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Taxation--Estate Taxes--Where Grantor Has Power to Accumulate Trust Income Such Income Is Taxable to His Estate (United States v. O'Malley, 383 U.S. 627 (1966))

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Proceedings deemed to be exclusively within the ambit of state jurisdiction should not be interfered with by a federal injunction premised solely on grounds not germane to the issues litigated. Instead, parties should be encouraged to exhaust state remedies before availing themselves of the aid of a federal court. This decision, if generally followed, would tend only to promote federal-state clashes rather than implement the explicit policy of the anti-injunction statute which is to avoid such conflict.

TAXATION — ESTATE TAXES — WHERE GRANTOR HAS POWER TO ACCUMULATE TRUST INCOME SUCH INCOME IS TAXABLE TO HIS ESTATE. — The grantor of a trust, as cotrustee, had the power to distribute or accumulate trust income. The executors brought a refund action after the Commissioner of Internal Revenue included in grantor-decedent's gross estate both the original trust corpus and the accumulated income arising from the principal. In reversing the decision of the Court of Appeals for the Seventh Circuit, the United States Supreme Court *held* that income accumulated pursuant to the exercise of the grantor's power, in addition to the original transfer of trust property, constituted a taxable transfer within the meaning of the Internal Revenue Code. *United States v. O'Malley,* 383 U.S. 627 (1966).

Under the Internal Revenue Code of 1954[1] and its predecessor,[2] a decedent's gross estate for estate tax purposes includes the value of all property of which a *transfer*[3] by trust or otherwise has been made under any of the following circumstances: (1) the transfer is in contemplation of death;[4] (2) the transfer is subject to certain retained[5] life interests;[6] (3) the transfer is intended to take effect in possession or enjoyment at or after the grantor's

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[1] INT. REV. CODE OF 1954, §§ 2035(a), 2036(a), 2037(a), 2038(a)(1), (2).

[2] Int. Rev. Code of 1939, §§ 811(c)(1), 811(d)(1).

[3] Such a transfer does not include "a bona fide sale for an adequate and full consideration in money or money's worth." INT. REV. CODE OF 1954, §§ 2035(a), 2036(a), 2037(a), 2038(a)(1), (2).

[4] It should be noted that a gift in contemplation of death, for Code purposes, is not necessarily one arising from "a reasonable fear that death is *near at hand*. . . . It is sufficient if contemplation of death be the inducing cause of the transfer whether or not death is believed to be near." United States v. Wells, 283 U.S. 102, 109 (1930).

[5] The retained power must be for the transferor's 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." INT. REV. CODE OF 1954, § 2036(a).

[6] The interests retained are either

(1) The possession or enjoyment of, or the right to the income from, the property, or

death; (4) the transfer is subject to reserved powers to alter, amend, revoke or terminate. While the Internal Revenue Code of 1954 and its predecessor include the value of the trust property transferred in decedent's gross estate, they fail to specifically provide for accumulated income subsequently generated by the transferred property.

With respect to inter vivos transfers within the first category, *i.e.,* gifts in contemplation of death, any subsequent accumulated income or property acquired by such accumulated income is not part of the taxable transfer.[7] In *Burns v. Commissioner,*[8] decided by the fifth circuit in 1949, the grantor set up an irrevocable trust in contemplation of death, naming as trustee an independent trust company. In holding that the value of securities acquired from income accumulations was not part of decedent's gross estate, the court reasoned that, since the statute does not make provision for the inclusion of accumulated income in the gross estate, it should be strictly construed in favor of the taxpayer.

A similar result was reached in 1952 by the seventh circuit in *Commissioner v. Gidwitz' Estate.*[9] There the grantor set up a trust in contemplation of death, naming himself and his spouse as cotrustees. According to the trust instrument *all* income was to be accumulated during the decedent's lifetime and distributed upon his death. Although the grantor had designated himself a trustee, the court held that the accumulated income generated by

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(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. INT. REV. CODE OF 1954, § 2036(a)(1), (2).

