

ST. LOUIS LAW REVIEW

Vol. XXI

JUNE, 1936

No. 4

RESERVATION OF CONTROL BY THE SETTLOR OF A PRIVATE TRUST AS AFFECTED BY FEDERAL TAX LEGISLATION*

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Taxes, at their best, are bothersome creatures. The battle between the taxpayer and the government is an incessant one. The government constantly bombards the fortifications of the taxpayer. With legalistic ingenuity of the same order, the taxpayer constantly seeks new defensive measures. Tax lawyers are the strategists for both sides in this endless battle of wits.

Impartially, the judges look down from their heights upon the ever-lasting conflict, here and there planting a judicial bomb which destroys the well-laid plans of both the government and the taxpayer. Both are within their legal rights. The government has its prerogative to tax; the taxpayer his license to escape taxation. "There is nothing unlawful, or even mildly unethical, in the motive of the petitioner, to avoid some portion of the burden of taxation."¹ The courts, as unbiased arbiters, have consistently given approval a disposition of property in the manner best suited to lessen the burden of taxation. As expressed by the oft quoted words of Mr. Justice Holmes, in *Bullen v. Wisconsin*,²

"We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as an evasion what is meant is that it is on the wrong side of the line indicated by the policy if not by the mere letter of the law."

* Submitted in fulfillment of requirement for degree of Doctor of Jurisprudence, Washington University, 1936.

¹ *Marshall v. Commissioner* (C. C. A. 1932) 57 F. (2d) 633.

² (1916) 240 U. S. 625.

Perhaps in no one field of taxation has there been such a conflict as that arising within the last twenty years in the realm of trusts. A discussion of the entire problem is clearly beyond the scope of any one article. An inquiry into the attempts of the settlor to reserve control as affected by the manipulations by Congress of its taxing powers is all that will be attempted here. Following a general introductory discussion of the question a thorough analysis seems logically to divide into three phases, first, control by the settlor alone, secondly, control by the settlor plus another, thirdly, control by the reservation of a prior particular estate.

I. THE PROBLEM IN GENERAL

A. *The Incidents of a Trust*

Though undoubtedly the problem has become of vast importance during the past two decades it is by no means of such recent origin. Trusts have long served as means of escape from the embarrassments of ownership and the onerous duties of taxation. Their prevalence for such a purpose was recognized so long ago as the reign of Henry the Eighth; and the now famous Statute of Uses was passed to prevent the avoidance of feudal dues by such means.³ The Statute merely converted the beneficial use into legal ownership and therefore did not abolish trusts as such. In fact it was perhaps after the enactment of this statute that trusts began to grow in legal prominence. As Lord Chief Justice Mansfield observed, "Trusts are made to answer the exigencies of families, and all other purposes, without producing one of the inconveniences, frauds, or private mischiefs which the statute of Henry VIII, c. 10, was intended to avoid."⁴

The advantage of the trust lies in the fact that the settlor can rid himself of the troublesome elements of ownership and at the same time retain perhaps not only the beneficial interest but also the element of control. It is this unwillingness to relinquish all

³ The Statute of Uses, 27 Hen. VIII, Ch. 1 (1535). Quoting from the preamble: "Where . . . by reason whereof, and by occasion of which fraudulent feoffments, fines, recoveries and other like assurances to uses, confidences and trusts, . . ., the Lords have lost their wards, marriages, reliefs, harriots, escheats, aids pur fair fits chivalier, and pur fil marier, . . .; the King's highness hath lost the profits and advantages of the lands of persons attainted, and of the lands craftily put in feoffments to the uses of aliens born, and also the profits of waste for a year and a day of lands of felons attainted, and the Lords their escheats thereof; . . ."

⁴ *Burgess v. Wheate* (1757), 1 Eden 177, l. c. 223, 28 Eng. Rep. 670.

power and control over the trust corpus, or even over the income, which causes the collision with the taxing statutes.

The validity of the trusts has not, strangely enough, been seriously questioned by the courts when involving themselves with the taxing statutes.⁵ A trust may be perfectly valid under the elements of trust law, and yet, so far as the principles of taxation are concerned, be considered as taxable to the settlor.⁶ However, in taxing to the settlor the income or corpus of a trust, Congress does seem to have been influenced by some of the distinctions bearing upon the validity of a trust. The retention of control, thereby preventing the complete passing of the beneficial interest, is the all important element. The problem is twofold. It involves, for purposes of the income tax, the distinction between a valid trust and an agency, and for purposes of the estate tax the distinction between a transfer *inter vivos* by deed, and a transfer by will, to a trustee.

"The germ of agency is hardly to be distinguished from the germ of another institution which in our English Law has an eventful future before it, the 'use, trust or confidence'." The features distinguishing a trust from an agency are simple of statement but difficult of application. The creator of a trust must keep in mind that the chief essential is that the instrument clearly states and shows that full possession, care, custody, control, and management, as well as legal title passes to the trustee, until the trust is revoked or terminated.⁷ He must divest himself of title in a permanent or definitive way and must strip himself of every interest in the subject matter of the trust estate.⁸ In taxing the income from a trust as if it were the settlor's income Congress has had in mind the retention by the settlor of the economic benefits and control. When there is no such retention the resulting instrument is clearly a valid trust, and, generally speaking, is free from taxation to the settlor.

⁵ Though of course they are urgently concerned with the problem as to whether one or several trusts have been created, thereby splitting up the income. See *Wynne v. Commissioner* (C. C. A. 1935) 77 F. (2d) 473.

⁶ The trustor may reserve the right to alter or amend and to revoke the trust instrument in whole or in part without affecting its validity, *McEvoy v. Boston Five Cent Bank* (1909) 201 Mass. 50, 87 N. E. 465, yet such a trust is clearly taxable to the settlor's estate under the present tax laws.

⁷ Pollock and Maitland, *History of English Law*, Vol. II, p. 228.

⁸ Restatement, *Trusts*, sec. 8.

⁹ *DuPont v. Commissioner* (1933) 289 U. S. 685.

The theoretical difference between a transfer by deed *inter vivos* and a transfer by will to a trustee is again quite simple of statement. A deed has an immediate operative effect to pass a present or future interest in property, either vested absolutely, vested subject to being divested, or contingent, whereas a will has no immediate operative effect. Worthy of consideration is the intent of the decedent, as well as the time of taking effect manifestly expressed upon the face of the instrument. A deed passes present interests to the grantee. If the grantor holds back for himself extremely broad rights and powers may he not reduce the interest granted to the grantee until it becomes in fact illusory? It is when the shifting of the economic interests is subject to some further action, or lack of action, on the part of the settlor before it passes to the beneficiaries that its validity as a transfer by deed comes in question, and Congress seeks to levy the tax against the settlor's estate.

Originally the task of the draftsman consisted chiefly in framing the trust instrument in such a way as to effectuate the expressed intention and desire of the settlor as to the disposition of the property, while at the same time observing the necessary formalities avoiding collision with such restrictions as those found in the rule against perpetuities and the rule against restraints on alienation. Today, due regard for the interests of his clients compels him to realize that a trust settlement may be framed in such a way as to approach perfection from these points of view, yet be seriously defective because it exposes the settlor's estate or the trust property and the beneficiaries to unnecessarily heavy tax burdens.¹⁰ In determining whether the trust form will be disregarded the elements of control retained by the settlor are of chief significance. The retention of too many of these elements indicates that there has been no material change in the settlor's relationship to the property conveyed.

B. *The Statutes Involved*

The rapidly changing legislation in this field necessitates a consideration of each decision in light of the specific statutes involved, and with the subsequent statutory changes in mind. Transfers in trust which, a few years ago, were free from taxation, today fall within the categories defined by the statutes and

¹⁰ Bogert, *Trusts and Trustees* (1935) Vol. 2, p. 836.

are thereby taxable. Definitely to state that certain factual situations are not taxable is to fail to reckon with the uncertainties of the Congressional mind. The present statutes have narrowed toward extinction the avenues of escape from taxes upon transfers of property without consideration. Before an intelligent discussion of the diverse situations which have presented themselves to the courts may be had a brief general discussion of the applicable statutes is essential.

A system of inheritance taxation restricted in scope to the disposition of property by will or intestacy would be futile. Little ingenuity is required to circumvent such legislation by *inter vivos* dispositions reserving to the transferor the benefits of ownership. Provisions of the Federal Estate Tax reaching these transfers thus impart effectiveness to an otherwise feeble measure. First enacted by Congress in 1916¹¹ the development of the estate tax has ever been a struggle more fully to effectuate the Congressional intent to tax the entire estate possessed by one during his lifetime. No one has the inherent right to transfer property to others at his death, either by will or intestacy. The right to take property by will or descent is a privilege, and the authority conferring the privilege may impose conditions upon its exercise.¹² The tax thus devised by Congress is not upon the property but is laid upon the privilege of transmitting property at death.¹³

The principal auxiliary provisions of the first enactment were the taxing of an interest or trust created in contemplation of death or intended to take effect in possession or enjoyment at or after death. The former was included because such a transfer is considered to be testamentary in effect, and such a provision was necessary to prevent circumvention of the law.¹⁴ Transfers in actual contemplation of death have characteristics in common

¹¹ Rev. Act of 1916, sec. 200 et seq. 39 Stat. 777.

¹² Knowlton v. Moore (1900) 178 U. S. 41. The power to impose conditions is not, however, unlimited. The provisions as to due process in both the Fifth and Fourteenth Amendments, as well as similar provisions in State Constitutions, are restricting hands.

¹³ Coolidge v. Long (1931) 282 U. S. 582; Y. M. C. A. v. Davis (1924) 264 U. S. 47; Ithaca Trust Co. v. U. S. (1929) 279 U. S. 151. It is collected on the transfer of his estate by the decedent and thus is known as the Estate or Transfer tax.

¹⁴ Keeney v. N. Y. (1912) 222 U. S. 525; Milliken v. U. S. (1931) 283 U. S. 15.

with transfers at death so as to justify the inclusion of the former with the latter in the scheme of taxation. Whether transfers are in contemplation of death is largely a question of the particular facts involved. Confronted with the difficulty of proof of such contemplation, statutory presumptions have been enacted.¹⁵

Closely allied with transfers in contemplation of death are those taking effect in possession or enjoyment at or after death. While they are within the same category for the purpose of taxation there is a clear line of demarcation between them. Gifts to take effect at or after death are distinguished from testamentary transfers in that they are made during life, usually by trust deed or declaration of trust. They are distinguished from gifts in contemplation of death in that the motive is not considered in the former. From the viewpoint of taxation there is, in principle, no difference between property passing by deed intended to take effect in possession or enjoyment at or after the death of the grantor and property passing by will or intestacy. In either case it is the privilege of disposing of property after the death of the grantor or testator which is taxed. Experience soon demonstrating the inadequacies of this system, Congress included in the revenue act of 1918 the value of property passing under a power of appointment exercisable by the decedent as well as amounts receivable under insurance policies upon the life of the decedent.¹⁶

There remained as two important means of tax avoidance: *inter vivos* gifts and the possibilities afforded by the trust device. Thus the revenue act of 1924 saw the birth of two new prodigies. The Estate Tax added a provision including in the value of the decedent's estate such transfers as were subject to revocation,¹⁷ and the Gift tax was enacted taxing all *inter vivos* gifts.¹⁸ The

¹⁵ In 1926 was enacted the so called "irrebuttable presumption" clause which provided that gifts made within two years of death are made in contemplation of death. Rev. Act. of 1926, sec. 302 (c) 44 Stat. 70. However this clause was held unconstitutional in *Heiner v. Donnan* (1932) 285 U. S. 312. Thus in 1932 the provision was dropped and under the present law there is merely a rebuttable presumption.

¹⁶ Rev. Act of 1918, sec. 402 (e), (f). 40 Stat. 1097. Sec. (f) as to insurance is subject to certain exemptions, viz., \$40,000 as to insurance payable to specific beneficiaries.

¹⁷ Rev. Act of 1924, sec. 302 (d). 43 Stat. 304.

