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What Interests May a Transferor Retain in Transferred Property Without Liability for the Federal Estate Tax?

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attitude is visible in the decision of the Baldwin case, for there is nothing inherent in the power of double taxation which renders it liable to the indictment of taking property without due process of law, as the Supreme Court itself maintained for many years, and the fact that bond owners resent being taxed in two places is no reason for invoking constitutional prohibitions. The remedy should be in the hands of the Legislatures, either of the several states, or of the Federal Government. It is submitted that the question of double taxation is properly the subject of social and economic considerations which should make their appeal to the Legislatures, rather than constitutional control by the courts under the Fourteenth Amendment.

V. B.

WHAT INTERESTS MAY A TRANSFEROR RETAIN IN TRANSFERRED PROPERTY WITHOUT LIABILITY FOR THE FEDERAL ESTATE TAX?—Since the days of yore people have matched their wits against revenue collectors, in attempts to avoid payment of taxes. Human nature has not changed a whit and today we find a similar situation present in the collection of estate taxes.

The purpose of the Federal Inheritance Tax laws [1] is to tax the privilege of passing property [2] and not the right to receive the property which is the *sine qua non* of the divers state inheritance tax laws.[3] The absolute transfers of property during the life of the donor fall outside the provisions of the tax since they are clearly not in

[1] The Federal Estate Tax can be traced back to 1797, when, under the Stamp Tax Act an inheritance tax was imposed. During the Civil and Spanish-American Wars similar taxes were levied, but for short periods. Our present Act is based on the Rev. Act of 1916, 39 Stat. 777 (1916), which has frequently been amended. Rev. Act of 1918, 40 Stat. 1097 (1919); Act of 1921, 42 Stat. 277 (1921); Rev. Act of 1924, 43 Stat. 303 (1924), 26 U. S. C., sec. 1092; Rev. Act of 1926, 44 Stat. 69 (1926). The present inheritance tax laws are under title III.

[2] Knowlton v. Moore, 178 U. S. 41, 20 Sup. Ct. 747 (1899). The Court stated, "It is the power to transmit, or the transmission from the dead to the living, on which such taxes are immediately rested." Edwards v. Slocum, 264 U. S. 61, 44 Sup. Ct. 239 (1924), Holmes, *J.*, "A taxable interest is not one to which some person succeeds but is an interest which ceases by reason of the death." Matter of Schmidlapp Est., 236 N. Y. 278, 140 N. E. 697 (1923), "It is a tax upon the creation of a right, not a charge upon the fruition in enjoyment or possession." Nichols v. Coolidge, 274 U. S. 531, 47 Sup. Ct. 710, 71 L. ed. 1084 (1927); see also Kroeger, Inheritance Taxation of Transfers Not Taking Place at Death (1930), 15 St. Louis L. Rev. 113, 117.

[3] The entire question of state and Federal inheritance taxes is treated in an exhaustive and scholarly series of articles by Professor Rottschaefer, *Taxation of Transfers Intended to Take Effect in Possession or Enjoyment at Grantor's Death* (1930), 14 Minn. L. Rev. 453 and 603; see also Stimson, *When Revocable Trusts Are Subject to Inheritance Taxes* (1926), 25 Mich. L. Rev. 839; Pinkerton and Millsaps, Inheritance and Estate Taxes (1926), p. 9; Gleason and Otis, Inheritance Taxes (3rd ed.), p. 4; Leaphart, *Trust to Escape Federal Income and Estate Taxes* (1930), 15 Corn. L. Rev. 587.

contemplation of death. Among the latter are included *bona fide inter vivos* gifts and transfers of property for adequate consideration.[4]

The statute carefully enumerates the items of property the transfer of which is to be taxed. Among the specified items is:

> "Any interest of which the decedent has any time made a transfer or with respect to which he has at any time created a trust, in contemplation of, or intended to take effect in possession or enjoyment at or after death, except in consideration of money or money's worth." [5]

To circumvent evasion of the tax laws by distributions in trust to members of the family, or others, certain *inter vivos* dispositions were included as taxable. These inclusions involve the transposition of such transfers from the potential field of gift taxation to that of inheritance taxation since the latter are in the nature of a testamentary disposition.[6] What, then, is to distinguish the *bona fide* trust or gift from one seemingly made to avoid the onerous tax? How much of an interest may the settlor retain in the property transferred or put in trust without subjecting his estate to a death duty?