[7] Commissioner v. Gidwitz' Estate, 196 F.2d 813 (7th Cir. 1952); Burns v. Commissioner, 177 F.2d 739 (5th Cir. 1949). See also Estate of Delia Crawford McGehee, 28 T.C. 412 (1957), wherein subsequent stock dividends were held includible in decedent's gross estate after a transfer in contemplation of death. The court stated that it made no difference whether the stock dividends represented a capitalization of earnings or a stock split, for in either case there was no change in the stockholders' interest in the corporation. The stock was therefore *transferred* since the total amount of stock represented the same proportional interest originally transferred.

[8] 177 F.2d 739 (5th Cir. 1949). No distinction was made, with respect to transfers in contemplation of death, between outright gifts and gifts in trust. Previous cases have held that, while only the value of the specific property transferred by outright gift was taxable in the gross estate, the value of the entire trust corpus at date of death was taxable in the gross estate when the transfer was by trust. See Pavenstedt, *Taxation of Transfers in Contemplation of Death: A Proposal for Abolition,* 54 YALE L.J. 70, 87-88 (1944); MONTGOMERY, FEDERAL TAXES ON ESTATES, TRUSTS & GIFTS 434-35 (1943). *Compare* Humphrey's Estate v. Commissioner, 162 F.2d 1 (5th Cir. 1947), *with In re* Kroger's Estate v. Commissioner, 145 F.2d 901, 907 (6th Cir. 1944), *and* Igleheart v. Commissioner, 77 F.2d 704, 711 (5th Cir. 1935).

[9] 196 F.2d 813 (7th Cir. 1952).

the trust corpus was not part of decedent's gross estate. It was reasoned that the transfer was irrevocable and effective during the grantor's life. Furthermore, the terms of the trust agreement expressly prohibited any change in distribution, disposition, possession or enjoyment of the trust property.

With respect to transactions in contemplation of death, Treasury Department Regulations have indicated that any improvements, additions and other enhancements in value made by the transferee are not to be considered in ascertaining the value of the gross estate.[10] The regulations have also made it explicit that income received subsequent to the transfer in contemplation of death, and property purchased with such income are to be excluded from the computation of decedent's gross estate.[11]

There is no comparable provision in the regulations with respect to the taxability of accumulated income in decedent's gross estate when the transaction qualifies under any of the other three statutory transfers. Thus, case law on the taxability of accumulated income has evolved without the aid of governmental guidelines where the grantor retains a life interest, retains a power to alter, amend, revoke or terminate, or establishes a trust not effective in possession or enjoyment until death.

The United States Supreme Court stated in *Maass v. Higgins*[12] that:

> The promise to pay interest or rent, or the expectancy of dividends upon stock, the amount of such payments, the past and prospective regularity of the payments, and other elements bearing upon the expectation of the receipt of income affect the value of any income producing property. But these elements are not separately valued in appraising the worth of the asset at any given time. It is the uniform practice to value the asset as an entirety, taking into consideration all the elements that go to give it value in the market.[13]

The Court held in this case that, upon an election to value an estate as of one year after death, income accrued and received between the time of death and the time of such valuation should not be included as part of the value of the gross estate. The reasoning in *Maass* has lent support to the premise that accumulated income is adequately reflected in the evaluation of the original trust corpus *without* the separate measurement of the accumulated income derived therefrom.[14] However, it has been held that income

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[10] Treas. Reg. § 20.2035-1(e) (1954).
[11] *Ibid.*
[12] 312 U.S. 443 (1941).
[13] Maass v. Higgins, 312 U.S. 443, 448 (1941).
[14] See, *e.g.*, Michigan Trust Co. v. Kavanagh, 284 F.2d 502 (6th Cir. 1960).

accumulated from trust property becomes taxable in the grantor's estate when the transfer does not take effect in possession or enjoyment until death,[15] or when the grantor retains the power to designate the possession or enjoyment of such income.[16]