¹⁸ Rev. Act of 1924, sec. 319 et seq. 43 Stat. 313. Until this time payments of money or irrevocable transfers of property which were wholly or partially donative in character were not taxed by the federal government unless they fell within the scope of the estate tax.

gift tax, owing to alleged administrative difficulties,¹⁹ was repealed in 1926, but it has reappeared in the 1932 act and has considerably minimized the advantages of estate tax avoidance by means of outright gifts *inter vivos*.²⁰

Following the decision in *May v. Heiner*²¹ wherein the Supreme Court held that if the settlor created an irrevocable trust *inter vivos*, retaining only the income from the trust property to himself for life, the trust was not taxable at his death as a transfer "intended to take effect in possession or enjoyment at or after death," Congress enacted an amendment to the revenue act of 1926, providing for the inclusion under the federal estate tax of *inter vivos* transfers in trust where the settlor reserved a life income.²²

With the passage of the sixteenth amendment and the subsequent taxing of incomes the trust was immediately seized upon as a source of aid to the taxpayer. It became a rather common occurrence for a wealthy person whose income was large enough to be subject to the higher rates of surtax, to convey a considerable portion of his estate to trustees to pay the income in designated shares to his wife and to one or more of his children, reserving however, the power to direct the management of the trust property and the investment of the funds, as well as the power to revest title in himself if he should so choose to do.²³ In this manner his income was split up and his tax bill greatly re-

¹⁹ It also met with constitutional difficulties, the Supreme Court refusing to apply it retroactively. *Blodgett v. Holden* (1927) 275 U. S. 142; *Untermeyer v. Anderson* (1928) 276 U. S. 40. Though the constitutionality of the act itself was upheld. *Bromley v. McCaughn* (1929) 280 U. S. 124.

²⁰ The present rates are approximately two-thirds the general level of rates under the Federal Estate Tax. And it must be remembered that the gift tax is due and payable immediately at the time of the gift, whereas the estate tax is not payable until the decedent's death. Thus the elements of present value and compound interest play an important part in determining the ultimate advantage of the use of the trust.

²¹ (1930) 281 U. S. 238. In this case the settlor reserved the income to herself only after the death of her husband. Thus this direct statement was really dicta. However the applicability of this dicta to a situation where the settlor reserved directly to himself a life estate with a vested remainder in fee limited over was the basis for the decisions in three Per Curiam decisions rendered March 2, 1931. *Burnet v. Northern Trust Co.* (1931) 782; *Morsman v. Burnet* (1931) 283 U. S. 783; *McCormick v. Burnet* (1931) 283 U. S. 784.

²² Enacted March 3, 1931, the day following the reading of these three Per Curiam decisions. (1934) 26 U. S. C. A. 411 (c), 46 Stat. 1516.

²³ *Op. Cit.*, note 10, p. 862.

duced by escaping the higher brackets of the surtax, while at the same time he reserved to himself virtually complete control over the property. It became evident that if the tax were to be effective, this loophole would have to be closed, and thus the act of 1924 inserted a provision taxing as income of the grantor the income of any trust in which the grantor retained the power, alone or with the consent of someone not a beneficiary to revest in himself, at any time during the taxable year, title to any part of the corpus.²⁴ The phrasing of the statute proved unfortunate and thus in 1934 the provision "at any time during the taxable year" was deleted and it now reads, "where at any time the power to revest. . ."²⁵

With these statutory enactments and their subsequent judicial application well in mind, the writer has concluded that the purpose of Congress²⁶ in enacting these auxiliary provisions to the Estate Tax and Income Tax was to tax to the settlor the income and corpus of transfers in trust in which the settlor has not relinquished the economic benefits therein. It is the retention of control over these economic benefits which subjects him to the income tax. It is their retention in such a manner that his death causes them to pass from him to another which brings them within the scope of the estate tax. It must be added that an additional incentive has influenced the progress of the Estate Tax, that is, a desire to tax the entire estate possessed by one during his lifetime. The Gift Tax adds to the strength of this position. It is with these principles in mind that we proceed to a consideration of the cases.

II. CONTROL BY THE SETTLOR ALONE

A. *The Right to Revoke*

"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. . . .

d) Revocable Transfers.

To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise,

²⁴ Rev. Act of 1924, sec. 219 (g), 43 Stat. 276.

²⁵ *Infra*, note 45 wherein cases circumventing this provision are discussed. Rev. Act. of 1934, sec. 166, 48 Stat. 729.

²⁶ Aside from the always elementary desire to produce revenue. See *Helvering v. Stockholm Enskilda Bank* (1934) 293 U. S. 84, l. c., 89, wherein the court said, "The General object of this act is to put money into the federal treasury."

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, or where the decedent relinquished any such power in contemplation of his death, except in the case of a bona fide sale for an adequate and full consideration in money or money's worth. . . ."²⁸

There can be no doubt that, barring constitutional difficulties, under this statute a transfer in trust wherein the settlor reserves to himself alone a power to alter, amend or revoke, will be properly included in his gross estate. Yet even before the inclusion of this comprehensive provision the courts had very little difficulty in holding such a transfer taxable as part of the decedent's estate.²⁹ Under the clause taxing "transfers to take effect in possession or enjoyment at or after death" the Supreme Court has clearly held such to be taxable.³⁰ The Estate Tax seeks to impose itself upon the transfer of the enjoyment of the property from the dead to the living. Granting that Congress has the power to levy a tax upon the net estate of a decedent it may adopt any reasonable measure of that tax.³¹ And it is reasonable to measure it by the value of property of which the decedent during his lifetime has made a disposition which partakes of the nature of a testamentary disposition. Obviously in such a situation the intent of the settlor is that the principal of the trust shall not vest in full possession and enjoyment until after the death of the settlor.³² Upon the death of the settlor the enjoyment of the property passes to others as effectively as though bequeathed by will. And it is the shifting and relinquishment of such economic benefit which the statute taxes.³³

A constitutional question vigorously urged by the taxpayer was

²⁸ 26 U. S. C. A. 411 (1934).

²⁹ *Bullen v. Wisc.* (1916) 240 U. S. 625. This case involved a state statute taxing transfers "to take effect in possession or enjoyment at or after death." The settlor reserved the right to revoke the trust, and the trust was held includible in the settlor's estate.

³⁰ *Reinecke v. No. Trust Co.* (1929) 278 U. S. 339.

³¹ *Coolidge v. Nichols* (1925) 4 F. (2d) 112, *affd.* (1927) 274 U. S. 531.

³² As Justice Holmes said in *Bullen v. Wisconsin*, *supra*, which seems to be the earliest case presented to the Supreme Court on the subject of powers of revocation in inheritance taxation, "The words of Lord St. Leonards apply with full force to the present attempt to escape the Wisconsin inheritance tax. 'To take a distinction between a general power and a limitation in fee is to grasp at a shadow while the substance escapes!'"

³³ *U. S. v. Stark* (C. C. A. 1929) 32 F. (2d) 453.

that of retroactivity. Retroactivity in itself does not seem to be objectionable. The objectionable feature arises when the law results in the taking of property without due process in violation of the fifth amendment.³⁴ Relying upon the decision of the Supreme Court in *Nichols v. Coolidge* several federal courts decided that a trust, reserving a power of revocation, was not taxable as part of the decedent's estate; that though they were subject to inclusion in his gross estate under the statute, as thus applied it was fatally retroactive.³⁵ The Supreme Court, however, soon corrected this erroneous view ruling that a "transfer made subject to power of revocation in the transferor is not complete until his death."³⁶ Though the taxing statute was passed after the establishment of the trust its application was not fatally retroactive since the settlor's death followed its enactment. Today there is no doubt as to the inclusion in the grantor's estate of a transfer in trust reserving to the settlor the right to alter, amend or revoke, regardless of the date of formation of the trust.³⁷

The Gift Tax is merely a means to an end. It is in accord with the desire of Congress to tax the transfer of the entire estate

³⁴ For a discussion of this see, Neuhoﬀ, *Retrospective Tax Laws*. 21 St. L. L. Rev. 1. *Nichols v. Coolidge* (1927) 274 U. S. 531 "Undoubtedly Congress may require that property subsequently transferred in contemplation of death be treated as part of the estate for taxation purposes. This is necessary to prevent evasion and give practical effect to the exercise of admitted power, but the right is limited by the necessity." And the case held, "so much of 402 (c), 1919, as requires that there be included in the gross estate of a decedent for purposes of taxation (estate) the value of property transferred by decedent prior to its passage merely because the conveyance was intended to take effect in possession or enjoyment at or after his death, is arbitrary and capricious, amounts to confiscation and violates the constitutional provision against taking property without due process of law." See also, *Coolidge v. Long*, supra, note 13.

³⁵ *Stark v. U. S.* (1927) 24 F. (2d) 37; *Hill v. Nichols* (1927) 18 F. (2d) 139 (d) "Fact that the settlor reserved the income and the right to alter or terminate is not sufficient to bring it within that reasonable relation to the subject of the tax which is necessary in order to render the measure a reasonable one."

³⁶ *Reinecke v. Northern Trust Co.* (1929) 278 U. S. 339. The court distinguished *Nichols v. Coolidge*, supra, note 34, on the ground that the trust therein was not revocable when the taxing statute was passed.

³⁷ *Home Trust Co. v. Edwards* (1929) 30 F. (2d) 976 (D); *Dean v. Willcutts* (1929) 32 F. (2d) 374 (D); *Fidelity Trust Co. v. McCaughn* (1929) 34 F. (2d) 443 (C. C. A.); *Hanna v. U. S.* (1929) 68 Ct. Cl. 45; *Union Trust Co. v. U. S.* (1931) 54 F. (2d) 152, cert. den. 286 U. S. 547, wherein the decedent reserved the right to make other disposition of the property. *Burnet v. Pac. etc. Bank* (1931) 45 F. (2d) 773 (C. C. A.), cert. den. 283 U. S. 825; *Tait v. Safe Deposit and Trust Co.* (1934) 74 F. (2d) 851, affg. 7. F. Supp. 40.

owned by one during his lifetime. Under the 1932 revenue act all transfers donative in character, whether in trust or otherwise, are subject to tax.³⁸ Consistent with the underlying economic theory including revocable transfers in trust in the gross estate of the decedent for purposes of the estate tax, such are not taxable as a gift. The gift tax is imposed upon a transfer passing both legal and beneficial title. It taxes the passing of the economic benefits from the property. Thus the cancellation of a power to alter, amend or revoke a trust is taxable as a gift.³⁹ Consequently all transfers in trust are taxable under the Gift Tax, but when the gift is not legally complete, i. e., the settlor reserving powers which renders the trust subject to inclusion in his gross estate for the purposes of the Estate Tax, it is taxable there and not as a gift.⁴⁰

"The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income whether he sees fit to enjoy it or not."⁴¹ It is upon this legal theory that taxation to the settlor of income from revocable trusts has been sustained. It takes no legal reasoning to see how easily one might avoid the higher brackets of the income tax by a division of his income into trusts, at the same time retaining full and complete authority through a power of revocation.⁴² The constitutionality of this clause was upheld in *Corliss*

³⁸ Rev. Act 1932, ss. 501-532, (1934) 26 U. S. C. A. sec. 550 et seq.

³⁹ *Burnet v. Guggenheim* (1933) 288 U. S. 280, rev. 58 F. (2d) 188. The decision in this case was under the 1924 Act. The 1932 act contained a specific provision taxing such transfers. The decision in this case rendering such a specific requirement unnecessary it was dropped in the 1934 act. Treasury Regulation 79, Art. 3 treats the surrender of such a power as a taxable gift. And *Kate R. DeForest*, (1932) 27 B. T. A. 373, held that the date of the surrender of the power determined the time of the gift.

⁴⁰ It thus may often happen that a person will make a transfer in trust and return a gift tax upon this, and later, upon his death, the government will properly assess and collect an estate tax upon this same property. However, the Estate Tax provides for just such a contingency allowing as a credit against the net Estate Tax payable the amount of tax paid under the Gift Tax. Sec. 801, Revenue Act of 1932. (1934) 26 U. S. C. A. sec. 413. The credit is however subject to some limitations and is not nearly as simple of application as this brief statement would seem to make it.

⁴¹ Mr. Chief Justice Holmes in *Corliss v. Bowers* (1929) 281 U. S. 376, l. c. 378.

⁴² The present provision in the revenue act applying to such transfers is as follows: Sec. 166, 1934 Revenue Act. "Revocable Trusts. (1934) 26 U. S. C. A. sec. 166. Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested

1) in the grantor, either alone or in conjunction with any person not hav-

v. Bowers,⁴³ as well as its application retroactively. The income being at all times potentially within the power and under the control of the settlor it is taxable to him.⁴⁴ Such a decision was practically a virtual necessity if the integrity of the surtax as a vital feature of the income tax system was to be maintained.

