v. Rathbone, 175 U.S. 414, 419 (1899). *See generally* J. SUTHERLAND, STATUTORY CONSTRUCTION (4th ed. 1972); *A Symposium on Statutory Construction*, 3 VAND. L. REV. 365 (1950); Frankfurter, *Some Reflections on the Meaning of Statutes*, 47 COLUM. L. REV. 527 (1947); Jones, *The Plain Meaning Rule and Extrinsic Aids in the Interpretation of Federal Statutes*, 25 WASH. U.L.Q. 2 (1939); Smith, *The Changing Construction of Revenue Laws*, 20 A.B.A.J. 12 (1934); Willis, *Statutory Interpretation in a Nutshell*, 16 CAN. B. REV. 1 (1938). The *Reed* court did not give effect to the plain meaning of the statute and as a result subverted its purposes. *See* notes 46 & 47 *infra* and accompanying text.

31. Commissioner v. Brown, 380 U.S. 563, 570-71 (1964); *see* note 30 *supra.*

32. INT. REV. CODE OF 1954, § 2038(a)(1), *quoted in* note 6 *supra.* Section 2038(a)(1) is broad enough in scope to encompass the *Reed* problem. The source of the decedent's power is immaterial to the operation of the section. *See* note 35 *infra.* Note that Congress could have used narrower language had it wanted to limit the application of § 2038(a)(1) to those after-acquired powers which arose from the conditions of the original transfer. It could have said, for example, "without regard to when the power was acquired so long as it derives from the original transfer." This would have incorporated the *White* decision rather than overruling it. The *Reed* court, in effect, placed this language in the statute—an action it was not at liberty to take. *See* note 30 *supra.* An argument can be made that Congress did not use limiting language because it wanted the courts to have discretion in applying the section. This argument is particularly weak in connection with the reservation of powers. A comparison of § 2038(a)(1) with §§ 2036 and 2037 shows that Congress placed a reservation requirement in the latter two, but not in the first. *See* note 11 *supra.* Section 2036 taxes transferred property in which decedent has a life estate only when the life estate was reserved at the time of the original transfer. Section 2037 taxes transfers intended to take effect at death only when decedent retained a reversionary interest at the time of the original transfer. Congress did not require a reservation of power in § 2038(a)(1) and expressly negated such a requirement. *See* note 21 *supra.*

There are several other indications that Congress did not intend the source of decedent's power to determine taxation. Since its codification in 1939, *see* note 22 *supra*, the statute has been entitled "Revocable Transfers" rather than "Transfers With Reserved Powers." Also, § 2038 and all its predecessors have referred to powers held at death rather than powers created at the time of the transfer and held until death. *See* notes 6 & 13 *supra.* The Supreme Court in *White* was not persuaded by this language. *See* note 15 *supra.* Since 1936 the Treasury Regulations have specifically directed that for post-1936 transfers the source of the power is immaterial. *See* Treas. Reg. 80, § 805, T.D. 4729, 1937-1 CUM. BULL. 286-88, *quoted in* note 35 *infra.*

Reed transaction.[33] The *Reed* court also failed to examine the statute's legislative history[34] or its interpretive regulations,[35] both of which are

33. 36 Am. Fed. Tax R.2d at 75-6416 to 6417, 75-1 U.S. Tax Cas. at 87,480. When Congress uses plain language in a statute, courts are not at liberty to apply their own interpretations of the language. *See* notes 30-32 *supra.*