In 1955, the Court of Appeals of the Seventh Circuit held, in *Commissioner v. Estate of McDermott*,[17] that the grantor's retention of power to designate the persons who shall possess or enjoy the transferred property or its income would not make the income accumulations taxable in the settlor's gross estate. The decedent, as trustee, was authorized to accumulate trust income which would be added to corpus. The court, relying on *Gidwitz* and *Burns*, ruled that the statute is only concerned with a *transfer* and since the accumulations of income were not transferred by the grantor to the trust, they did not form part of decedent's gross estate. The court rejected the Commissioner's attempt to distinguish the case from *Gidwitz* on the ground that the latter was concerned with a transfer in contemplation of death and was therefore complete during the grantor's lifetime. The court asserted that the transfer in *McDermott* was complete since the trusts were irrevocable and no power was reserved to revoke, change or modify the terms of the trusts for the benefit of the grantor. Any control over the distribution and accumulation of income "could not result in any financial benefit to the trustee, and neither could it affect the rights of the beneficiaries in the aggregate."[18]

In 1963, the Tax Court refused to follow the doctrine of *McDermott*. In *Estate of Round*,[19] the grantor possessed both the power to alter, amend, or revoke,[20] and the power to designate

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15 Estate of Showers, 14 T.C. 902 (1950). The Tax Court held that the accumulated income as well as the original trust corpus was taxable in decedent's gross estate since the enjoyment of the transfer was not effective until death. The grantor had unrestricted power of sale or other disposition, and could terminate the trust and deliver the trust estate to the beneficiaries. It was reasoned that decedent's power to terminate and deliver the trust estate also extended to the property acquired with trust income, and, therefore, the tax was measured by the value of the trust estate at the time of death. The same result was reached, but without discussion, in Estate of Spiegel v. Commissioner, 335 U.S. 701 (1949), under § 811(c)(1)(C) of the 1939 Code.

16 Estate of Yawkey, 12 T.C. 1164 (1949). The statutory ground for including the transfer was the retention of rights to designate the enjoyment of the income derived from the trust corpus, based upon the grantor's power to accumulate or distribute trust income at his discretion.

17 222 F.2d 665 (7th Cir. 1955).

18 Commissioner v. Estate of McDermott, 222 F.2d 665, 668 (7th Cir. 1955).

19 40 T.C. 970 (1963).

20 Int. Rev. Code of 1939, § 811(d), which is substantially re-enacted as INT. REV. CODE OF 1954, § 2038(a). See Estate of Newberry, 17 T.C. 597 (1951), *rev'd on other grounds*, 201 F.2d 874 (3d Cir. 1953) (decedent's power to change the beneficiaries requires inclusion of trust corpus and

the beneficiaries who were to possess the enjoyment of the property or its income. Since these powers extended to the income accumulations as well as the original corpus, the value of the accumulations was held to be included in decedent's gross estate. The court stated that its holding could be justified either on the theory that the transfers were incomplete until the date of death; or that the withholding of income from the beneficiaries, in itself, constituted a *transfer* within the meaning of the statute.[21] *Estate of Round* was affirmed by the First Circuit Court of Appeals on the theory of incomplete transfer,[22] thus creating an apparent conflict between circuits.

In the instant case, the Supreme Court resolved the conflict of authority by holding that the grantor's discretionary power to accumulate income, thereby denying to the beneficiaries the privilege of immediate enjoyment, would make the accumulated income taxable as part of the grantor's estate under Section 811(c)(1)(B)(ii) of the Internal Revenue Code of 1939.[23] The grantor owned the right to the present and future income produced by the property at the time the trusts were established. Because of the retention of the power to accumulate income, the Court reasoned that the subsequent exercise of this power was an effective *transfer* within the meaning of the Internal Revenue Code.

In resolving the controversy, *McDermott* was expressly overruled as representing an erroneous extension of *Gidwitz* in which only the original trust corpus was taxed as a gift in contemplation of death. It was pointed out that in *Gidwitz* the taxable event was a completed inter vivos transfer, while in the present case the transfer was not completed until the grantor's death terminated the reserved power to accumulate. A further distinction can be drawn in that in *Gidwitz* the value of the original transferred property was deemed an adequate estimate of any future income rights since the grantor retained no interest in the property. In the instant case the decedent retained the power to accumulate

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accumulated income under § 811(d)(2) of the Internal Revenue Code of 1939); Estate of Daniel Guggenheim, 40 B.T.A. 181, 182 (1939), *modified and aff'd,* 117 F.2d 469 (2d Cir.), *cert. denied,* 314 U.S. 621 (1941) (decedent's power "'to alter, define and prescribe the relative interests of the beneficiaries . . .'" was equated to the power of revocation and required inclusion of accumulated income under the Revenue Act of 1926. *Id.* at 182-83). The same result was reached, but without discussion, in Commissioner v. Estate of Holmes, 326 U.S. 480 (1945), under § 811(d)(2).