A brief skirmish here by the taxpayer soon forced Congress to retrench behind the protecting walls of a statutory enactment. The taxpayer was quick to seize upon the phrase, in the original draft, "at any time during the taxable year," and thereby sought to avoid the ominous burden imposed by Congress. Through a simple but adroit legal form trusts were established, which though revocable, were not so during the taxable year, and the courts confirmed this practice as a successful compliance with the terms of the statute.⁴⁵

They were careful to point out that these disputed words were not in the original draft of the bill as passed by the House, but were inserted by the Senate and adopted in Conference.⁴⁶ Thus the application of the statute was limited to those cases where

ing a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or,

2) in any person not having a substantial adverse interest in the disposition of such part of the corpus for such taxable year shall be included in computing the net income of the grantor."

⁴³ *Supra*, note 41. Another oft cited phrase was there uttered by Mr. Chief Justice Holmes, "But taxation is not so much concerned with the refinements of title as it is with the actual command over the property taxed—the actual benefit for which the tax is paid."

⁴⁴ *O'Donnell v. Commissioner* (C. C. A. 1933) 64 F. (2d) 634; cert. den. 290 U. S. 635; *George Washington* (1934) 30 B. T. A. 788.

⁴⁵ *Langley v. Commissioner* (C. C. A. 1933) 61 F. (2d) 796. The settlor retained the right to revoke upon notice in writing given twelve months and one day prior to its taking effect. No such notice being given the income for that year was held not taxable to the grantor. *Accord*, *Mabel A. Ashforth* (1932) 26 B. T. A. 1188; see also, *Faber v. U. S.* (Ct. Cl. 1932) 1 F. Supp. 859, wherein the provisions of the trust were, "shall not have the power during any taxable year, within the meaning of the Revenue laws of the U. S., to revert in himself title, except upon written notice delivered to the trustee during the preceding taxable year." Held, not taxable to the grantor. *F. M. Canfield* (1934) 31 B. T. A. 724, wherein the trust was to expire Jan. 3, 1931, irrevocable during its existence. Held, 1930 income not taxable to the grantor. *Lewis v. White* (D. 1932) 56 F. (2d) 390, App. Dis. 61 F. (2d) 1046, wherein notice had to be given prior to January first. Held, not taxable to the grantor.

⁴⁶ The Senate Finance Committee, referring to this section, reported as follows: "This section provides that when the grantor of a trust reserves the right to change the trust in favor of himself, the income is taxed to the grantor. The subdivision of the House Bill has been rewritten in order that there shall *not* be taxed to the grantor the income of a trust as to which the grantor has a power of revocation subject however to a condition which has not happened." *Lewis v. White*, *supra* l. c. 392.

the grantor had reserved in the trust agreement an unconditional power by the exercise of which during any taxable year he could control or appropriate the income derived from the trust during that year which was actually payable to another.⁴⁷ The reservation of this "unfettered command" over the income was alone subject to the tax. And so a trust revocable upon sixty days notice,⁴⁸ and one upon six months notice,⁴⁹ were taxable.

Judge Augustus Hand vigorously dissented in *Langley v. Commissioner*⁵⁰ contending that the "condition" referred to in the report of the Committee could not reasonably be thought to have been a mere notice of intention to revoke within the sole control and whim of the settlor, but must be something of substance dependent upon an occurrence other than what amounts to an exercise of the power itself. From a practical taxable basis this is by far a more logical view of the situation. The 1934 Revision of the revenue act corrects this technicality by taxing to the grantor the income of a trust where "at any time" the power to revert in the grantor exists. This is in accord with the theory that the tax shall be imposed whenever the economic benefits remain within the control of the grantor. Apparent support for the authority of Congress to do this is found in the dictum in *DuPont v. Commissioner*. Aside from the real basis of the decision the court stated that the income from the trust was taxable to the grantor because he did not permanently divest himself of title, and upon this point the judges were in complete concurrence.⁵¹

⁴⁷ An interesting sidelight as to this situation was presented in the case of Richard E. Bebb, (1933) 27 B. T. A. 1091, wherein the decedent created a trust reserving the right to revoke by a notice given December 1, to take effect the succeeding January. By this means it was sought not only to avoid the income tax but also the federal Estate Tax. The Board of Tax Appeals however pointed out the distinction between 302 (d), the estate tax, and 219 (g) and said that while the income therefrom might not be taxable, under the decision in *Lewis v. White*, supra note 45, this provision had no effect as to the Estate Tax and it was properly taxable thereunder.

⁴⁸ *Simpson v. Commissioner* (C. C. A. 1935) 77 F. (2d) 668.

⁴⁹ *Clapp v. Heiner* (C. C. A. 1931) 51 F. (2d) 224, affg. 34 F. (2d) 506.

⁵⁰ Supra, note 45 l. c. 798, "It is evident that, if the act can be defeated by such a simple mode of drafting a power of revocation as was employed here, a settlor who consults skilled counsel can never be taxed upon the income of a revocable trust. While a man has a perfect right to keep outside of a taxing statute if he can, such an obvious mode of completely avoiding a tax while substantially occupying the position the tax was intended to reach is not to be lightly assumed."

⁵¹ Supra, note 9. See also the decision under the Estate Tax taxing to the settlor the corpus of revocable trusts, supra, notes 35 and 37.

Thus whenever one establishes a trust reserving to himself alone the power to revoke, the trust is included in his gross estate for the purposes of the estate tax, and the income therefrom is taxable as his income.⁵² The beneficial interest remains in the grantor and is properly attributable to him for the purpose of taxation.

B. The Right to Management

The estate tax being levied upon the transfer of economic benefits it is quite evident that it is possible for the settlor to retain to himself certain powers of control in the management. If he goes no farther than to reserve powers which might properly be exercised by a trustee, the trust is not taxable. The shifting of the economic interests being complete when the trust was made it is without the estate tax.⁵³ Similarly it is quite proper for the settlor to declare himself trustee and as such exercise the power completely and solely to manage the trust property and make payments as he sees fit. "By the declaration of trust . . . the legal title, possession and control of the trust estate passed irrevocably from the grantor as an individual to himself as trustee. The effect is no different than if the trustee had been another person."⁵⁴

Still it is easily possible for a situation to arise wherein the

⁵² The Treasury Regulations covering this are found in Reg. 86, Art. 166-1, and have recently been amended by T. D. 4629, March 7, 1936. 1936 P. H. Fed. Tax Service, par. 15, 209.

"If the title to the corpus will revert in the grantor upon the exercise of such power, the income of the trust is attributed to and taxable to the grantor regardless of—

1) Whether such power or ability to retake the trust corpus to the grantor's own use is effected by means of a power to revoke, to terminate, to alter or amend or to appoint;

2) Whether the exercise of such power is conditioned on the precedent giving of notice, or on the elapsing of a period of years, or on the happening of a specified event;

3) the time at which the title to the corpus will revert in the grantor in possession and enjoyment, whether such time is within the taxable year or not, or whether such time be fixed, determinable or certain to come . . ."

⁵³ *Reinecke v. Northern Trust Co.* (1929) 278 U. S. 339. In this case the settlor reserved, 1) a power of supervision as to reinvestment of the trust funds, 2) to require the trustee to execute proxies to his nominees, 3) to vote any shares of stock held by the trustee, 4) to control all leases executed by the trustee, 5) to appoint successor trustees.

For an earlier case on this point see *Norris v. Goodcell* (D. 1927) 17 F. (2d) 181.

⁵⁴ *Becker v. St. Louis Union Trust Co.* (Nov. 11, 1935) 80 L. Ed. (adv.) 54, l. c. 55, 296 U. S.

settlor attempts to reserve a power to manage in such a manner as to render it subject to inclusion in his net estate at death. If he retains such rights therein, or control, as defers possession and enjoyment in the ultimate beneficiaries until his power to control is terminated by death, his death becomes a generating source and the transfer falls within the scope of the estate tax.⁵⁵ If the power reserved is merely one of management the transfer in trust is still subject to the gift tax.

The reservation of the right of management has been of much greater importance in connection with the income tax. The solidarity of the average family has made it possible for the taxpayer to surrender title to another and at the same time to keep dominion for himself, or, if not technical dominion, at least the substance of enjoyment. Early faced with this difficulty in the taxing of incomes, as a companion clause to the revocability provision, Congress enacted a statute taxing income which is for the benefit of the grantor.⁵⁶ Liability for taxes does not have to rest upon the enjoyment by the taxpayer of all the privileges and

⁵⁵ *Burnet v. Pacific etc. Bank*, supra note 37. See also *Commissioner v. Erickson* (C. C. A. 1934) 74 F. (2d) 327, cert. den. 294 U. S. 730, wherein it was held that the power to control amounted to a power to revoke. The settlor had the right to terminate the trust if the trustees sold any of the corpus. And see *U. S. v. Stark*, (C. C. A. 1929) 32 F. (2d) 453. Investments were subject to the control of the settlor during his lifetime, plus a power to revoke. Considering both powers the court held, "he has reserved to himself for life all powers and rights ordinarily incident to ownership, viz., possession, control, enjoyment, disposition. The nature of the trust in effect was testamentary."

⁵⁶ Rev. Act of 1924, sec. 219 (h); 43 Stat. 276. For the present act see Rev. Act of 1934, sec. 167; (1934) 26 U. S. C. A. sec. 167. Sec. 167—"Income for Benefit of the Grantor.

a) Where any part of the income of a trust—

1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor; or

2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor; or

3) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, applied to the payment of premiums upon insurance policies on the life of the grantor (charitable exception) then such part of the income of the trust shall be included in computing the net income of the grantor.

b) As used in this section the term "in the discretion of the grantor" means "in the discretion of the grantor either alone or in conjunction with any person not having a substantial adverse interest in the disposition of the income in question."

benefits enjoyed by a normal owner. It may rest upon the enjoyment by the taxpayer of privileges and benefits so substantial as to make it reasonable and just to deal with him as if he were the owner and to tax him upon that basis.⁵⁷ When the ends of the trust and the income therefrom clearly are to the benefit of the grantor it is only just that it should be taxable to him. "The courts will not permit themselves to be blinded or deceived by mere forms of law, but regardless of fictions will deal with the substance of the transaction involved."⁵⁸

Burnet v. Wells,⁵⁹ a milestone in income tax law, upheld the constitutionality of Section 219 (h) and taxed as income of the settlor the income of a trust which was used to pay annual premiums upon insurance policies on the life of the insured.⁶⁰ Mr. Justice Cardozo, for the majority, pointed out that such a trust involved a continuing exercise by the settlor of a power to direct the application of the income along predetermined channels, and that the use to be made of the income was subject to the will of the grantor at all times. The dissent⁶¹ emphasized the irrevocability of the trust and upon this ground found it not taxable. A companion decision met a unanimous court⁶² as in this case the

⁵⁷ An explanatory statement by the Committee on Ways and Means of the House of Representatives is of aid; referring to sec. 219 (h), now sec. 167, it said: "Trusts have been used to evade taxes by means of provisions allowing distribution of income to the grantor or its use for his benefit. The purpose of this subdivision of the bill is to stop this evasion." H. R. #179, 68th Cong. 1st sess. p. 21; accord, Senate Re. #179, 68th Cong. 1st sess., pp. 25, 26.

⁵⁸ Charles T. Fisher (1933) 28 B. T. A. 1164; accord. C. S. Mott. (1934) 30 B. T. A. 1040; Pillsbury v. Burnet (App. D.) (C. 1934) 67 F. (2d) 151; Yuengling v. Commissioner (C. C. A. 1934) 69 F. (2d) 971; wherein it was said, "Income for tax purposes may include not only ownership but rights or privileges that are mere indicia of ownership."

⁵⁹ (1933) 289 U. S. 670, revg. 63 F. (2d) 425.

⁶⁰ Though technically this decision is limited by the facts to the insurance trust situation covered specifically by the statute, practically it has a much broader application. The old distinction as to constructive receipt of income seemed to be that where no liquidation of a legal obligation is involved taxation of the trust income to the settlor is not permissible. But here no legal obligation was involved and a substituted test would seem to have been evolved, viz., one of general advantage to the settlor even though it be an indirect advantage and lacking in any element of legal duty. This seems more in accord with Congressional intent.

