

INFERENCE OF RETAINED POSSESSION OR ENJOYMENT UNDER
SECTION 2036

*In re Estate of Harry H. Beckwith, 55 T.C. 242 (1970),
acquiesced in, 1971 INT. REV. BULL. No. 27, at 7.*

Decedent transferred common stock of his closely held corporation to various trusts for the benefit of his children.¹ By the terms of the trusts agreements, the trustees had the discretionary power both to distribute amounts of net income for the benefit of the beneficiaries and to purchase or sell any of the trust property. The decedent retained the right to remove any trustee² and to appoint a successor other than himself.³

1. The pertinent provisions of the trust instruments are as follows:

FIFTH: The property of each trust pertaining to a minor beneficiary shall be disposed of as follows:

(a) During such beneficiary's minority, or until said trust shall be sooner terminated as provided in article SIXTH hereof, the trustee shall pay to or apply for the benefit of such beneficiary, such amounts of the net income and principal thereof as the trustees from time to time deem advisable. Accumulated income may, in the trustees' discretion, be added to principal or distributed from time to time as current income.

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ELEVENTH: . . . the trustees shall have the following powers . . .

(a) To retain for any period of time and, in their sole discretion to purchase or sell any securities or property, although of a kind or amount which ordinarily would not be considered suitable for a trust investment, even to the extent of keeping the whole or any portion of the trust fund invested in the securities or shares of Beckwith-Arden, Inc., a New Hampshire corporation, or any of its subsidiaries, or any successor to the business of any one or more of them; . . .

* * * * *

TWELFTH: There shall be no more than two trustees and at least one of them or the trustee, if there is only one, shall be a bank or trust company authorized by law to conduct a fiduciary business in The Commonwealth of Massachusetts. Subject to that requirement the donor may, in his lifetime and at his pleasure, remove any trustee and appoint a successor trustee, other than the donor, to fill any vacancy.

So long as there shall be an individual trustee hereunder, such individual trustee shall have sole authority to determine in what manner the trust property shall be invested and to vote or act in respect to all shares or securities held in trust hereunder, and, during that period, the corporate trustee shall have no such authority or duty and shall not be liable for any loss resulting therefrom.

2. In practice the trustees were all close business associates of the decedent who was described by the lawyer for the estate as "having a dominant personality." See letter from Chester M. Howe to the Washington University Law Quarterly, Sept. 7, 1971, on file Washington University Law Quarterly.

3. Treas. Reg. § 20.2036-1(b)(3) (1960) states that if the decedent reserved the unrestricted power to remove or discharge a trustee at any time and appoint himself as trustee, the decedent is considered as having the powers of the trustee. See *Walter v. United States*, 341 F.2d 182, 185 (6th Cir. 1965); *Clark v. United States*, 267 F.2d 501, 502 (1st Cir. 1959).

See also Van Vechten, *The Grantor's Retention of Powers as Trustee or Otherwise: Income and Estate Tax Consequences*, N.Y.U. 25th INST. ON FED. TAX. 943 (1967), for a discussion of the general principles involved with the grantor's retention of powers as trustee.

At the time of his death, the decedent owned no stock in his individual capacity; however, as trustee under both his wife's will and a revocable trust which he had created, he had a legal right to vote 37% of the outstanding shares of stock. In addition, the trustees of the Harry H. Beckwith Trusts annually executed proxies which were voted by the decedent.⁴ These additional proxies gave him control of a total of 76% of the outstanding shares of the corporation.

The Commissioner determined that because of the continued voting of the stock after the transfer, the assets of the Harry H. Beckwith Trusts were includible in the decedent's estate under § 2036 of the Internal Revenue Code of 1954.⁵ The Commissioner's principal arguments were that the decedent retained the right "to designate the persons who shall possess or enjoy the property or the income therefrom" within the meaning of § 2036(a)(2) and that the decedent retained "possession or enjoyment" of the transferred property within the meaning of § 2036(a)(1).⁶ *Held*: Section 2036 does not require inclusion of the closely held corporate stock because, on these facts, no express or implied agreements could be inferred which would restrict the trustees' freedom either in voting or disposing of the closely held corporate stock.⁷

The purpose of § 2036 is to prevent avoidance of estate taxes by means of *inter vivos* transfers of property.⁸ Under this section, the value

4. The annual granting of proxies is consistent with the laws of Maine, the state in which the corporation was incorporated, which provides:

Proxies; general power of attorney:

Shareholders may be represented by proxies granted not more than one year before the meeting, which shall be named therein; they are not valid after a final adjournment thereof

. . . .

ME. REV. STAT. ANN. tit. 13, § 104 (1964).

5. INT. REV. CODE OF 1954, § 2036 TRANSFERS WITH RETAINED LIFE ESTATE.

(a) General Rule—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bonafide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before 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.