34. H.R. REP. No. 2818, 74th Cong., 2d Sess. 9 (1936) (emphasis added) stated:

> Section 206 amends section 302(d)(1) of the Revenue Act of 1926 . . . . The changes made by this section are made necessary largely by reason of the decision of the United States Supreme Court in the case of *White v. Poor* . . . . The case, therefore, suggests that section 302(d) may be circumvented in many ways so long as the power . . . does not accrue to the settlor by virtue of the reservation in the trust instrument. It is, therefore, provided that *section 302(d) covers a power whether created at the time of the transfer or thereafter arising from any source and whether exercisable in any individual or representative capacity.* To some extent, it is believed this amendment is declaratory of existing law . . . .
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> *Another change made . . . has been to expressly include a power to terminate* along with the powers to alter, amend, or revoke. In the case of *White v. Poor, supra,* the Supreme Court did not pass on the question of whether the power to terminate was included . . . . Since in substance a power to terminate is the equivalent of a power to revoke, this question should be set at rest. Express provision to that effect has been made and it is believed that it is declaratory of existing law.
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> . . . In view of the increased estate tax rates, it is probable also that taxpayers will be straining every effort to devise transfers which will permit them to retain control of their property during their lifetime and escape the imposition of estate taxes thereon. The proposed amendments are designed to plug up loop holes which now appear, so that taxpayers may not be successful in effecting tax avoidance.

This report accompanied H.R. 12793, 74th Cong., 2d Sess. (1936), a bill on estate taxes that was not enacted. The House also submitted H.R. 12395, 74th Cong., 2d Sess. (1936), which was similar to H.R. 12793. Both bills were rejected by the Senate, but the Senate's amendment to H.R. 12395 included § 805(d) and, after slight modification by the House, was passed and became law. *See* H.R. CONF. REP. No. 3068, 74th Cong., 2d Sess. 19 (1936). The developments are indexed in 80 CONG. REC. (PERM. ED.) pt. 11, at 554 (1936).

The validity of the House Report accompanying H.R. 12793, 74th Cong., 2d Sess. (1936), as an indication of congressional intent has never been questioned and the Report has been cited with approval by several courts. *See, e.g.,* Commissioner v. Estate of Holmes, 326 U.S. 480, 488-89 (1946); Welch v. Terhune, 126 F.2d 695, 696 (1st Cir.), *cert. denied,* 317 U.S. 644 (1942); Estate of Franklin W.M. Cutcheon, 3 T.C. 636, 637 (1944). The Report clearly shows that Congress was concerned with tax avoidance schemes that the *White* holding would have allowed. Moreover, the broad language of the Report implies that Congress intended to go beyond *White* and extend the section to any possible type of return of power.

35. The Treasury Regulations for Revenue Act of June 22, 1936, ch. 690, § 805(a), 49 Stat. 1744-45, (now INT. REV. CODE OF 1954, § 2038) specifically stated that the section operated on after-acquired powers regardless of the source of the power:

> (b) Taxability.—The property or interests so transferred shall be included in the gross estate if coming within any one of the following paragraphs:
>
> . . . .
>
> (2) When the transfer was made . . . before the amendment of the subdivi-

consistent with the plain meaning of the section. The House Report states that the statute operated on powers reserved at the time of the transfer or "thereafter arising from any source,"[36] while the Regulations provide that the source of the power is "immaterial."[37]

The court reasoned that since no cases involving after-acquired powers had reached the courts, while many reserved power cases had, Congress must have intended section 2038(a)(1) to apply to after-acquired powers only if, as in *White*, they arose from the conditions of the original transfer.[38] This is fallacious.[39] The absence of case law

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sion by the Revenue Act of 1936 . . . and the decedent's death occurred at any time subsequent to the transfer, and the power was reserved at the time of the transfer . . . .

(3) When the transfer was made and the decedent died after June 22, 1936 . . . and the power was either reserved at the time of the transfer or *later created or conferred*, without regard to the source from which the power was acquired . . . .

Treas. Reg. 80, § 805, T.D. 4729, 1937-1 CUM. BULL. 286-88 (emphasis added).

The Treasury Regulations for § 2038 continued the distinction between pre- and post-1936 transfers. As in the earlier regulations, cited *supra*, the *White* rule controls pre-1936 transfers, but for post-1936 transfers, the source of the power is immaterial:

(a)(3) [in reference to transfers made after June 22, 1936]—Except as provided in this paragraph, it is *immaterial* . . . at what time or from what source the decedent acquired his power . . . .