21 See, however, Michigan Trust Co. v. Kavanagh, 284 F.2d 502 (6th Cir. 1960), where the court, relying upon the decision in *McDermott,* held that the accumulated trust income was not includible in the decedent's gross estate, though the grantor reserved the right within the statutory provision to alter, amend or revoke the trust.

22 Round v. Commissioner, 332 F.2d 590 (1st Cir. 1964).

23 United States v. O'Malley, 383 U.S. 627 (1966).

income until the moment of his death and the corpus additions produced by the exercise of this power were properly included in the grantor's gross estate.

Mr. Justice Stewart, dissenting, literally interpreted the statute as applying only to property "of which the decedent has at any time made a transfer."[24] Here, the grantor never made an actual transfer of the subsequent accumulated income. Consequently, he was of the opinion that this accumulated income was sufficiently reflected as income-producing capacity in the valuation of the original trust corpus.

United States v. O'Malley has eliminated the confusion resulting from conflicting case law. The Court, interpreting the code in a situation where the grantor retained an accumulative power, has apparently made a sound policy decision. Since it is this accumulative power which makes the trust corpus initially includible in the decedent's gross estate, it follows logically that this same power should also make any income increment derived therefrom part of the estate. However, where such trusts have existed for long periods the accumulated income may substantially increase estate taxes. To avoid the increased estate tax burdens, grantors of such trusts must either relinquish their retained powers in favor of an independent trustee or distribute the past accumulated and present income to the beneficiaries who would then be taxed under the income tax provisions of the code.[25] The instant case will make it more difficult for estate planners to provide for the payment of estate taxes since provision must be made not only for fluctuations in market value, but also for the investment skill of the trustee.

Left unanswered is the question of the exact extent of the applicability of this decision. The Court does not discuss the includibility of accumulated income under Section 2038 of the Internal Revenue Code of 1954 relating to transfers where the grantor retains the power to alter, amend, revoke, or terminate the trust. Where in such trusts the accumulations are not made as a result of the grantor's discretion, the withholding of income cannot be described as a new *transfer* by the grantor to the trust. However, such accumulated income can be taxed on the theory that the grantor's retention of power makes the original transfer incomplete, and such reserved power applies to the accumulated income as well as the trust corpus.[26]

The Court distinguished the instant case from *Gidwitz* and *Burns* which held that in a transfer in contemplation of death the

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24 INT. REV. CODE OF 1954, § 2036(a).

25 See INT. REV. CODE OF 1954, §§ 662, 666.

26 See Estate of Round, 40 T.C. 970 (1963), *aff'd sub nom.*, Round v. Commissioner, 332 F.2d 590 (1st Cir. 1964).

subsequent accumulated income is not included within decedent's gross estate. Nevertheless, there seems little doubt that, when the grantor makes a transfer in contemplation of death but retains the right to accumulate income, the accumulated income would be included in decedent's gross estate. In such a situation the transfer in contemplation of death would be incomplete as a result of the grantor's reservation of power. Under Section 2038(a) of the 1954 Code, the grantor's relinquishment in contemplation of death of a power to alter, amend, revoke, or terminate will make the *transfer* includible in decedent's gross estate. The subsequent accumulated income, however, should not be included since the transaction completely divested the grantor of all rights in the property.

The most logical theory for including accumulated income is the incompleteness of the transfer. This theory can be applied to both the retained power to designate the enjoyment of the trust and to the power to alter, amend, revoke, or terminate the trust. Although *United States v. O'Malley* finds support in both the incomplete and new transfer theories, it employs the incomplete aspect to justify the difference between gifts in contemplation of death and transfers reserving the power to accumulate income. While a transfer in contemplation of death may be complete in all respects, a transfer with the grantor retaining power to accumulate income is not a complete transfer of all the grantor's property rights.[27]

[27] See Commissioner v. Gidwitz' Estate, *supra* note 7.