⁶¹ Sutherland, rendering the opinion, VanDevanter, McReynolds, and Butler concurring. "The fact here show that Wells created certain irrevocable trusts. He retained no vestige of title to, interest in, or control over, the property transferred to the trustee. The result was a present executed, outright gift, which could then have been taxed to the settlor."

⁶² DuPont v. Commissioner (1933) 289 U. S. 685.

trust was to terminate at the end of three years and revert to the settlor. The income therefrom was held taxable to the grantor, as the grantor did not divest himself of title in any permanent or definitive way, and did not strip himself of every interest in the subject matter of the estate. And one who retains for himself so many of the attributes of ownership is not the victim of despotic power when for the purpose of taxation he is treated as absolute owner. Hence the courts have held trust income taxable to the grantor when there was a reservation of the right to direct the corpus of the trust, its sale and reinvestment,^{62a} the retaining of absolute dominion over the property, rents, issues and profits of the trust,^{62b} retaining the right to sell and to change the trust agreement at any time,⁶³ retaining the right to dispose of the income in amounts and to persons designated by him.⁶⁴ And so too when the income is to be accumulated for the grantor to be distributed to him in the future it is taxable to him⁶⁵ even though such interest is a mere reversion.⁶⁶

A somewhat analogous situation arises when the income from a trust is to be used for the support and maintenance of the settlor's children. It has of late been contended by the government, and not without support,⁶⁷ that it being a father's duty to support his minor children the income from a trust being used to effectuate this duty should be taxable to him. And this is quite in line with congressional intent to tax to the grantor the retention of economic benefits, although the early cases decided by the Board of Tax Appeals and the courts did not support this theory and when such trusts were irrevocable they were not taxable to the grantor.⁶⁸ Relying on *Burnet v. Wells* the Board of Tax Ap-

^{62a} *Clapp v. Heiner*, supra, note 49.

^{62b} *Estate of Huntington* (1933) 28 B. T. A. 289.

⁶³ *McCauley v. Commissioner* (C. C. A. 1930) 44 F. (2d) 919.

⁶⁴ *E. Bradley* (1932) 27 B. T. A. 280.

⁶⁵ *Margaret S. Sawtell* (1934) 32 B. T. A. 687.

⁶⁶ *Kaplan v. Commissioner* (C. C. A. 1933) 66 F. (2d) 401; and this is taxable even though exercisable only with the consent of the trustees, as a trustee is not a person with an adverse interest. *Greenough v. Commissioner* (C. C. A. 1934) 74 F. (2d) 25.

⁶⁷ In *Burnet v. Wells*, supra, note 59, though the decision did not turn on this point, Cardozo considered the fact that "insurance for dependents is today in the thought of many a pressing social duty," and held that paying the premiums on insurance policies is a benefit to the settlor. See also *Pillsbury v. Burnet*, supra, note 58.

⁶⁸ *P. H. Clark* (1935) 31 B. T. A. 1082; *T. P. Grosvenor* (1934) 31 B. T. A. 574. This case involved the right to revoke upon three months' notice.

peals reversed its stand in *Schweitzer v. Commissioner*,⁶⁹ saying,

"We are of the opinion, however, that the reasoning of the Supreme Court in that case is equally applicable in the proceedings at bar and that income from trust funds created by a father for the support of his minor children whom he is bound to support, which income is received by the father and applied for the support of his children is taxable to him."⁷⁰

In the meantime a case involving similar features made itself heard in the Supreme Court of the United States.⁷¹ Affirming the decision of the Eighth Circuit Court of Appeals the Court held as taxable income of the settlor income from a trust set up in lieu of alimony. "The creation of a trust by the taxpayer as a channel for the application of the income to the discharge of his obligation leaves the nature of the transaction unaltered."⁷² By virtue of the nature and purpose of the trust the income remained attributable to the creator of the trust and accordingly taxable to him.

The court further said, ". . . we find no warrant for a construction which would preclude the laying of the tax against the one who through the discharge of his obligation enjoys the benefit of the income as though he had personally received it."⁷³ It is true that in the *Douglas* case the Supreme Court spent some time discussing the legal obligation to pay alimony, yet it is quite probable that the decision will have a far wider effect. It has already been extended by the Court to include those trusts, the income from which is to be used for the support of the settlor's

Commissioner v. Yeiser (C. C. A. 1935) 75 F. (2d) 956, revocable by the trustee who was her husband, but held not revocable in the eyes of the law. He was also a beneficiary. See also a long list of B. T. A. decisions cited in *Schweitzer v. Commissioner*. Until this decision the B. T. A. had consistently held (C. C. A. 1935) 75 F. (2d) 702, that the income from a trust of this character, or analogous to it, was income to the beneficiaries and not to the creator of the trust.

⁶⁹ (1934) 30 B. T. A. 155.

⁷⁰ In *Theodore P. Grosvenor*, supra, note 68, the Board reverted to its prior rulings and expressly overruled the *Schweitzer* case. However, see note 74, infra.

⁷¹ *Douglas v. Willcuts* (Nov. 11, 1935) 80 L. Ed. (adv.) 10, 296 U. S.—The C. C. A. deciding the *Schweitzer* case had distinguished the decision of the 8th C. C. A. in that in this case there was a legal obligation to pay alimony, the court having so decreed the trust settlement as a substitute, affirming a prior agreement between the parties.

⁷² *Ibid.*, l. c. 14.

⁷³ *Ibid.*, l. c. 14.

children.⁷⁴ If carried to its logical conclusion this decision might well become the vehicle for bringing within the reach of the tax collector that larger group of irrevocable trust whose beneficiaries are outside the immediate family of the taxpayer, but whose welfare may be of a very tangible, though non-legalistic interest to him. To the government the implications of such a change would be great, since through this use of the doctrine of constructive receipt the efficacy of the trust device as a significant means of tax avoidance would be seriously impaired.

Hence reserving powers of management equivalent to those exercised by a trustee does not, generally speaking,⁷⁵ render the trust liable to the Estate Tax, but when such powers constitute the right to control the purposes of the trust so as to use it for the benefit of the grantor the income therefrom is properly taxable to him.

C. Right to Change the Beneficiaries and the Purpose of the Trust

A difficult situation is presented when the settlor reserves full power to modify the terms of the trust by designating beneficiaries or changing the beneficiaries already designated, but at the same time expressly excludes the power to revest the beneficial interest in himself. When the settlor reserves to himself alone a power to change the ultimate beneficiaries without any limitations upon whom should be named, the trust has been taxed as part of the settlor's gross estate.⁷⁶ In such a case power still remains to revest ownership in himself, in effect amounting to a power to revoke, and the transfer is not complete until the possibility of the exercise of such a power is terminated by death.⁷⁷

⁷⁴In a *Per Curiam* decision, *Schweitzer v. Commissioner*, rendered Dec. 9, 1935, the Supreme Court, on authority of *Douglas v. Willcuts*, reversed the 7th Circuit Court 75 F. (2d) 702, which had reversed the B. T. A. 80 L. Ed. (adv.) 221, 296 U. S.—.

A similar case was also reversed, *Helvering v. Stokes*, 80 L. Ed. (adv.) 221, 296 U. S.—, revg. (C. C. A., 3) 79 F. (2d) 256. In this case the income was distributed to the settlor's children during minority. The B. T. A. had held such not taxable to the settlor and it was affirmed by the C. C. A. Rehearsing was denied in both of these cases. Jan. 6, 1936. 80 L. Ed. (adv.) 353, 296 U. S.—.

⁷⁵From a practical viewpoint this is almost equivalent to a power to revoke, since a trustee may, even though fraudulently, effectively destroy the trust. Thus it is quite possible that at some future time Congress might change the law to include such a situation.

⁷⁶*Anna B. Hunt* (1930) 20 B. T. A. 677.

⁷⁷*Chase National Bank v. U. S.* (1929) 278 U. S. 327.

But when it is impossible for title to revest in the settlor, even though the ultimate beneficial ownership might remain undetermined until the death of the settlor, he has parted with title irrevocably at the time of the creation of the trust. His death is not a moving factor in the transferring of any economic benefits.⁷⁸ This argument proved convincing to several of the lower federal courts, they emphasizing that the applicability of the tax depended upon the retention of control over the economic benefits or enjoyment.⁷⁹

Still it would seem that a right to control the disposition of one's property is tantamount to ownership. The Second Circuit Court of Appeals recognized this and was affirmed by the Supreme Court in the case of *Porter v. Commissioner*,⁸⁰ another buoy in the tumultuous sea of taxation. The impelling element under the statute was whether or not the donor had retained any right to control the disposition of the property. If he had, until his death there was a reserved control with respect to the property which could determine its ultimate distribution. The termination of this control resulted in a very definite transfer from the decedent to the designated beneficiaries. If the Federal Estate Tax were strictly a transfer tax imposed upon the cessation of the donor's interest this might be open to criticism, but the tax is more than that. It is a tax upon the right to transfer any interest passing from the dead to the living and the death of the decedent thereby preventing a subsequent change in the disposition clearly results in such a transfer. And, since such a transfer in trust does not pass the complete economic interest at the time of its creation, it is not subject to the gift tax.

A kindred status arises when such control is reserved through a right to make a change in the settlor's will. It can scarcely be

⁷⁸ *Brady v. Ham* (C. C. A. 1930) 45 F. (2d) 454, revg. 38 F. (2d) 659, laid down as a test, "Whether the donor or decedent has reserved to himself control over the economic benefits or enjoyment of the trust property. If the economic benefits passed under the trust deed from the decedent's control beyond recall, there can be no transfer tax."

⁷⁹ *Washburn v. White* (D. Mass. 1932) 1933 P. H. Fed. Tax Serv. R. 403; *Cover v. Burnet* (App. D. C. 1931) 53 F. (2d) 915; *Brady v. Ham*, supra, note 78, Anderson, J. concurring in *Brady v. Ham*, said, "If a power to alter and divert, absolutely divorced from economic benefits to the holder of the power is not taxable, our decision is right. But I record my doubt as to what the Supreme Court will ultimately hold on that." The Supreme Court ultimately held contra, infra, note 80.

⁸⁰ (1933) 288 U. S. 436, affg. 60 F. (2d) 673.

argued that such a transfer is not of a testamentary character. It clearly reserves the privilege to dispose of property after one's death. The mere fact that the trust has been made irrevocable thereby depriving the settlor of the right to return the property to himself, as already shown, has little effect. Consequently such reservation of control has been held tantamount to a power to revoke and properly subject to inclusion in the settlor's estate.⁸¹ And even though the settlor specifically fails to exercise this power, allowing the trust property to pass under the provisions of the trust indenture, his death is a moving factor in the transfer of the economic benefits and it is still taxable to his estate.⁸² Even when the power is strictly limited in its terms so as to give the right merely to modify the relative size of the distributive shares of the beneficiaries it has been found to be without the provisions of the "revocability clause" in the estate tax.⁸³

A transfer in trust to pay premiums upon the settlor's life insurance policies has already been discussed from the standpoint of income tax liability.⁸⁴ A problem also arises under the Estate Tax when the settlor reserves the right to change the beneficiaries, and other incidents of ownership. That the reservation of such a power as to a transfer in trust is equivalent to a power to revoke and properly taxable as part of the settlor's estate has been shown.⁸⁵ The natural result therefrom is to hold as part of the settlor's estate the value of a trust, the income from which is to pay insurance premiums, when the settlor reserves the right to change the beneficiaries.⁸⁶ The proceeds of life insurance policies have been specifically dealt with in the Estate Tax.⁸⁷ When

⁸¹ Maria C. M. F. Valentine (1930) 22 B. T. A. 197; Caroline B. Foster (1932) 26 B. T. A. 708, *affd.* (1st C. C. A. 1933). No written opinion. Frederick Foster et al., Ex'rs. (1934) 31 B. T. A. 769.

⁸² Kimball v. Commissioner (1934) 29 B. T. A. 60, *affd.* without opinion, C. C. A. 2, 1934.

⁸³ Equitable Trust Co. of N. Y., Adm'r. (1934) B. T. A. 329. This case was distinguished in Frederick Foster, *supra*, note 81, as in this case "she could not divest the class named as remaindermen but could only designate the proportions in which the members of the class would take."

⁸⁴ Burnet v. Wells, *supra*, note 59.

⁸⁵ Porter v. Commissioner, *supra*, note 80.

