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Taxation of Insurance Trusts

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TAX COMMENT

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TAXATION OF INSURANCE TRUSTS.—Innumerable attempts to evade taxes have led in recent years to much litigation and confusion.[1] One of the most prevalent of these methods used to circumvent the tax laws is the trust. By the creation of trusts, incomes have been so divided and subdivided as to withdraw from the government the benefit of the graduated taxes and surtaxes applicable to income when concentrated in a single ownership.[2] The courts, in their attempt to prevent these circumventions of the law, have often gone beyond the strict interpretation of the statutes and have included as taxable those cases which were not expressly covered by the law.[3] Income from revocable trusts has been taxed to the settlor for the reason that he still retained control and dominion over the property.[4] The courts have disregarded the refinements of legal title and have sought to tax the person with actual command over the property taxed.[5] In their liberal construction of these acts, however, the courts must keep within the limitations of the Constitution, particularly those of the Fifth Amendment.[6] Congress may not be permitted to tax *A* for the

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[1] Surrey, *Assignments of Income and Related Devices: Choice of the Taxable Person* (1933) 33 COL. L. REV. 791. This article was written in connection with a research project on the subject conducted by Professors Robert M. Haig and Roswell Magill of Columbia University.

[2] Burnet v. Wells, 289 U. S. —, 53 Sup. Ct. 761, 763 (1933).

[3] Bullen v. Wisconsin, 240 U. S. 625, 36 Sup. Ct. 473 (1916); Saltonstall v. Saltonstall, 276 U. S. 260, 48 Sup. Ct. 225 (1928); Chase National Bank v. United States, 278 U. S. 327, 49 Sup. Ct. 126 (1929); Reinecke v. Northern Trust Co., 278 U. S. 339, 49 Sup. Ct. 123 (1929); Corliss v. Bowers, 281 U. S. 376, 50 Sup. Ct. 336 (1930); Tyler v. United States, 281 U. S. 497, 50 Sup. Ct. 356 (1930); see Note (1931) 29 MICH. L. REV. 796; (1928) 41 HARV. L. REV. 916.

[4] REVENUE ACT OF 1924, 43 Stat. 253, 313, c. 234, §§319, 320, 26 U. S. C., §§1131, 1132, "where the grantor of a trust has, at any time during the taxable year, either alone or in conjunction with any person not a beneficiary of the trust, the power to revest in himself title to any part of the corpus of the trust, then the income of such part of the trust for such taxable year shall be included in computing the net income of the grantor"; Corliss v. Bowers, *supra* note 3; Reinecke v. Smith, 288 U. S. 596, 53 Sup. Ct. 570 (1933); Burnet v. Guggenheim, 288 U. S. 280, 53 Sup. Ct. 369 (1933); Note (1933) 7 ST. JOHN'S L. REV. 357; see (1930) 28 MICH. L. REV. 778.

[5] *Supra* notes 3 and 4.

[6] UNITED STATES CONSTITUTION, AMENDMENTS, Art. V: "No person shall * * * be deprived of life, liberty, or property without due process of law; nor shall private property be taken for public use without just compensation"; Pacific Telephone & Telegraph Co. v. State Board of Equalization, 259 Pac. 42 (1927); Southern California Telephone Co. v. State, etc., 201 Cal. 474, 259 Pac. 47 (1927). These cases are authority for the proposition that, where a tax statute conflicts with a constitutional provision, the Constitution must prevail.

property of *B*, or to impose a tax upon *C* for the income of *D*.[7] So, also, if a man creates an irrevocable trust, giving all the benefits and powers of control to another, it is considered an executed gift, the income of which cannot be taxed to the settlor.[8]

In a recent case decided by the Supreme Court of the United States,[9] the taxpayer created five similar trusts. All five were irrevocable. In the first, he assigned $100,000 worth of securities to the Minneapolis Trust Co. The income from the securities was to be used to pay the annual premiums upon a policy of insurance for $100,000 on the life of the settlor. The excess income, if any, was to be accumulated until an amount sufficient to pay an additional annual premium had been reserved. Additional income was to be paid to a daughter, if the trustee so desired. After the grantor's death, the trustee was to collect the policy and with the entire proceeds was to buy securities belonging to the "Wells estate" at their appraised value. These securities were to be held in trust for the daughter. Upon her death, the trust was to end and be divided as she might appoint in her will, in the event of a failure of appointment or issue, to Wells' sons. The court. Mr. Justice Cardozo writing the opinion, reversed the decision of the lower court and held the income of the insurance trust taxable to the settlor. The section of the Internal Revenue Act under which the Commissioner brought this action [10] was held to be constitutional and not an arbitrary taking of property in violation of the Fifth Amendment.[11] With this conclusion the writer respectfully disagrees.

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[7] Henier v. Donan, 285 U. S. 312, 326. 52 Sup. Ct. 358, 361 (1932): "This proposition is also true of cases arising under the due process clause of the Fourteenth Amendment which is similar to that of the Fifth Amendment. Hoeper v. Tax Commission of Wisconsin, 284 U. S. 206, 215, 52 Sup. Ct. 120, 122 (1931). We have no doubt that, because of the fundamental conceptions which underlie our system, any attempt by a state to measure the tax on one person's property or income of another is contrary to due process of law as guaranteed by the Fourteenth Amendment. That which is not in fact the taxpayer's income cannot be made such by calling it income."