Unfortunately, the statute does not define just what the settlor may retain. The Treasury Department has from the first applied the same interpretation to the section quoted, as given by the state courts, since its statutory language was drawn from state sources.[7] The Federal courts in attempting to solve the problem have been following an erratic course, but in the main favoring the taxpayers. By splitting up the bundle of rights transferred into its legal constituents it becomes easier to comprehend the holdings of the various courts.

It has been the settled law in state courts that where a settlor of a trust reserves for himself the income for life, the transfer is taxable.[8] Where only a part of the trust corpus is required for the life

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[4] See Note (1929), 38 Yale L. J. 659.

[5] Rev. Act of 1928, sec. 302 c.

[6] Kroeger, *supra* Note 2.

[7] Handy, Inheritance and Other Death Taxes (1929), p. 23. The first state court to contain the clause, "intended to take effect, etc.," is found in the Penna. Act of 1826. The Civil and Spanish-American Wars Acts also contained it. In 1892, it first appeared in New York Tax Legislation. The clause itself and its implications appear to have been taken from the law of remainders, the word "possession" referring to the legal, and "enjoyment" to the equitable estates. McCloy, Recent Developments Affecting Taxation of Irrevocable Trusts Under Federal Estate Tax Law, 84 N. Y. L. J., Oct. 30, 1930 at 544.

[8] Rottschaefer, *supra* Note 3 at 628; Matter of Green, 153 N. Y. 223, 47 N. E. 292 (1897); Matter of Cochrane, 117 Misc. 18, 190 N. Y. Supp. 895, *aff'd* 202 App. Div. 751, 194 N. Y. Supp. 924 (2nd Dept., 1922). On the basis that the estate tax is determined by the shifting of economic interests, McCaughn v. Girard Trust Co., 11 F. (2nd) 520 (C. C. A., 3rd, 1926); Reed v. Howbert, 8 F. (2nd) 641 (D., Colo., 1925).

income, only that part is subject to the inheritance tax.[9] Merely because the right of revocation has been retained as to the trust, does not make it taxable. This is the majority rule in state courts which base their contention on the principle that since a revocation is neither a property right nor an estate it cannot pass at death.[10] A strong minority hold otherwise on the theory that a gift cannot be absolute and revocable at the same time.[11] It is submitted that the more practical view is held by the minority.

Recently, the United States Supreme Court indicated a tendency to favor a liberal construction for the taxpayer. In Reinecke v. Northern Trust Co.,[12] no tax was declared due on the corpus of five trusts, even though the settlor reserved power, first, to reinvest the trust res; second, to require the trustee to execute proxies to his nominees; third, to execute all leases; fourth, to vote the stock held by the trustee and to alter the trust itself with the consent of the beneficiaries. The mere retention of these items were not such beneficial interests that should be taxed. However, concerning the other two trusts, the Court did tax the corpus needed to produce the income for the settlor's life. It seems that the donor retained enough beneficial or economic interest in the corpus of the five trusts to make the trusts part of his gross estate. Although it is technically true that his interest did not pass at his death, it was the event which shifted to the remaindermen certain benefits and upon that theory the tax might readily have been imposed.[13] The Reinecke case indicates that extensive powers of control and management do not make the transfer taxable.

A transfer of a house followed immediately by a renewable lease by the donees to the donor for a nominal rental was not such a transfer as to be taxable. This was the holding in Nichols v. Coolidge, though impliedly the donor could have had the lease as long as she desired.[14] The Court stated that since full title vested in the donees at once, their right to possession or enjoyment did not depend on the donor's death. To make the vesting of title in the transferee the sole

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[9] Tipps v. Bass (D. C., Texas, 1927), 21 F. (2nd) 460; *Cf.* Pol v. Miles, 268 Fed. 175 (D. C., Md., 1920); *Cf.* Hirsh v. U. S. (Ct. of Cl., 1929), 35 F. (2nd) 982 where property was held non-taxable, it being passed for donee's promise to pay either donor or his wife a stated annuity for life.