⁸⁶ Cook v. Commissioner (C. C. A. 1933) 66 F. (2d) 995, *cert. den.* 291 U. S. 660; William Laird (1933) 29 B. T. A. 196.

⁸⁷ Rev. Act of 1918, s. 402 (f), U. S. C. A. (1934) s. 411, (g) The present act is unchanged from the original;

"(g) Proceeds of Ins. Policies. To the extent of the amount receivable by the executor as insurance under policies taken out by the decedent on his own life; and to the extent of the excess over \$40,000 of the amount receiv-

the proceeds are payable to the Estate there is of course no problem. But difficulties arise when the proceeds are payable to specific beneficiaries.

In *Chase National Bank v. United States*,⁸⁸ the Supreme Court answered a great many of the perplexing problems which had arisen under this law.⁸⁹ An outstanding power residing exclusively in the donor to recall a gift after it is made is clearly a limitation upon the gift which makes it incomplete as to the donor, as well as to the donee, and the termination of such a power by death is the appropriate subject of a tax upon transfers. The Court treated such a power to change the beneficiaries as similar in effect to the power to revoke a trust. Thus unquestionably the proceeds of life insurance policies in which the insured retains the right to change the beneficiaries may properly be included in his gross estate.⁹⁰ Similarly a reservation of the right to surrender the policy and to pledge it for loans equal to its surrender value, and other acts of ownership exercised over the beneficial economic interests make it taxable to the insured's estate.⁹¹

A strict interpretation and literal reading of the act would lead one to the conclusion that, subject to the exemption, even though the insured reserves no rights of legal ownership the insurance payable to beneficiaries would still be taxable to his estate. But by construction the Treasury Department has ruled that the incidents of ownership must be retained by the insured

able by all other beneficiaries as insurance under policies taken out by the decedent upon his own life."

⁸⁸ (1929) 278 U. S. 327.

⁸⁹ In *Heiner v. Grandin* (C. C. A. 1930) 44 F. (2d) 141, *affd.* 56 F. (2d) 1082, *Cert. den.* 286 U. S. 561, the third Circuit Court of Appeals had applied the same principles to insurance policies as to trusts, holding that a reservation of a right to change a beneficiary is a limitation upon the gift which makes the transfer incomplete until the exercise or non-exercise (termination by death) of the reserved power. And this could apply retroactively to policies issued prior to the passage of any such statute as it is the exercise of the power or its termination by death which causes the transfer of the benefits. Prior, in *Frick v. Lewellyn* (D. C.) 298 F. 803, *affd.* in 268 U. S. 487, it had been held that the original statute was not intended to have retroactive effect. A new subsection (h) inserted in section 302 of the revenue act of 1924 provided expressly for such retroactivity and thus corrected this erroneous impression.

⁹⁰ *Levy's Estate v. Commissioner* (C. C. A. 1933) 65 F. (2d) 412; *Newman v. Commissioner* (C. C. A. 1935) 76 F. (2d) 449, *cert. den.* 80 L. Ed. (adv.) 111, 296 U. S.—.

⁹¹ *Ballard v. Helburn* (1935) 9 F. Supp. 812; *E. H. Sharp* (1934) 30 B. T. A. 532; *Sampson v. U. S.* (D. 1932) 1 F. Supp. 95.

until his death for the tax to apply.⁹² The reason for such an interpretation would seem to be a desire to treat this section in accord with Congressional intent, as evidenced by the other provisions of the Estate Tax, to tax merely the passing of the economic interest. When no such rights are reserved and the policy is irrevocable all economic benefits therein pass immediately and thus it should not be taxed to the grantor. Since this is merely an interpretation by the Treasury Department there is no certainty that it will not be changed nor that the change will not be upheld by the courts.

Taxability of the income from such a trust has already been considered.⁹³ It is quite evident that a reservation of such powers results in the income therefrom being taxable to the grantor. Since he retains all the attributes of ownership he may quite properly be treated as owner.⁹⁴

Thus a reservation of the right to change the beneficiaries either in the trust instrument directly, by will, or in an insurance policy, renders such trust subject to the estate tax, and the income therefrom is taxable as the settlor's income.

III. CONTROL BY THE SETTLOR PLUS ANOTHER

A. *A Trustee*

A curious discrepancy between the estate tax and the income tax has long perplexed the settlors of trusts as well as the courts. Under the provisions of the estate tax, a trust created by a decedent during his lifetime is treated as revocable if at the time of his death he retains a power of revocation in conjunction with "any person."⁹⁵ Under the income tax it is treated as revocable only when subject to revocation in conjunction with "any person not having a substantial adverse interest."⁹⁶ Despite the different wording in these provisions, and the persistence of this difference during many general revisions of both taxes, it was generally felt that the estate tax would be construed to mean the

⁹² By construction of Reg. 80, Art. 25. (1936) P. H. Fed. Tax Serv. 23, 296-A. *Ballard v. Helburn*, supra, note 91; *Anthracite Trust Co. v. Phillips* (D. 1931) 49 F. (2d) 910; *Parker v. Commissioner* (1934) 30 B. T. A. 342; *Martha H. Reybire* (1934) 31 B. T. A. 314.

⁹³ See Part II, B. p. 289.

⁹⁴ Op. Cit. note 10, Sec. 268, p. 869.

⁹⁵ *Supra*, p. 282-283.

⁹⁶ *Supra*, note 42.

same thing as the income tax.⁹⁷ "Any person" was translated rather freely to mean any person lacking a substantial adverse interest in the trust.⁹⁸ Still such a view, though it undoubtedly removed any doubt as to its constitutionality, seriously hampered the effectiveness of the change embodied in the 1924 Revenue Act. In view of the fact that the normal trust settlement ordinarily includes among its beneficiaries someone fully amenable to the settlor's wishes, because of social or moral obligation, a provision requiring such a beneficiary's consent was of no real restraint upon the settlor's control.

Fortunately the situation has been much clarified by a very recent decision of the Supreme Court, *Helvering v. City Bank Farmers Trust Co.*⁹⁹ "The two sections have a cognate purpose but they exhibit marked differences of substance. . . . To credit the assertion that the difference in phraseology is without significance and in both sections Congress meant to express the same thought, would be to disregard the clear intent of the phrase 'any person' employed in sec. 302, (d). We are not at liberty to construe language so plain as to need no construction or to refer to Committee reports where there can be no doubt of the meaning of the words used."¹⁰⁰ From a practical point of view this is truly a fortunate decision for it not only simplifies the application of section 302 (d) but also seems more fully to effectuate the intent of Congress to prevent the use of the revocable trust as a device for escaping the estate tax.

The most obvious situation in which such a reservation of control should fail to avoid the estate tax is that wherein control is reserved with the consent of the trustee. Such a proposition first appeared under the statute taxing a transfer "to take effect in possession or enjoyment at or after death."¹⁰¹ Reversing the District Court the Circuit Court of Appeals for the Second Cir-

⁹⁷ In connection with s. 302 (d), the House Ways and Means Committee Report said, "This provision is in accord with the principle of 219 (g) (now s. 166) of the bill which taxes to the grantor the income of a revocable trust." H. R. #179, 68th Cong. p. 28.

⁹⁸ Before the revision of this provision in 1934 it had read "any person not a beneficiary of the trust," Revenue Act of 1928, s. 166, and the corresponding section in the estate tax was interpreted accordingly.

⁹⁹ (Nov. 11, 1935) 80 L. Ed. (adv.) 1, 296 U. S.—.

¹⁰⁰ *Ibid.*, l. c. 3; *Frew v. Bowers* (C. C. A. 1926) 12 F. (2d) 625, cert. gr. 273 U. S. 578, Dis. by consent, 275 U. S. 578.

¹⁰¹ For the statute see, *infra*, note 138.

cuit found that the power to revoke was not absolute and unconditional as it was dependent upon the trustee's consent. Thus the trust was not taxable to the settlor's estate.¹⁰² Recognizing the distinctions in the revocability clauses, already pointed out, in *Erskine v. White*¹⁰³ the court decided that a trustee was a party having an adverse interest and thus, in accord with Congressional intent, such was not a revocable trust taxable to the settlor. The property rights and beneficial interests having passed from the settlor, subject to revestment only with the consent of the trustee, there was no taxable transfer at the decedent's death. Still, even before the Supreme Court definitely passed upon the problem, some of the Federal Courts reached a contra decision upon the reasoning that a trustee did not have an adverse interest.¹⁰⁴ The privileges which flow from ownership and control bear upon the power to tax transfers at death and such control is not relinquished when it requires merely the consent of the trustee. Generally speaking the trustees owe no duty to the beneficiaries to resist alteration or revocation of the trust by the settlor. And this view was affirmed by the Supreme Court in *Helvering v. City Bank Farmers Trust Co.*, supra, holding that when power to revoke was vested in the settlor plus a trustee the trust was properly taxable as part of the settlor's estate.

The broad interpretation which might have arisen from this case was immediately limited by the Court in *White v. Poor*.¹⁰⁵ In this case the right to revoke was expressly limited to the trustees and such was held not a revocable trust. Nor did the fact that the settlor was a trustee change the decision since she had acquired her status "solely by virtue of the action of the other trustees and the beneficiaries, and not in any sense by virtue of

¹⁰² From a practical point of view the decision in this case seems clearly wrong. The settlor had also reserved the right to change trustees. Having this right it would seem he could quite effectively control the consent of the trustee. The words of Hamilton in the *Federalist*, #79, cited by Mr. Justice Holmes in his dissent in *Evans v. Gore* (1920) 253 U. S. 245, might well apply, "Power over a man's subsistence amounts to a power over his will."

¹⁰³ (C. C. A. 1930) 47 F. (2d) 1014, affg. 43 F. (2d) 765.

¹⁰⁴ *Wetherbee v. Commissioner* (C. C. A. 1934) 70 F. (2d) 696, cert. den. 293 U. S. 582, rehear. den. 293 U. S. 631; *Henrietta G. Fitz* (1934) 30 B. T. A. 97; The cases cited, *Reinecke v. Smith*, infra, note 11, and *Porter v. Commissioner*, supra, note 80, both of which, though concerned with income tax liability held that a trustee did not have an adverse interest.

¹⁰⁵ (Nov. 11, 1935) 80 L. Ed. (adv.) 8, 296 U. S.—.

any power reserved to herself as settlor in the original declaration of trust."¹⁰⁶ The practical aspect of this decision may give the settlor the opportunity to hazard little loss of control by entrusting his property to other members of his immediate family for a short time, with an understanding that one of the trustees will resign, and the others, with the beneficiaries, will reappoint him. This might easily follow since the terms of the decision make no requirement that the settlor's divestment be more than momentary. Still, if the court were confronted with an instance where the substitution of trustees was plainly a device for tax avoidance it might well reach a contra result.¹⁰⁷

Another constitutional point involved in the *City Bank Farmers Trust Co.* case, and which, in view of the companion decisions,¹⁰⁸ appears of some importance is that of retrospective operation. In this case the tax as applied was a prospective one. The case arose under the 1926 act and the trust in issue was created in 1930. The taxpayer was amply warned in advance that such a transaction was disputable. It was upon this constitutional point that Justices Brandeis, Stone, and Cardozo concurred in the decision in *White v. Poor*, supra. They felt that section 302 (d), properly construed, applied to this trust, but if it were so applied it was fatally retroactive. Thus one might safely hazard a guess that if the trust in question had been confronted prospectively with the taxing statute the result might have been contra. And so too in the *City Bank Farmers Trust Co.* case if the tax had applied retroactively the decision might have been different.¹⁰⁹

¹⁰⁶ *Ibid.*, l. c. 10; In the trust declaration the settlor had named herself as one of the trustees. However in the interim she resigned and another was appointed. Subsequently, however, she was reappointed. The court gave no clue as to the probable result if she had retained her status as trustee by virtue of the trust declaration. Still if *Helvering v. City Bank Farmers Trust Co.*, supra, were carried to a logical conclusion it would seem that such a situation would create a trust taxable to the settlor as from a practical viewpoint it amounts to a right to revoke in conjunction with "any person." Assuming, of course, that the regalia of a trustee should make no practical difference.

¹⁰⁷ *Supra*, note 50; *infra*, note 121.

¹⁰⁸ *White v. Poor*, supra note 105; *Helvering v. Helmholtz* (Nov. 11, 1935) 80 L. Ed. (adv.) 5, 296 U. S.—.