6. Estate of Harry H. Beckwith, 55 T.C. 242, 247 (1970).

7. *Id.* at 246-47.

8. INT. REV. CODE OF 1926, § 302(c) was the precursor of the present § 2036; that section read as follows:

Property is to be taxed to the decedent's estate 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

of the transferred property is included in the decedent's estate whenever the decedent has transferred, during his life, an interest in property which qualifies as having been "retained" under the inclusionary language of § 2036.⁹ Under the regulations, an interest is treated as having been retained if there was an understanding, express or implied, that the interest would later be conferred.¹⁰

In *Estate of McNichol v. Commissioner*,¹¹ the Third Circuit interpreted the use of "retain" in § 2036. There the decedent conveyed income-producing real estate to his children with no reservation of interests or rents to himself; he also entered into contemporaneous oral agreements with his children under which he was entitled to receive the rents until his death. The court rejected the petitioner's argument that to be includible in the estate of the decedent the retained income interest must be reserved in the instrument of transfer. It was held that if the interest is retained either in connection with, or as an incident to the transfer, then the interest will be taxable to the decedent's estate.¹² The court, however, had doubts whether the receipt of all the income from the property would be sufficient to satisfy the "enjoyment" clause without the oral agreement or prearrangement.¹³

The same court went one step further in their interpretation of retention under § 2036 in *Estate of Skinner v. United States*.¹⁴ In this case the settlor thought she had a life estate in the income from the trust, and in actual fact, she did receive the income for life. The court was able to find that these two circumstances, combined, created a "strong inference" that there was an understanding between the settlor and the

The Supreme Court in *May v. Heiner*, 281 U.S. 238 (1930) held that the transfer of property in trust with a reservation of a life estate in the income thereof was not a transfer intended to take effect in possession or enjoyment at or after death within section 302(c) of the INT. REV. CODE OF 1926. Congress responded to this decision by passing a joint resolution which amended the statute to tax transfers wherein the transferor retained a life estate in the income. See 46 Stat. 1516 (1931). With minor changes, the resolution was incorporated into the INT. REV. CODE OF 1932, § 803(a) which is the same as the INT. REV. CODE OF 1954, § 2036. See also C. LOWNDES & R. KRAMER, FEDERAL ESTATE AND GIFT TAXES 136 (2d ed. 1962).

9. See note 5 *supra*.

10. Treas. Reg. § 20.2036-1(a)(ii) (1960).

11. 265 F.2d 667, 673 (3d Cir. 1959), *cert. denied*, 361 U.S. 829, *aff'g* 29 T.C. 1179 (1958).

12. *Id.* at 670.

13. *Id.* at 671 n. 6. "We intimate no opinion as to whether we would have followed these decisions if, in the case before us, the decedent had received the rents following the transfer without an agreement with his children that he might do so."

See also *Atkinson v. United States*, 231 F. Supp. 933 (E.D.S.C. 1964), which held that shares of stock which decedent in his lifetime had purchased in names of his wife and children were includible in his estate, when by agreement, he received the dividends during his life.

14. 316 F.2d 517 (3d Cir. 1963), *aff'g* 197 F. Supp. 726 (E.D. Pa. 1961).

trustee that the trustee's "discretion" would be exercised exclusively in favor of the settlor for her life. The court concluded that the existence of an agreement at the time of transfer, by which the possession or enjoyment of the property is retained, may be inferred from the circumstances of the transfer and the manner in which the transferred property is used. The donor's interest need not be reserved by the instrument of transfer, nor need it be legally enforceable.¹⁵

The Internal Revenue Service under *Skinner* has the authority to go directly to the substance of the transfer. If there is evidence of continued "possession or enjoyment, or right to income thereof" after the assets are transferred, the Commissioner may infer the arrangement necessary to constitute retention under § 2036.¹⁶ A common situation which immediately comes under attack is the transfer of a family residence. In Revenue Ruling 7-155,¹⁷ the facts clearly stated that an elderly father transferred his home to his son with the *understanding* that he would remain in *exclusive* possession of the home; the Commissioner ruled that the property was includible in the donor's estate.¹⁸ However, when the facts are not so clearly posited, the Commissioner must present evidence of a similar agreement, either express or implied, in order to be successful.¹⁹ The fact that the donor lived in the house with the donee after the transfer is, by itself, not sufficient to infer an agreement or to satisfy the requirement of possession or enjoyment as set out in § 2036;²⁰ predictably, this inference has even less validity when the donee is the donor's spouse and factors other than estate planning presumably influence the decision to continue in co-occupancy of the residence.²¹

Since an express or implied prearrangement is required under § 2036,

15. *Estate of Skinner v. United States*, 197 F. Supp. 726, 729 (E.D. Pa. 1961). See also *Uhl v. Commissioner*, 241 F.2d 867 (7th Cir. 1957) which held that only the life interest in the specified amount was includable in the estate when the trustee used his discretion in two of the eight years of the trust's duration to distribute excessive amounts to the settlor.