[10] See Note (1929) 38 Yale L. J. 659; also Thurber, Federal Estate Tax (1921) 52; Matter of Carnegie, 203 App. Div. 91, 196 N. Y. Supp. 502 (1st Dept., 1929); Matter of Kountze, 120 Misc. 289, 198 N. Y. Supp. 442 (1923); *In re* Miller, 236 N. Y. 290, 140 N. E. 201 (1923). On the basis of these decisions New York courts follow the majority holding of the state decisions.

[11] Matter of Bostwick, 160 N. Y. 489, 55 N. E. 208 (1899); see Note (1928), 6 N. Car. L. Rev. 198; Coolidge v. Com'r, 167 N. E. 757 (1929).

[12] Reinecke v. Northern Trust Co., 278 U. S. 339, 49 Sup. Ct. 123, 73 L. ed. 410 (1928).

[13] "It appears that the real test is not whether a technical legal transfer of title is effect, but, if in fact economic interests *shifted* at death." (1930) 18 Cal. L. Rev. 302.

[14] Nichols v. Coolidge, 274 U. S. 531, 47 Sup. Ct. 760, 71 L. ed. 1184 (1927).

criterion is conducive to tax evasion, with its concomitant loss of revenue to the government.

With these and the Supreme Court rulings as criteria, a rule has been established, that "the effect upon taxability of the donor's reservation of powers of amendment, control, or revocation depends entirely upon whether their exercise would enable him to divert to himself the economic benefits of the property. If that is permitted, the property is *includible* in the gross estate." [15]

Several months ago, the Supreme Court in a momentous decision settled a long-standing point of conflict. May v. Heiner [16] denied taxability under the Revenue Act of 1918 in a case where the donor created an irrevocable trust in 1917, the income of which was to be paid to her husband during his life and thereafter to herself. The decision stated that there was no interest retained by the donor in the property. Although her death "did obliterate" something, it was not such an interest that carried with it the postponement of possession, though it was admitted that enjoyment was postponed. This case not only flouts the intent of section 302 but practically nullifies it. As long as the donor retains an interest no matter how speculative, his death shifts some economic interests and the remaindermen are relieved of a condition that might have defeated their estate. This "shifting" is the basis of the tax and should therefore cause the property to be included in the gross estate.[17] Technical legal analysis should bow to practical and economic considerations.

This startling decision has already shown its effect on cases that followed in the Circuit Courts. McCaughn v. Carnill [18] held that a transfer, wherein the settlor reserved the income of an irrevocable trust, for life to himself, was not taxable as a transfer intended to take effect in possession or enjoyment at or after death. The transfer was said not to be testamentary in character since no reservation of revocation was made. Relying on May v. Heiner, Davis, *Ch. J.*, asserted: "There is no difference in law between retaining the entire or only part of the income from the property." [19] In the May case, it

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[15] Rottschaefer, *supra* Note 3 at 632.

[16] May v. Heiner, 281 U. S. 238 (1930), *revers'g* 32 F. (2nd) 1017 (C. C. A., 3rd, 1929). The decision might be upheld on the basis of retroactive taxation of an irrevocable trust. Frew v. Bowers, 12 F. (2nd) 625 (C. C. A., 2nd, 1926).

[17] This statement in effect is the test that Prof. Rothschaefer would apply as a means of making tax decisions more uniform. He cautions that it is not, however, a panacea for all ills since it is not easy to determine that a "shift" occurs at one time or another; *supra* Note 3; Chandler v. Kelsey, 205 U. S. 466, 27 Sup. Ct. 550 (1907): "shifting of economic benefits is the true subject of the test of taxability." In Tyler v. U. S., 281 U. S. 497 (1930), commented on in (1930) 5 St. John's L. Rev. 135, the Supreme Court shows that it still regards the test of shifting of economic benefits.

[18] McCaughn v. Carnill (C. C. A., 3rd, 1930), V U. S. Daily, Aug. 26, 1930, *aff'g* (D. C., Pa., 1929) 30 F. (2nd) 696.