¹⁰⁹ Especially in view of the fact that this was a 5 to 4 decision and Brandeis, Stone and Cardozo constituted part of the majority. The minority in this case consisted of Justices VanDevanter, McReynolds, Sutherland and Butler.

As has been previously shown, the income from trusts revocable only with the consent of one having a substantial adverse interest is not taxable to the settlor.¹¹⁰ It is clear that a trustee is not a beneficiary in the ordinary sense of the word. He owes no duty to the beneficiary to resist alteration or revocation of the trust, though he does, of course, owe a fiduciary duty to the beneficiary to protect the trust and administer it faithfully. Thus when it is evident that the power to revoke is vested solely in the settlor with the consent of the trustee, or trustees, the income therefrom is taxable to the grantor. This was very definitely pointed out by the Supreme Court in the clarifying and important decision of *Reinecke v. Smith*.¹¹¹ The only difficulty in the problem arises when the right to revoke is with the consent of one who, though a trustee, also has some element of beneficial interest. This problem will be considered shortly.

B. *Plus a Beneficiary*

The Supreme Court seems to have settled this problem, in so far as the Estate Tax is concerned, by its decision in the *City Bank Farmers Trust Co.* case, *supra*, although with the limitations previously shown.¹¹² The statute embraces such transfers even though they are complete when made and thereafter beyond the unfettered control of the settlor. As the court observed, "Congress may well have thought that a beneficiary who was of the grantor's immediate family might be amenable to persuasion or be induced to consent to a revocation in consideration of other expected benefits from the grantor's estate." Still it would not be amiss to review the decisions leading up to this case.

In view of the decision in *Reinecke v. Northern Trust Com-*

¹¹⁰ *Supra*, notes 97, 98.

¹¹¹ (1933) 289 U. S. 172, 174 "The unambiguous phraseology of the act precludes the suggested construction. A trustee is not subsumed under the designation beneficiary. Both words have a common and accepted meaning; the former signifies the person who holds title to the res, and administers it for the benefit of others; the latter the cestui que trust who enjoys the advantages of such administration. The ordinary meaning of the terms used, which we are bound to adopt, and the view held by those charged with the enforcement of the Act, ratified by reenactment of the section, alike forbid the adoption of the construction for which the respondents contend." That construction was that the trustee is a beneficiary of the trust as the phrase is used in the act.

¹¹² *Supra*, p. 41, 42. It applies prospectively and it does not apply when the right to revoke is solely in the trustees, even though the settlor has subsequently been appointed a trustee.

*pany*¹¹³ it would have seemed quite reasonable to predict that the Supreme Court would construe the term "any person" not to include persons having substantial adverse interests in the subject matter to which the power relates.¹¹⁴ The court there held that since the power to revoke was dependent upon the consent of one entitled to a beneficial, and consequently adverse, interest, for all practical purposes the trust had passed as completely from any control by the decedent which might enure to his own benefit as if the gift had been absolute. However it must be remembered that this case was decided under Section 402 (c) of the 1921 act¹¹⁵ and the Court was very careful to point out this fact in its *City Bank Farmers Trust Co.* decision. Still, upon authority of the *Reinecke* case the Board of Tax Appeals and several federal courts applied the same theory as to the revocability section¹¹⁶ interpreting the term "any person" to mean "any person not a beneficiary,"¹¹⁷ and held such transfers in trust not includible in the settlor's gross estate.¹¹⁸ Others though refused to follow this argument by the taxpayer and held such transfers taxable to the settlor's estate.¹¹⁹ The Supreme Court now having spoken, there is no longer doubt upon this point, viz., that reserv-

¹¹³ *Supra*, note 53.

¹¹⁴ So able an authority as Bogert so predicted. See, Bogert, *Trusts and Trustees*, (1934) Vol. 2, p. 895, under discussion on "Powers jointly held."

¹¹⁵ This is essentially 302 (c) under the 1926 Act. See (1934) U. S. C. A. sec. 411 (c). Under 402 (c) the Court also decided *Morsman v. Burnet* (1931) 283 U. S. 783, reversing 44 F. (2d) 902 (C. C. A.); and *McCormick v. Burnet* (1931) 283 U. S. 784, reversing 43 F. (2d) 277 (C. C. A.). In both these cases the settlor reserved the power to terminate or change the trust with the consent of a beneficiary. The two Circuit Courts of Appeal held the trusts taxable. The Supreme Court, without opinion, reversed these decisions upon the authority of *May v. Heiner*, note 134, *infra*.

¹¹⁶ Sec. 302 (d) under the 1924 act. See p. 382, *supra*.

¹¹⁷ *Supra*, notes 97, 98.

¹¹⁸ *Louis C. Raegner* (1934) 29 B. T. A. 1243, appeal dismissed (C. C. A.)—F. (2d)—; *William B. Kurtz* (1931) 22 B. T. A. 1377; *Logan v. Denman* (C. C. A. 1932) 63 F. (2d) 1008; *Irving L. Stone* (1932) 26 B. T. A. 1, *Pet. for Rev. dismissed* (C. C. A.)—F. (2d)—; *Wm. H. McCurdy* (Old. Natl. Bank in Evansville, Ex'rs.) (1934) 31 B. T. A. 379; *Lit. v. Commissioner* (C. C. A. 1934) 72 F. (2d) 551.

¹¹⁹ *Dort v. Helvering* (App. D. C. 1934) 69 F. (2d) 836, *Cert. denied*, 293 U. S. 569, *Rehearsing denied*, 293 U. S. 630. *Commissioner v. Straus* (C. C. A. 1935) 77 F. (2d) 401, it was because of a conflict between the decision in this case and the decision in *Lit. v. Comm'r* and *City Bank Farmers Trust Co. v. Commissioner* that the Supreme Court granted *certiorari* in the latter case. Reversing the C. C. A. in the latter case the court has in effect affirmed this decision.

ing power to amend, alter or revoke, but only with the consent of the beneficiaries does not make the trust irrevocable within the meaning of the Federal Estate Tax, and such a trust is still taxable to the grantor's estate.

Reserving control with the consent of a beneficiary as affecting income tax liability has been specifically interpreted by the Supreme Court in *Reinecke v. Smith*.¹²⁰ Though the Court was particularly concerned with the question as to whether reservation of control with the consent of a trustee rendered the trust irrevocable within the taxing statute, the language in the opinion is much broader than that alone.¹²¹ The wording of the original act was "any person not a beneficiary" and thus the courts have clearly held that when the trust can only be revoked with the consent of one who is a beneficiary the income therefrom is not taxable to the settlor.¹²² And this is true even though the beneficiary be also a trustee.¹²³ But when the right to revoke exists with the consent of one who clearly is not a beneficiary the income is taxable to the grantor.¹²⁴ Continuing its efforts to tax the retention of control over the economic benefits Congress has since made a change in phraseology which may be of aid to the courts. The statute now reads "any person not having a sub-

¹²⁰ (1933) 289 U. S. 172; *ibid.*, l. c. 178.

¹²¹ "The measure of control of corpus and income retained by the grantor was sufficient to justify the attribution of the income of the trust to him. . . . A contrary decision would make evasion of the tax a simple matter. There being no legally significant distinction between the trustee and a stranger to the trust as joint holder with the grantor of a power to revoke, if the contention of the respondents were accepted it would be easy to select a friend or relative as co-holder of such a power and so place large amounts of principal and income accruing therefrom beyond the reach of taxation upon the grantor while he retained to all intents and purposes control of both. Congress had power, in order to make the system of income taxation complete and consistent and to prevent facile evasion of the law to make provision by 219 (g) for taxation of trust income to the grantor in the circumstances here disclosed."

¹²² *Smith v. Commissioner* (C. C. A. 1932) 59 F. (2d) 56; *Margaret A. Holmes* (1932) 27 B. T. A. 660.

¹²³ *B. R. Jones v. Commissioner* (1932) 27 B. T. A. 171; *Olive H. Prouty v. Commissioner* (1934) 30 B. T. A. 1068; *Stetson v. Commissioner* (1932) 27 B. T. A. 173.

¹²⁴ *Bowler v. Helvering* (C. C. A. 1935) 80 F. (2d) 103. When it is revocable by a majority of several persons, one of whom is a beneficiary, it is taxable to the grantor so long as there is a possible combination by which it may be revoked without the consent of one a beneficiary. *Lillian T. Savage* (1934) 31 B. T. A. 633. See also *Jackson v. Commissioner* (1933) (C. C. A.) 64 F. (2d) 359. *Greenough v. Commissioner* (C. C. A. 1934) 74 F. (2d) 25.

stantial adverse interest." This obviates the necessity of determining whether the joint holder of the power to revoke is or is not a beneficiary of the trust within the meaning of the act. However, the question of a substantial adverse interest in itself may cause difficulty. It would seem that the rewording of this phrase will result in a wider inclusion of such trusts within the act. Under its prior status it was not difficult for one practically to reserve the right to revoke without the release of any substantial power of control. Simply by making one amenable to his wishes a beneficiary, and reserving the right to revoke with his consent, the transaction would be without the statute. It is quite possible that under the present phrasing of the statute the courts would hold such not to be a substantial adverse interest and thus properly hold the trust income therefrom taxable to the grantor. If Congress would go one step further and define a "substantial adverse interest" as not including a member of the family, even though a beneficiary, it would effectively limit the use of the revocable trust as a means of tax avoidance. It would also greatly simplify the duties of the court in interpreting the meaning of a "substantial adverse interest."

C. *Plus All the Beneficiaries*

Another decision laid down at the same term of court as some of these other momentous decisions already cited¹²⁵ would appear to have settled this point. *Helvering v. Helmholtz*¹²⁶ involved a transfer in trust which could be revoked by the settlor only with the consent of all the beneficiaries. Under the decision in the *City Bank Farmers Trust Co.* case one might well reason that here was a trust revocable with the consent of "any person" and thus it might properly be included in the settlor's estate. The court however further limited the effect of this decision and held that such a trust was not taxable to the settlor. Mr. Justice Roberts delivered the opinion, saying, "The general rule is that all parties in interest may terminate the trust. (Citing sections 337,338 of the Restatement of Trusts.) The clause in question added nothing to the rights which the law conferred."¹²⁷ Thus

¹²⁵ *Helvering v. City Bank Farmers Trust Co.*, supra, note 99; *Douglas v. Willcuts*, supra, note 71; *White v. Poor*, supra, note 105; *Becker v. St. Louis Union Trust Co.*, supra, note 54.

¹²⁶ (Nov. 11, 1935) 80 L. Ed. (adv.) 5, 296 U. S.—.

¹²⁷ *Ibid.*, l. c. 7.

since this right exists under all trusts its express inclusion in an otherwise irrevocable trust does not operate to make the trust revocable within the scope of section 302 (d). As Congress seeks to tax the corpus of the trust as part of the settlor's estate only when there is such a retention of the economic benefits that his death results in their transfer this decision seems fully correct. The transfer is complete when it is made and his death neither hinders nor furthers it.

And it is quite evident that the income from such a trust is not taxable to the grantor. The beneficiaries all have a substantial adverse interest to the grantor and thus the trust falls within the statutory exception.¹²⁸

IV. RESERVATION OF A PARTICULAR ESTATE

The reservation of powers of revocation, the right to change the beneficiaries, and the right to participate in the management of the trust are not the only means by which a settlor may retain an element of control over the transfer in trust. The Federal Estate Tax concerning itself as it does with the passing of an economic benefit from the dead to the living, the courts attach much importance to this shifting of economic interests. It is undeniable that a donor who, though irrevocably transferring property, reserves a life estate or the right to the income for life, retains a most important economic benefit therein until his death. The retention of such interests comes within the scope of section 302 (c).¹²⁹ To prevent tax evasion by *inter vivos* gifts used as a substitute for a will such was absolutely essential. The statute's objective was to tax transfers similar to transfers by wills and intestate laws because they accomplish a transfer of property, donative in effect, under circumstances which impress it with the characteristic of a disposition made at the time of the transferor's death.

Such a trust raises no problem in relation to income tax. The income being payable to the settlor it is properly taxable to him. On the other hand if the income is payable to another the trust, being irrevocable, does not come within the scope of Section

¹²⁸ *Supra*, note 42.

¹²⁹ Rev. Act of 1926, 44 Stat. 70, as amended by Joint Resolution #131, Seventy-first Congress, March 3, 1931. Rev. Act of 1932, sec. 803. See *infra* note 138.