16. Treas. Reg. § 20.2036-1(a)(ii) (1960), states that an interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest would later be conferred.

17. Rev. Rul. 155, 1970-1 CUM. BULL. 189.

18. *Accord*, *Guynn v. United States*, 437 F.2d 1148 (4th Cir. 1971); *Peck v. United States*, 16 Am. Fed. Tax R.2d 6125 (M.D. Ga. 1965); *Estate of Edward Linderme*, 52 T.C. 305 (1969).

19. *Estate of George Burr*, 4 T.C.M. 1054 (1945).

20. See, e.g., *Union Planters Nat'l Bank v. United States*, 361 F.2d 662 (6th Cir. 1966), *aff'g*, 238 F. Supp. 883 (W.D. Tenn. 1965); *Diehl v. United States*, 68-1 U.S. Tax Cases 12,506 (W.D. Tenn. 1967).

21. See Rev. Rul. 155, 1970-1 CUM. BULL. 189; *Estate of G.A. Binkley v. United States*, 358 F.2d 639 (3d Cir. 1966); *Stephenson v. United States*, 238 F. Supp. 660 (W.D. Va. 1965); *Estate of A.D. Gutchess*, 47 T.C. 554 (1966), *acq.* 1967-1 CUM. BULL. 2.

it is difficult to infer a retained interest when, as in the *Beckwith* case, there is a transfer of stock and no dividends are paid to the grantor. This is because there are no direct benefits²² to the grantor and taxation under § 2036 requires a showing of retained interest as opposed to the mere fact of actual possession or enjoyment.²³ The Commissioner has argued that retention of *voting control* of a corporation constitutes retained possession or enjoyment as required by § 2036.²⁴ Despite recent court decisions to the contrary,²⁵ this argument has continuing vitality since the Commissioner has refused to acquiesce when the issue has been determined contrary to his position. For this reason, owners of closely held corporations should review with interest the holding in *Beckwith*. Through a process similar to that used in *Beckwith*, a grantor can divest himself of assets which would otherwise be includible in his estate and still be able to retain effective control and direction of the business. If dividends or other direct benefits are not retained by the grantor, it will be extremely difficult for the Commissioner to present evidence of any agreement or prearrangement which existed at the time of the transfer.²⁶

22. A right of possession or enjoyment can indirectly be created when a grantor unwittingly reserves a life estate because his legal obligations may be satisfied out of the income or principal of a trust. See Rossbach, *Gifts with Retained Life Estates Including the Use of Property: Income and Estate Tax Consequences*, N.Y.U. 25th INST. ON FED. TAX. 1077, 1083 (1967).

23. Cf. Ehrlich, *Current Developments Involving Non-Voting Stock in Estate Planning*, N.Y.U. 26th INST. ON FED. TAX. 1275, 1282 (1968).

24. See Rev. Rul. 54, 1967-1 CUM. BULL. 269 where a decedent transferred nonvoting stock to a restricted trust and retained for his life a controlling interest in the voting stock of the corporation; the value of the nonvoting stock was included in the decedent's gross estate. See also Pamela D. Holland, 47 B.T.A. 807 (1942), *modified*, 1 T.C. 564 (1943).

25. The question of the extent and validity of Rev. Rul. 54, 1967-1 CUM. BULL. 269 was directly before the court in *Byrum v. United States*, 440 F.2d 949 (6th Cir. 1971). There the court held that the reservation in the trust agreement of the voting rights of stock in a closely held corporation did not cause stock which was transferred to irrevocable trusts for the settlor's children to be includible in his gross estate. This was held even though the grantor's retaining of the right to vote the stock in trust combined with stock he personally retained, kept him in voting control of the corporation. The court concluded that by retaining voting control of the corporation, the grantor only controlled the selection of corporate directors. These individual directors would then be under a fiduciary obligation to exercise sound business judgment and could not act in bad faith to the injury of the beneficial owners of the stock. The court went on to state that although Rev. Rul. 54-67 tended to support the position of the Commissioner, rulings do not have the force of law and are at most merely persuasive. See also *Yeazel v. Coyle*, 68-1 U.S. Tax Cases 12,524 (N.D. Ill. 1968).

26. See Comment, *The Doctrine of External Standards under Sections 2036(a)(2) and 2038*, 52 MINN. L. REV. 1071 (1968) for a discussion of the doctrine of external standards under section 2036. If a grantor's powers to designate enjoyment of property interests or to modify such interests are ministerial or controlled by an ascertainable standard, and thus are duties enforceable in a court of equity, the property so transferred is not includible in the grantor's gross estate when he dies.