[8] *Ibid.;* KLEIN, FEDERAL INCOME TAXATION (1930) 1142; see also *In re* Ponzi, 6 F. (2d) 324 (1925); Schoenheit v. Lucas, 44 F. (2d) 476 (1930); Ferguson v. Com'r, 59 F. (2d) 891 (1932).

[9] Burnet v. Wells, *supra* note 2.

[10] REVENUE ACT OF 1924, 42 STAT. 253, 26 U. S. CODE §960 (26 U. S. C. A. §960 n.), "Where any part of the income of a trust is or may be applied to the payment of premiums upon policies of insurance on the life of the grantor (except policies irrevocably payable for the purposes and in the manner specified in paragraph (10) of subdivision (a) of sections 214, 955 (the exception having relation to trusts for charities), such part of the income of the trust shall be included in computing the net income of the grantor." This section was incorporated in the Revenue Act of 1926.

[11] *Supra* note 6.

Mr. Justice Cardozo in his opinion states:[12]

> "One who takes out a policy on his own life, after application in his own name accepted by the company, becomes in so doing a party to a contract, though the benefits of the insurance are to accrue to someone else."

If the benefits accrue to another and the entire power of control and dominion over the trust corpus is divorced from the settlor, the trust being irrevocable, what is left on which to tax him? Although it is true that the settlor may sue the Minneapolis Trust Company, the trustee, if it were to refuse to apply the income to the preservation of the insurance, and hold it to its duty, this does not vest in him any interest which may be taxable.[13] Wells could not end his interests in the policies through non-payment of the premiums or stamp out the contract.[14] As far as he was concerned, this was an executed gift in which his interest ceased to exist.

Mr. Justice Cardozo again states:[15]

> "Income permanently applied by the act of the taxpayer to the maintenance of contracts of insurance made in his name for the support of his dependents is income used for his benefit in such a sense and to such a degree that there is nothing arbitrary or tyrannical in taxing it as his."

Life insurance today has become a common practice. Practically every family head in the United States has a policy of insurance on his life. Up to the present time, however, it has not been made compulsory by law. The only benefit derived by the policy-holder is the personal satisfaction from the fact that his dependents will be taken care of after his death. It is not analogous to the case cited by the Court,[16] wherein the settlor created a trust, to give insurance proceeds to creditors. In the latter case the settlor is actually benefited by having his indebtedness reduced. The courts in such a case should uphold a tax upon the settlor because the income from the trust accrues to his benefit by reducing his legal obligations.[17] The other

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[12] Burnet v. Wells, *supra* note 2, 53 Sup. Ct. at 764; see Mutual Life Insurance Co. v. Hurin Packing Co., 263 U. S. 167, 44 Sup. Ct. 90 (1923).

[13] Burnet v. Wells, *supra* note 2, 53 Sup. Ct. at 764 and cases cited therein; see *supra* note 1, at 791.

[14] The trust being expressly declared irrevocable by the settlor, his power in its administration was lost.

[15] Burnet v. Wells, *supra* note 2, 53 Sup. Ct. at 765.

[16] *Ibid.*

[17] Chase National Bank v. United States, 278 U. S. 327, 49 Sup. Ct. 126 (1929); Wells v. Com'r, 63 F. (2d) 425 (C. C. A. 8th, 1933); Sampson v. United States, 1 Fed. Supp. 95 (D. Mass. 1932).

case cited by the Court contains a blanket trust created for the payment of all the items of the settlor's and the family budget. This is also very dissimilar to the life insurance trust in the instant case. In the former, the income, like that of the trust, in favor of creditors, is used to pay the legal obligations of the settlor.[18] This he is bound to do. In the case under discussion, however, only a moral obligation of the creator of the trust is settled. When one uses the income of a trust to pay his personal legal obligations he is indirectly receiving the benefits therefrom and should be taxed thereon.[19] Where, however, he irrevocably transfers to others both the corpus and income of a trust to pay for something which will accrue solely to the benefit of a third person, we do not see how he can be taxed upon the income without violating his constitutional rights under the Fifth Amendment.[20]

It is respectfully submitted that the trust, in the instant case, is similar to a charitable trust which has been expressly exempt from the tax.[21] Both trusts leave in the creator only a certain amount of happiness and security of mind and these do not justify a tax under the statute.

ALFRED HECKER.

THE MINNESOTA TEA CASE.—Because of the wording of the statute[1] the decision of the Board of Tax Appeals in the case of the *Minnesota Tea Company* v. *Commissioner of Internal Revenue*[2] will in our opinion be reversed.

In the *Minnesota Tea* case[3] the petitioner (Minnesota Tea Company) transferred its real estate and some miscellaneous prop-

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[18] Van Valkerburg v. Watson, 13 Johns. 480 (N. Y. 1816); Wanamaker v. Weaver, 176 N. Y. 75, 68 N. E. 135 (1903); De Brawere v. De Brawere, 203 N. Y. 460, 96 N. E. 722 (1911); Frank v. Carter, 219 N. Y. 35, 113 N. E. 549 (1916); Laumeier v. Laumeier, 237 N. Y. 357, 143 N. E. 219 (1924).

[19] *Supra* note 17.

[20] *Supra* note 6.

[21] *Supra* note 10, §§214, 955, par. 10, subd. a.

[1] REV. ACT 1928 §112 (i) (1): "As used in this Section and in Sections 113 and 115 * * * the term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferror or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected."

[2] 18 B. T. A. — (June, 1933).

[3] *Ibid.*