166.¹³⁰ And unless the income is subject to accumulation for the benefit of the settlor it would not fall within the provisions of Section 167.¹³¹

A. Income to the Settlor for Life, with the Remainder Over

The simplest situation within the scope of the statute is that in which the settlor reserves to himself the income therefrom for life, the trust itself being irrevocable. The remainder over does not take effect until the death of the settlor. The course of interpretation of similar provisions in state legislation has been to hold such taxable to the settlor.¹³² Similarly several of the federal courts held that such transfers in trust were within the statute.¹³³ A reservation of income is clearly a reservation of "that which gives value to the property," the beneficial interest, and this is what Congress seeks to tax. The donees of such a trust cannot exercise full dominion over it, sell or otherwise dispose of it, until the termination of the rights of the donor by death.

Despite the practical logic behind such a view the Supreme Court laid down a contra rule in a far reaching decision, *May v. Heimer*.¹³⁴ The specific facts in the case show that the settlor reserved the income to herself only after the death of her husband, but the court did not confine itself to this. In effect it held that even if she had reserved the income to herself from the very beginning the trust would not have been taxable as a part of her estate.¹³⁵ The District Court had¹³⁶ found the trust taxable upon the theory that in order to escape liability the donee must be in actual possession and enjoyment before the donor's death, and must have the use and disposal of the property without reference

¹³⁰ *Supra*, note 42.

¹³¹ *Supra*, note 56.

¹³² *Missionary Society v. Bugbee* (1925) 97 N. J. Eq. 343, 127 Atl. 565; *In re Cochrane* (1921) 117 Misc. 18, 190 N. Y. S. 895; *In re Barber's Estate* (1931) 204 Pa. 235, 155 Atl. 565.

¹³³ *Reed v. Howbert* (D. 1925) 8 F. (2d) 641; *Coolidge v. Nichols* (D. 1925) 4 F. (2d) 112, though the tax could not be applied retroactively. See also *Bradley v. Nichols* (D. 1926) 13 F. (2d) 857, wherein the executor admitted that the statute applied to the one half of the trust to which the settlor reserved the income for life. Contra however, see *Fidelity & Columbia Trust Co. v. Lucas* (D. 1925) 7 F. (2d) 146; *Estate of August F. W. Brehmer* (1927) 9 B. T. A. 423.

¹³⁴ (1930) 281 U. S. 233.

¹³⁵ "The record fails clearly to disclose whether or not Mrs. May survived her husband. Apparently she did not. But this is not of special importance since the refund should have been allowed in either event."

¹³⁶ (D. 1929) 25 F. (2d) 1004, *affd.* 32 F. (2d) 1017.

to the said death. But the Supreme Court cast this aside and ruled that such a transfer was not testamentary, was beyond recall by the decedent, and at her death no interest passed, from her to the living, which was subject to tax.

The full implication of this decision was brought forth the next year by the decision in *Burnet v. Northern Trust Company*.¹³⁷ The settlor there executed an irrevocable trust reserving to himself for life the income. In a Per Curiam decision the Supreme Court affirmed the decision of the Circuit Court of Appeals holding, under the authority of *May v. Heiner*, that this was not taxable as part of the decedent's estate.

That Congressional intent was not that such a transfer was to be without the act was immediately made evident. The day after the memorandum decision Congress amended the statute to include irrevocable transfers in trust in which the settlor retained for his life, or any period, control over the income from the corpus of the trust.¹³⁸ Since in this memorandum decision the Court explicitly indicated that the question was one of statutory interpretation, and "not the constitutional authority of Congress to impose prospectively a tax with respect to transfers or trusts of the sort here involved," there should be no doubt as to the validity of this act when prospectively applied.

Thus in cases involving trusts executed prior to the 1931 amendment, the trust being irrevocable, the mere reservation of income to the settlor for life is not sufficient to make it taxable as a transfer to take effect in possession and enjoyment at or after death.¹³⁹ The retroactive operation of the present act remains

¹³⁷ (1931) 283 U. S. 782. See also *supra*, note 115.

¹³⁸ Joint Resolution #131, approved March 3, 1931, Rev. Act. of 1932, sec. 803 (1934) 26 U. S. C. A. s. 411, (c): "To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, in contemplation of or intended to take effect in possession or enjoyment at or after his death, or of which he has at any time made a transfer, by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death. (1) The possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

¹³⁹ *Hodgkins v. Commissioner* (C. C. A. 1930) 44 F. (2d) 43, cert. den. 283 U. S. 825; *McCaughn v. Carnhill's Ex'rs* (C. C. A. 1930) 43 F. (2d) 69, affg. 30 F. (2d) 696; *Commissioner v. Austin* (C. C. A. 1934) 73 F. (2d) 758, affg. 26 B. T. A. 1216; *Helvering v. Duke* (C. C. A. 1933) 62 F. (2d) 1057, aff'd by divided court, 290 U. S. 591; *Blanch L. Block* (1930) 20 B. T. A. 782; *John D. McIlhenny* (1931) 22 B. T. A. 1377; *Caroline B. Foster* (1932) 26 B. T. A. 708, aff'd without opinion (C. C. A. (1) 1933).

an open question.¹⁴⁰ The retroactive operation of section 402 (c) was considered in the well known case of *Nichols v. Coolidge*.¹⁴¹ The transfer in trust, made prior to the passage of the estate tax, was irrevocable but the grantor reserved the income therefrom for life. Assuming that such might be within the scope of 402 (c) the Court held that such an application would make the tax fatally retroactive as being arbitrary and capricious. In view of this decision, and the Treasury Regulation providing that this new act shall only be given prospective effect,¹⁴² it is probably quite safe to say that it will not be applied retrospectively. However, considering the unsettled status of such laws applied retroactively, and that *Nichols v. Coolidge* was a 5 to 4 decision, even this is not definite assurance that a future decision by the Supreme Court might not result in a change in the Court's attitude and the ruling of the Treasury Department.

B. Income to Another for Life, with the Remainder Over

Under these facts the grantor reserves neither the right to retain the beneficial interest therein, as evidenced by the income, nor the right to revoke. The trust, in its terms, has no reference to his death and is unaffected whether he lives or dies. At the time of the transfer title passes out of the grantor and becomes vested in the beneficiaries, whether in fee, for life, in remainder, or in reversion. Such would clearly seem not to be taxable to the grantor's estate.¹⁴³ Thus when there is an absolute conveyance *in praesenti* of an estate in fee in which the possession and enjoyment is not postponed until the death of the grantor it is not taxable to him.¹⁴⁴

A similar situation arose in *Shukert v. Allen*.¹⁴⁵ The settlor created a trust which was to terminate in thirty years, the income therefrom to accumulate in favor of the beneficiaries during this time. The Supreme Court found this to be an out and out transfer leaving no interest remaining in the grantor and hence not subject to inclusion in his gross estate. It would seem that

¹⁴⁰ *Supra*, p. 283.

¹⁴¹ *Supra*, note 34.

¹⁴² *Treas. Reg.* 80, Art. 18.

¹⁴³ *Frew v. Bowers* (C. C. A. 1926) 12 F. (2d) 625, cert. gr. 273 U. S. 682, dis. by consent, 275 U. S. 578.

¹⁴⁴ *Bradley v. Nichols* (C. C. A. 1928) 27 F. (2d) 47, affg. 13 F. (2d) 47.

¹⁴⁵ (1927) 273 U. S. 545, *Rev. G. F.* (2d) 551.

if the termination of the trust were based upon the settlor's death the trust would be taxable to the settlor. Since the death of the settlor is the date at which the trust is to terminate and go to the *cestui*, under the theory of taxing the passing of "economic benefit" this increased benefit to the *cestui* might well be sufficient to place the corpus in the taxable group. Though it might also be argued that a transfer of this sort does not give rise to a cessation of enjoyment and control, and transfer thereof, which is within the purview of the estate tax.

C. Income to Another for Life, with a Reversionary Interest in the Settlor

This may arise in several different phases. In all trusts there is of course a possibility of a reversion to the grantor of the trust estate upon the failure of the trust purposes. But this was never within the intention of Congress, as there is no retention of a beneficial interest.

The most obvious situation which would seem to be within the meaning of the statute is when the income is granted to another for life with the remainder over to the settlor or his heirs, or if none, to others. This is merely a life estate in another with the remainder over to the settlor. Such is obviously an attempt to circumvent the statute and is in effect the same as a transfer by will. If the donor dies before the termination of the life estate the trust passes to his heirs. The only interest with which the grantor parts is the right to the income for his life. It is the death of the donor which causes the transfer to pass to his heirs. Thus the present value of such a reversionary interest is also subject to inclusion as part of the settlor's gross estate.¹⁴⁶

The only value to the settlor derived from the creation of such a trust is the fact that it does result in a reduction of his income tax. But even the efficacy of this has been greatly deterred by the passage of the Gift Tax, for the income therefrom each year is subject to this levy. Specific exemptions under the gift tax do, however, enable one to make a practical saving in his total taxes, provided the gift is not too large. There is a total exemption of \$40,000 as to all gifts made at any time by the grantor, and

¹⁴⁶ Commissioner v. Schwarz (C. C. A. 1934) 74 F (2d) 712; Morris Schinasi (1932) 25 B. T. A. 1153.

in addition, each year the donor is entitled to make gifts, not exceeding \$5,000 to any one individual, tax free.¹⁴⁷

A somewhat similar situation arises when the settlor reserves the power to appoint the remainder by will. As previously demonstrated, such a power directly reserved by the donor is tantamount to a power to revoke, and is properly taxable to his estate.¹⁴⁸ Somewhat analogous is the case in which the decedent himself is the donee of a power. While it is true he is not exercising any control over the trust which he himself has reserved, still, by a retention of such power he does retain control over valuable economic benefits and the right to transfer them at his death. This has been specifically dealt with by Congress in section 302 (f).¹⁴⁹ Under the Revenue Act of 1916 the Treasury Department sought to include this under the provision "to take effect in possession and enjoyment at or after death," but the decision in *United States v. Field* precluded this possibility.¹⁵⁰ Congress, perhaps foreseeing this difficulty, had in the meantime added section 302 (f) which expressly taxes the exercise of such a power.¹⁵¹

The act specifically restricts itself to the exercise of a "gen-

¹⁴⁷ Rev. Act of 1932, sec. 504, 505. The \$5,000 exemption does not apply to future interests. As to what is a future interest within the meaning of the statute see *Wells v. Commissioner* (1936) 34 B. T. A. #53. 1936 P. H. Tax Service 1034.

¹⁴⁸ *Supra*, p. 34. See also *Thomas B. Scott* (1933) 27 B. T. A. 1224; *Alfred J. Reach* (1933) 27 B. T. A. 972.

¹⁴⁹ Rev. Act 1918. The present act reads (1934) 26 U. S. C. A. 411, (f); "To the extent of any property passing under a general power of appointment exercised by the decedent (1) by will, or (2) by deed executed in contemplation of or intended to take effect in possession or enjoyment at or after his death, or (3) by deed under which he has retained for his life or any period not ascertainable without reference to his death or for any period which does not in fact end before his death (A) the possession or enjoyment of, or the right to the income from, the property, or (B) the right either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom; except in case of a bona fide sale for an adequate and full consideration in money or money's worth."

¹⁵⁰ (1921) 255 U. S. 257.

¹⁵¹ In recommending the amendment of this law the Ways and Means Committee of the House, H. R. #767, 65th Cong., 2nd session, P. 21, said: "A person having a general power of appointment is, with respect to disposition of the property at his death, in a position not unlike that of its owner. The possessor of the power has full authority to dispose of the property at his death, and there seems to be no reason why the privilege which he exercises should not be taxed in the same degree as other property over which he exercises the same authority."

eral" power of appointment,¹⁵² and thus it does not apply when the donee is required to appoint to a specified person or class of persons.¹⁵³ But it applies even though the donee can appoint by will only.¹⁵⁴ This is because such a power is regarded as general when it is not restricted by the donor to particular objects or beneficiaries, even though the method of exercising it may be restricted and limited to a testamentary power.