. . . .

(c) [T]he value of an interest in property transferred by the decedent *before June 22, 1936*, is not included in his gross estate under section 2038 unless the power to alter, amend, revoke, or terminate *was reserved* at the time of the transfer. For purposes of this paragraph, the phrase "reserved at the time of the transfer" . . . *has reference to any understanding, express or implied, had in connection with the making of the transfer that the power would later be created or conferred.*

Treas. Reg. § 20.2038-1 (1958) (emphasis added).

36. H.R. REP. No. 2818, 74th Cong., 2d Sess. 9 (1936), *quoted in* note 34 *supra*.

37. Treas. Reg. § 20.2038-1 (1958), *quoted in* note 35 *supra*.

38. 36 Am. Fed. Tax R.2d at 75-6416 to 6417, 75-1 U.S. Tax Cas. at 87,480 (M.D. Fla. 1975). The court's statement is quoted in note 27 *supra*.

39. The type of cases arising under a statute has no bearing on congressional intent. Since 1936 only two cases other than *Reed* have arisen involving after-acquired powers, and both dealt with pre-1936 transfers. Fabian v. United States, 127 F. Supp. 726 (D. Conn. 1954); Estate of Franklin W.M. Cutcheon, 3 T.C. 636 (1944). The absence of cases shows either that decedents have not held after-acquired powers at death sufficient to cause operation of § 2038, or that the parties have not taken these cases to the courts for determination. One reason for the absence of litigation may be that attorneys recognized that § 2038 would apply in such circumstances and have advised their clients not to accept such returns of power. It is illogical to suggest that the absence of judicial authority indicates congressional intent or lends support to one construction over another. *See* H. KAHANE, LOGIC AND CONTEMPORARY RHETORIC 56 (1971).

construing a statute does not itself support one construction over another.[40] The court may have been swayed by its belief that imposition of the tax on the Reed estate would cause hardship.[41] When the statute is clear, however, hardship should not influence the court's decision.[42]

The court's heavy reliance on three insurance tax decisions[43] interpreting section 2038 was unwarranted. The discussion in two of these cases was dictum,[44] the third, although on point, relied on the same faulty logic as *Reed*.[45] In essence, section 2038(a)(1), after the 1936

40. The two cases that followed *White* involved transfers made before 1936. Fabian v. United States, 127 F. Supp. 726 (D. Conn. 1954); Estate of Franklin W.M. Cutcheon, 3 T.C. 636 (1944). *Reed* was the first case to test whether § 2038(a)(1) applied to post-1936 unconditional transfers when the decedent held after-acquired powers at death. *See* note 39 *supra*.

41. The court stated that the decedent had made a "complete, absolute disposition" and only because of a "totally unrelated and fortuitous reconveyance" did he have any control over the property at his death. 36 Am. Fed. Tax R.2d at 75-6417, 75-1 U.S. Tax Cas. at 87,480. The reconveyance might not have been either fortuitous or unrelated because the decedent asked his daughter to create the trust. *See* note 3 *supra*. For a discussion of express or implied agreements between the decedent and his daughter, see notes 5 & 19 *supra*.

42. Clear statutory language should apply regardless of hardship. J.E. Riley Inv. Co. v. Commissioner, 311 U.S. 55, 59 (1941). If the language is plain, courts must assume that Congress considered the possibility of hardship and decided that the benefits of the statute outweighed the burdens of hardship. *Id.* For a discussion of the plain meaning rule, see note 30 *supra*. The Supreme Court has stated that it will not grant relief for hardship created by the plain meaning of a statute:

> Petitioner urges that this result will produce hardship here. . . . That may be the basis for an appeal to Congress in amelioration of the strictness of that section. But it is no ground for relief by the courts from the rigors of the statutory choice which Congress has provided.