[19] To the same effect see Northern Trust Co. v. Commissioner (Est. of Van Schaick) (C. C. A., 7th), June 5, 1930; also the Morsman case (C. C. A., 8th) appealed from 14 B. T. A. 103 (1928).

was pointed out, the grantee would give up his entire possession only at his death, while in the instant case, the settlor at all times retained the income. The distinction was disregarded.

Commissioner v. McCormick,[20] recently decided, gives the situation a more hopeful hue. After battling with the effects of the Heiner decision it avoids it on the basis of the rule that the intention of the settlor is decisive in ascertaining whether a trust may be taxed. The trust in this case was conditionally revocable. The settlor was to retain a life use with the possibility of a retransfer. Evans, *Ch. J.*, stated: "The irrevocable character of the trust is not the determinative influence of the controversy, but is important only as it helps illuminate the settlor's intention. So as approaching the question of irrevocability, a case can be easily conceived where a trust agreement might be defined as legally irrevocable and yet the estate thus conveyed be subject to the Federal inheritance tax."

A recent District Court case included as part of the taxable estate such property from which the decedent had retained the income for life and the power to dispose of the property by a will.[21] The Federal tax applied even though full legal ownership was not retained by the donor, since "taxation is a practical question and may be dealt with in a practical way." In this decision the May decision was not mentioned and seems correct in that enjoyment and possession clearly were postponed until death.

Also the Board of Tax Appeals has held that where in the creation of a trust there is a reservation of the power to change the beneficiaries and to vary the amounts which they are to receive, the property in trust was properly included in the estate in computing the Estate Tax since the transfer of the beneficial interests in the trust property was not complete until the death of the creator.[22] The basis of the decision is upon the principles stated in Saltonstall v. Saltonstall,[23] Chase National Bank v. United States [24] and the Reinecke case.[25] Here, the Board in feeling that there would be a shifting of economic benefits on the donor's death, correctly taxed the gross estate.

At present the situation is in a decidedly unsatisfactory state of flux. The May case, although indicating the attitude of mind of the

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[20] Commissioner v. McCormick (C. C. A., 7th, V U. S. Daily 2388), Oct. 4, 1930.

[21] Stralton *et al.* v. U. S. (D. C., Mass., 1930), V U. S. Daily, Sept. 4, 1930.

[22] Bank of N. Y. and Trust Co. v. Commissioner, V U. S. Daily, Sept. 8, 1930; this decision will no doubt be appealed from, as the amount involved justifies it.

[23] Saltonstall v. Saltonstall, 276 U. S. 260, 48 Sup. Ct. 225, 72 L. ed. 565 (1927). (Power of revocation retained, to be exercised in conjunction with trustee was sufficient basis for state inheritance tax.)

[24] Chase Nat. Bank v. U. S., 278 U. S. 327, 49 Sup. Ct. 126, 47 A. L. R. 525, 73 L. ed. 405 (1928).

[25] *Supra* Note 12.

Supreme Court, does not conclusively point out just what may be retained by the settlor or donor without being subject to an estate tax. It has resulted, first, in allowing a large degree of latitude to those desiring to utilize the trust device as a means of tax avoidance; second, in almost negativing the effect of section 302 (c).

It is submitted that if the courts become more attentive to the significant factor of the shifting of economic interests, the problem will be greatly simplified. It would at least do away with the consideration of technical property rules in the field of taxation, and make more difficult the circumvention of the taxing statutes. Congress, in order to prevent this, and to simplify the construction of another phrase in section 302 (c)—"contemplation of death," by the 1926 Revenue Act, summarily created an absolute presumption that a voluntary transfer made within two years prior to the date of death are testamentary in character and hence in contemplation of death.[26] If that were possible, certainly the taxation of property from which the transferror retained any economic interest is less revolutionary and at least not open to attack on constitutional grounds. Furthermore, increased revenue for the Government would result, together with a more equitable distribution of the burden of taxation.

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[26] Shinn, A Conclusive Presumption Against the Constitution, 8 Nat. Tax Mag. 334 (Oct., 1930).