The reason for taxing such a power is that it is of such a character as to give to the donee actual and practical dominion of it as fully to all practical intents and purposes as if it were owned outright. However since the statute taxes only the "passing" of property under such a power it does not apply to the non-exercise of the power nor to property which is taken under the original provisions of the trust.¹⁵⁵ The problems of ascertaining when the power is exercised,¹⁵⁶ and when the power is general are not easy of application. The latter controversy generally arises due to the varying interpretations by state courts as to what is or what is not a general power of appointment. Since the Government has its option to tax not only a general power but also a special power it would seem quite proper for Congress to classify such and create a special meaning of such terms for the purposes of tax law. The state law itself creating merely a classification there would seem to be no reason for binding the Federal Government thereby. While Congress cannot change the law of property in the states it would seem that Congress is not limited in its selection of subjects for taxation by mere rules of the state courts.¹⁵⁷ But nevertheless the Courts have concerned themselves with the question as to whether or not a power is, under the state law, general or special.¹⁵⁸

¹⁵² *Fidelity-Philadelphia Trust Co. v. McCaughn* (D. 1929) 34 F. (2d) 600; *Wear v. Commissioner* (C. C. A. 1933) 65 F. (2d) 665.

¹⁵³ *Fidelity Trust Co. v. McCaughn* (1924) 1 F. (2d) 987.

¹⁵⁴ *Whitlock-Rose v. McCaughn* (C. C. A. 1927) 21 F. (2d) 164, affg. 15 F. (2d) 591; *Lee v. Commissioner* (App. D. C.) (1932) 57 F. (2d) 399, cert. den. 286 U. S. 563; *Stratton v. U. S.* (C. C. A. 1930) 50 F. (2d) 48, affg. 42 F. (2d) 779, cert. den. 284 U. S. 651.

¹⁵⁵ *Helvering v. Grinnell* (1935) 294 U. S. 153.

¹⁵⁶ *Vredenburg Minot* (1934) 29 B. T. A. 677, Pet. for Rev. dis. 70 F. (2d) 1020, wherein it was held that a residuary bequest was an exercise of the power of appointment held by decedent.

¹⁵⁷ *Fidelity Trust Co. v. McCaughn*, *Wear v. Commissioner*, supra, note 152; *Blackburne v. Brown* (C. C. A. 1930) 43 F. (2d) 320, affg. 35 F. (2d) 963.

¹⁵⁸ *Leser v. Burnet* (C. C. A. 1931) 46 F. (2d) 756; *Old Colony Trust Co.*

A third situation which would seem to fall within the scope of a transfer "to take effect in possession and enjoyment at or after death" is that in which an irrevocable transfer in trust contains a provision whereby upon the decease of the beneficiary, or the remainderman, prior to the settlor the trust shall vest in the settlor, whereas if the beneficiary survive the grantor title shall vest in him in fee simple. Such a case confronted the Supreme Court in *Klein v. U. S.*,¹⁵⁹ the transfer there being by deed but the principle involved being the same. The grantee survived the grantor. Since the vesting of the fee in the grantee was dependent upon the happening of the condition precedent the court had little difficulty in finding that the transfer was postponed to take effect in possession and enjoyment at the death of the grantor. Until the death of the grantor only a life estate was vested in the beneficiary and his death was the indispensable and intended event which effected the transmission of the larger estate from the dead to the living thereby satisfying the terms of the taxing act and justifying the tax imposed. Mr. Justice Sutherland there observed, "Nothing is to be gained by multiplying words in respect of the various niceties of the art of conveyancing or the law of contingent and vested remainders."

In view of two rather recent decisions of the Supreme Court,¹⁶⁰ Justice Sutherland joining in the majority opinions, this phrase would seem to have been rather inopportunately uttered. It is quite impossible to reconcile these decisions with that in *Klein v. U. S.* without reference to a few magic words by one learned in the "niceties of the art of conveyancing." In the *Becker* case a transfer in trust contained the provision that if the beneficiary should die before the donor then the trust estate shall "revert" to the donor immediately and absolutely, whereas if the donor die prior the property shall become the beneficiary's immediately and absolutely. The practical effect of this provision is clearly no different from that in *Klein v. U. S.* Yet the court found that this changed the tax situation and it did not fall within the pro-

v. Commissioner (C. C. A. 1935) 73 F (2d) 970; *Johnstone v. Commissioner* (C. C. A. 1934) 76 F (2d) 55, affg. 29 B. T. A. 957, cert. den. 80 L. Ed. (adv.) 103, 296 U. S.—.

¹⁵⁹ (1931) 283 U. S. 231, affg. 42 F (2d) 596.

¹⁶⁰ *Helvering v. St. Louis Union Trust Co.* (Nov. 11, 1935) 80 L. Ed. (adv.) 49; 296 U. S.—; *Becker v. St. Louis Union Trust Co.* (Nov. 11, 1935) 80 L. Ed. (adv.) 54, 296 U. S.—.

visions of the statute. The magic word in this conveyance was "revert." "The provision that the trust estate shall 'revert' in case of the predecease of the beneficiary removes any doubt as to the completeness of the transfer, if otherwise there would be any."¹⁶¹ Similarly in the *Helvering* case the irrevocable transfer contained a provision that if the beneficiary predecease the grantor the trust shall terminate and revert to the grantor. This case, was, in fact, decided first and was cited by the court in its decision in the *Becker* case. The provision was treated as a contingency in the grantor in the nature of a condition subsequent the occurrence of which was entirely fortuitous so far as any control, design or volition on his part was concerned. Thus it was not taxable as a transfer to take effect in possession and enjoyment at or after death.

The decision of the court is clearly not without support of ample authority both in property law and in tax law. In a grant upon condition subsequent nothing remains in the grantor or his heirs except the right to take advantage of the breach of the condition. This amounts to a mere possibility of reverter which in itself is not an estate but merely a possibility of having an estate at a future time. And a mere possibility of reverter would not seem subject to tax. Thus many of the lower federal courts have held that the settlor has parted with all right of beneficial interest and actual control over the property, and his death merely forecloses the possibility of any reversionary interest.¹⁶² Shortly prior to the decision in the *Klein* case by a *Per Curiam* decision the Supreme Court reversed a decision of the Circuit Court of Appeals which had sustained the tax upon the ground of the reversionary interest retained.¹⁶³ The income was payable to the settlor for life with remainder over to her three children, but if they predeceased the settlor the trust was to revert to the settlor. But since the reversal was based upon the decision in

¹⁶¹ *Ibid.*, l. c. 61.

¹⁶² *Nichols v. Bradley* (1928) 27 F. (2d) 47; *Burnet v. Pac. etc. Bank* (C. C. A. 1931) 45 F. (2d) 773, cert. den. 283 U. S. 825, the third trust therein involved; *Peabody v. Commissioner* (1931) 24 B. T. A. 787; *Commissioner v. Dunham* (1934) 73 F. (2d) 752; *Commissioner v. Bonney* (1934) 75 F. (2d) 1008, affg. 29 B. T. A. 45; *Emma R. Morse* (1933) 27 B. T. A. 1070; *Commissioner v. Wallace* (C. C. A. 1934) 71 F. (2d) 1002, cert. den. 293 U. S. 600; *George F. Spencer* (1934) 31 B. T. A. 171; *Amoskeog Trust Co. v. Field* (1935) 10 F. Supp. 635.

¹⁶³ *McCormick v. Burnet* (1931) 283 U. S. 784, Revg. 43 F. (2d) 277.

*May v. Heiner*¹⁶⁴ it would seem that the Court was more concerned with the reservation of income by the settlor than it was with the retention of the reversionary interest. The exact point was considered by the Board of Tax Appeals in *Duke v. Commissioner*,¹⁶⁵ the Board coming to the conclusion that such a mere possibility of a reversionary interest did not make it subject to the tax, and this was affirmed by an equally divided court in *Helvering v. Duke*.¹⁶⁶ Thus there is prior authorization for the present decree.

The criticism of the court however comes from its apparent reversal of attitude and decision in *Klein v. U. S.* True the court specifically distinguished *Klein v. U. S.* but the practical effect of these later decisions is to make it perfectly possible to give away one's property and still retain an express reversionary interest, without incurring liability under the Estate Tax, provided that sufficient respect is paid to the niceties of the art of conveyancing. As observed by Mr. Justice Stone, speaking for the dissent,¹⁶⁷ "if he had reserved a remainder in himself with gift over, if he did not survive his daughter" the gift would have been taxable. "Instead, by using a different form of words, he attained the same end and has escaped the tax. Having in mind the purpose of the statute and the breadth of its language it would seem to be of no consequence what particular conveyancers' device—what particular string—the decedent selected to hold in suspense the ultimate disposition of his property until the moment of his death. In determining whether a taxable transfer becomes complete only at death we look to the substance, not to form."¹⁶⁸ It would seem, clearly, that in these second situations the settlor fully retained his hold upon the property by reserving the interest, terminable only at his death, by which full ownership would be restored to him if he survived the beneficiaries. Such termination of the settlor's reversionary interest would seem to be a transfer of economic benefit within the purview of Congressional intent as evidenced by section 302 (c). The practical result of

¹⁶⁴ *Supra*, note 34.

¹⁶⁵ (1931) 23 B. T. A. 1104.

¹⁶⁶ (1933) 290 U. S. affg. 62 F. (2d) 1057 Chief Justice Hughes took no part in the consideration of this case.

¹⁶⁷ Mr. Justice Stone, the Chief Justice, Mr. Justice Brandeis, and Mr. Justice Cardozo dissented.

¹⁶⁸ *Supra*, note 60, l. c. 53.

the establishment of such a trust, with a provision that if all the beneficiaries predecease him the corpus shall revert to him, is substantially the same as leaving the property by will to his family. By determining the liability by the verbal form of the trust deed the Court seems to be sanctioning a technical method of tax avoidance which Congress had sought to destroy.

The decision in these two cases has already been extended, being applied by the Supreme Court to an analogous situation arising under insurance policies.¹⁶⁹ The insurance policy provided that in the case of the prior death of the beneficiaries the proceeds therefrom should be paid to the decedent's estate. Reversing the Circuit Court of Appeals for the First Circuit, and the Court of Claims, The Supreme Court applied the principles laid down in the *St. Louis Union Trust Co.* cases, and held that these proceeds were not includible in the insured's gross estate. Justices Brandeis, Stone, and Cardozo concurred upon the first ground of the opinion, viz., the statute was not to be applied retroactively, and the Chief Justice acquiesced because of the recent decisions in the *St. Louis Union Trust Co.* cases.

Whether the recent amendment of the Revenue Act¹⁷⁰ will remedy this defect remains to be seen. It seems that it quite properly should. Congress has, in this Amendment to the Estate Tax, clearly expressed a desire to provide that the taxable estate shall include all property of which the decedent has at any time made a transfer under which until the time of his death he might by any possibility become entitled to the return of any interest in it. A reasonable and clear construction of the statute should result in the inclusion of such interests. A contra construction by the Court will force Congress into an exhaustive study of the "niceties of the art of conveyancing."

V. CONCLUSION

Throughout this paper an attempt has been made to point out that in taxing to the settlor the corpus and income of transfers in trust Congress has ever had in mind a retention of the economic benefits by the grantor. The logic of this position seems unquestionable. True, it is clearly improper to tax as income of

¹⁶⁹ *Bingham v. U. S.* (Dec. 9, 1935) 80 L. Ed. (adv.) 206; *Industrial Trust Co. v. U. S.* (Dec. 9, 1935) 80 L. Ed. (adv.) 208, 296 U. S.—.

¹⁷⁰ *Supra*, note 138.

A income received by B.¹⁷¹ But when the income received by B is within the power of A to appropriate, merely having been diverted to B through an outside channel, the trust, such income, quite properly, may be regarded as A's income. Similarly the corpus, remaining within A's control, should be included in the estate of A. These are the situations which Congress has attempted to meet. The lines which have been drawn have herein been discussed.

The problem is far from settled. Its development has been perhaps a process of judicial exclusion and Congressional inclusion. Each time Congress and the courts succeed in crystallizing the definition of what transactions shall be included in the taxable group, and they often do not agree, a differently formulated problem is developed for the purpose of avoiding taxation, and the problem arises anew.

It would seem however that under the present law legislative achievement has ably fostered legislative objective. It still remains possible to reduce one's taxes through the establishment of a trust, but to do so the settlor does have to pay a price in the form of a real surrender of ownership and a permanent abandonment of the possibility of enjoyment of the economic fruits thereof.

¹⁷¹ *Hoeper v. Tax Commission* (1931) 284 U. S. 206, 215.