J.E. Riley Inv. Co. v. Commissioner, *supra* at 59 (1941). *See also* Helvering v. Lerner Stores Corp., 314 U.S. 463, 468 (1942); McClain v. Commissioner, 311 U.S. 527, 530 (1941); Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of Recent Decisions*, 35 ILL. L. REV. 779 (1941). Surrey contends that the tax laws must be more specific because the judiciary develops standards too slowly and often inadequately. He discussed two clear problems created by particularity: 1) hardship; and 2) tax avoidance schemes based on strict interpretation of the statute. To overcome these problems Surrey suggests that courts should intervene to halt tax avoidance, but should leave amelioration of hardship to the taxpayer up to the Congress, which could use private relief bills and, in recurring situations, retroactive amendment of the statute to solve the problems. *Id.* at 808-13.

43. Rose v. United States, 511 F.2d 259 (5th Cir. 1975); Estate of Lumpkin v. Commissioner, 474 F.2d 1092 (5th Cir. 1973); Estate of Skifter v. Commissioner, 468 F.2d 699 (2d Cir. 1972). *See* note 29 *supra*.

44. Rose v. United States, 511 F.2d 259 (5th Cir. 1975); Estate of Lumpkin v. Commissioner, 474 F.2d 1092 (5th Cir. 1973). *See* note 29 *supra*.

45. Estate of Skifter v. Commissioner, 468 F.2d 699 (2d Cir. 1972). *Skifter*

amendment, presumed all transfers of property, the enjoyment of which was subject to the transferor's control at his death, to be testamentary in nature and taxed them as such.[46] The *Reed* holding denies effect to this presumption.[47] If *Reed* were followed, courts must exam-

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concerned insurance policies originally held by decedent and unconditionally assigned to his wife, who in turn devised them to a trust and named decedent as trustee. The *Skifter* opinion, while hardly a model of clarity, relied on two distinct theories to exclude these policies from taxation: each was premised on the belief that § 2038 applied only to retained powers. First, the court reasoned that the absence of a beneficial interest in the insurance policies meant decedent lacked the necessary incidents of ownership. The Commissioner argued that § 2042 did not require such a beneficial interest if decedent held incidents of ownership at death, citing cases dealing with § 2038. The court refuted this argument by construing § 2038 to require a retained interest. *Id.* at 703. Second, the court construed § 2042 *in pari materia* with the rest of the estate tax code, *id.* at 702; hence, the retention requirement of § 2038 also applied to § 2042.

The premise of the court's holding—that § 2038 required an originally retained interest—rested on a weak foundation. The court reasoned that § 2038 had never before been applied in such situations. *Id.* at 704, *quoted in* notes 27 & 29 *supra*. Before *Reed*, however, no court had rejected such a construction since the issue had simply not been litigated. The absence of case law construing a particular rule does not support one conclusion over another. *See* note 39 *supra* and accompanying text. The *Skifter* court also thought that estate planning would be disrupted by a contrary ruling. Donors choose to divest themselves of powers based on anticipated tax consequences, dispositions which would be upset if property transferred unconditionally were later to return, at least in part, to decedent's control. 468 F.2d at 703. Because trustees can always decline to accept a position in which they have such powers, this argument is not convincing. Of greater concern is the ease of tax avoidance under the *Reed* construction. *See* notes 46-50 *infra* and accompanying text.

46. INT. REV. CODE OF 1954, § 2038(a)(1), *quoted in* note 6 *supra*. For a discussion of the purposes of the statute and the intent of Congress, see notes 10 & 11 *supra* and accompanying text. With few exceptions, the statute taxes the value of all transferred property when the transferor held some control over the property at his death. The source of the power is immaterial. *See* note 35 *supra*. Thus, the taxpayer who transfers property to avoid taxation must not allow control of the property ever to revest since if he died holding such powers, the value of the transferred property would be includible in his gross estate under § 2038(a)(1). The propriety of such a rule is not for the courts to decide. *See* note 42 *supra*. The section exempts transfers for bona fide consideration, and some courts exempt transfers when the control decedent held at death was minimal. INT. REV. CODE OF 1954, § 2038(a)(1); United States v. Powell, 307 F.2d 821 (10th Cir. 1962) (decedent's investment powers and his power to invade trust corpus not included in § 2038(a)(1) because they were limited to judicially enforceable external standards); Estate of Edward E. Ford, 53 T.C. 114 (1969), *aff'd*, 450 F.2d 878 (2d Cir. 1971) (same). Neither of these exceptions is applicable to *Reed*.

47. *See* note 7 *supra* and accompanying text and note 46 *supra*. Other than *White*, the only case cited by the *Reed* court specifically dealing with revocable transfers was Howard v. United States, 125 F.2d 986 (5th Cir. 1942), which is of little precedential value since it dealt only with pre-1936 law. In *Howard*, decedent and his wife were Louisiana residents, and under state law all gifts between spouses

ine the conditions of the original transfer to find an express or implied agreement that the donee was to reconvey control to the donor in order to find section 2038(a)(1) liability when the transferor does not directly reserve control. While such an agreement would create liability,[48] this decision tempts taxpayers to make this type of transfer, gambling that a court would not imply such an agreement.[49] *Reed* thus reintroduces the problems Congress sought to avoid by enacting the 1936 amendment.[50] A better interpretation of section 2038(a)(1) which considers the plain language and legislative history would avoid these problems and properly carry out the purposes of the statute.[51] *Reed* should not be followed.[52]

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during marriage were revocable. Prior to the 1936 amendments, decedent made gifts to his wife and died while holding this statutory power to revoke. The decedent argued that under *White* § 302(d) would not apply to transfers when the power to revoke was not reserved in the transferring instrument. The court held the value of the gifts includible in the decedent's gross estate and stated:

> The revenue statute does not create any distinction as to the source of the power to revoke. It has been uniformly construed to operate alike upon all gifts rendered incomplete by a reservation in the donor of a power to revoke.

Howard v. United States, 125 F.2d 986, 989 (5th Cir. 1942).

48. Treas. Reg. § 20.2038-1(c) (1958), *quoted in* note 19 *supra.*

49. 36 Am. Fed. Tax R.2d at 75-6416 to 6417, 75-1 U.S. Tax Cas. at 87,480.

50. *See* notes 19 *supra* & 51 *infra.*

51. Some of the problems created by this decision are discussed in note 19 *supra.* The major problems would involve proof of the parties' intentions. The statute does not require the parties to have intended to reserve a power, but for a court to imply an agreement to return a power it would have to examine the parties' intentions. The obvious problem is that by the time the case reaches the court one of the parties to the agreement is dead. Another problem arises from the court's language. The court stated that the statute was intended to apply when the decedent "sets machinery in motion which purposefully allows fiduciary powers . . . to return to him." 36 Am. Fed. Tax R.2d at 75-6416, 75-1 U.S. Tax Cas. at 87,480. The court's language might mean that the decedent must intend the provision in the transferring instrument be used to return control to him. A taxpayer might argue that it was not his intention to have the provision used to return control to him. For example, did the decedent in *White* intend the provision in her trust allowing the appointment of new trustees to be used to return power to her? The proper interpretation should be that the decedent intended to create a mechanism to cope with unforeseen circumstances—the resignation of a trustee in *White*—and the mechanism was, in fact, used to return control to him.

If the clear language of the statute is followed, none of these problems arise. Congress, by the use of broad language, sought to avoid the problems *Reed* has recreated. The benefits gained from a strict statutory interpretation outweigh the hardships such an interpretation creates. *Reed* allows a perfect means of tax avoidance.

52. On August 14, 1975, the Solicitor General decided not to appeal *Reed.* Letter from Rodger A. Moore to author, Aug. 28, 1975. Appeal was not filed within the statutory period. Fed. R. App. P.4(a) (30 days).