

NOTES

FEDERAL ESTATE TAX: PRE-1936 RESERVED POWER TO AFFECT THE TIME OR MANNER OF ENJOYMENT*

THE RECENT CASE of *Lober v. United States*¹ appears finally to have resolved the much debated question of whether a power reserved to the settlor of a pre-1936 trust to affect merely the time or manner of enjoyment of the trust property is a taxable power under § 811(d) of the Internal Revenue Code.² The settlor, prior to 1936, had created an irrevocable trust for the benefit of each of his three children, pursuant to the terms of which, he, as trustee, was to pay over or accumulate the income, in his discretion, until the beneficiaries reached twenty-one years of age, after which time he was required to pay over all accumulated income.³ When the beneficiaries reached twenty-five years of age, they were to receive the principal, although the decedent reserved to himself power to pay over all or a part of the principal, in his discretion, at any time before then. Although the indentures made no provision for the contingency of death of the beneficiaries prior to termination of the trusts, the Court assumed that, in such event, the beneficial interests thereunder would vest in their respective estates under New York law.

At the death of the settlor prior to termination of the trusts, the Commissioner of Internal Revenue included the value of the trust property in his gross estate, which determination was upheld by the Court of Claims.⁴ The Supreme Court granted certiorari,⁵ and held, through Mr. Justice Black (Mr. Justice Douglas and Mr. Justice Jackson dissenting without opinion) that the decedent had retained such control over the trusts as to bring them within his gross estate under § 811(d)(2) for the purposes of the federal estate tax.

* *Lober v. United States*, 74 Sup. Ct. 98 (1953).

¹ 74 Sup. Ct. 98 (1953).

² 49 STAT. 1744 (1936), 26 U.S.C. § 811 (1946). See note 8 *infra*.

³ It would appear that when the beneficiary reached twenty-one years of age, the trustee was also obliged to pay him all current income, although the Supreme Court's statement of the case does not make this explicit.

⁴ 108 F. Supp. 731 (Ct. Cl. 1952).

⁵ 345 U.S. 969 (1953).

In 1935, the Supreme Court in *White v. Poor*⁶ created some doubt, *inter alia*, as to whether a power reserved to a settlor to terminate a trust was a power taxable to his estate upon death. The decedent had created a trust in 1919 with powers of termination reserved to the three trustees. Decedent was one of the three original trustees, but later resigned. Subsequently, the successor-trustee to the decedent also resigned, whereupon the decedent was reappointed trustee by the other two trustees, in which capacity she served until her death. The Court held that the trust property was not includible in the decedent's gross estate under § 302(d) of the Revenue Act of 1926, because the power to terminate was not reserved to the decedent by the trust instrument, but rather was conferred on the decedent solely by the other trustees under the provisions of the trust. The Court expressly declined to decide whether a *reserved* power to terminate would be taxable.⁷ As an aftermath of this decision, Congress, in 1936, amended what is now § 811(d) of the Internal Revenue Code,⁸ making taxable to the settlor's estate, upon his death, a power to "terminate," "in whatever capacity exercisable," and "without regard to when or from what source the decedent acquired such power."⁹ Since this 1936 amendment was ex-

⁶ 296 U.S. 98 (1935).

⁷ *Id.* at 101.

⁸ *Supra* note 2; formerly, § 302(d) of the Revenue Act of 1926, as amended by § 805 of the Revenue Act of 1936.

⁹ Provisions here relevant are:

"§ 811. Gross estate . . .

"(d) Revocable transfers

"(1) Transfers after June 22, 1936. To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished in contemplation of decedent's death;

"(2) Transfers on or prior to June 22, 1936. To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, 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 other person, to alter, amend, or revoke, or where the decedent relinquished any such power in contemplation of his death, except in case of a bona fide sale for an adequate and full consideration in money or money's worth. Except in the case of transfers made after June 22, 1936, no interest of the decedent of which he has made a transfer shall be included in the gross estate under paragraph (1) unless it is includible under this paragraph. . . ."

pressly applicable only to transfers made after June 22, 1936, it would appear that it was intended to be purely prospective in application. The question soon arose, however, as to whether this 1936 amendment should be applied to transfers made on or prior to June 22, 1936, upon the theory that it was merely declaratory of the pre-existing law. The Treasury has taken the position that the phrase, "in whatever capacity exercisable," is declaratory of the pre-existing law,¹⁰ but that the phrase, "without regard to when or from what source the decedent acquired such power," is not.¹¹ Finally, the Treasury has taken the position that the addition of the word "terminate" is declaratory of the law as it existed prior to 1936.¹² This was the view of the House Ways and Means Committee,¹³ and it also derives at least limited support from *Commissioner v. Holmes*.¹⁴

Although the *Holmes* opinion supported the view that pre-1936 powers to terminate were taxable, it created some confusion as to the precise scope of that amendment. In 1935 the decedent had conveyed property to himself in trust for each of his three sons, reserving to himself the power to terminate the trusts and to pay over principal and accumulated income to the beneficiaries at any time. If, prior to the termination of the trust, a beneficiary should die without issue, his share was to go pro rata to the other sons or their surviving issue, *per stirpes*; if either other son should die without issue, the survivor or his issue was to take the whole; if all the sons should die without issue, the trust property was to go to decedent's wife, if living, if not, to her heirs at law. In an opinion by Mr. Justice Rutledge the Supreme Court held that the reservation of this power to terminate was sufficient to warrant

¹⁰ U.S. Treas. Reg. 105, § 81.20(a) (1945). In *White v. Poor*, *supra* note 6, the Court had found it unnecessary to consider this point, and in *Commissioner v. Holmes*, 326 U.S. 480 (1946), notes 14 and 15 *infra* and accompanying text, it again left the question open. The Treasury position has, however, been supported by decisions in the lower federal courts. See *Welch v. Terhune*, 126 F.2d 695 (1st Cir. 1942), *cert. denied*, 317 U.S. 644 (1942); *Union Trust Co. v. Driscoll*, 138 F.2d 152 (3d Cir. 1943), *cert. denied*, 321 U.S. 764 (1943); *Commissioner v. Newbold's Estate*, 158 F.2d 694 (2d Cir. 1946); *Jurd v. Commissioner*, 160 F.2d 610 (1st Cir. 1947); *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947); *Du Charme's Estate v. Commissioner*, 164 F.2d 959 (6th Cir. 1947); *Industrial Trust Co. v. Commissioner*, 165 F.2d 142 (1st Cir. 1947).

¹¹ U.S. Treas. Reg. 105, § 81.20(a) (1945).

¹² *Ibid.*

¹³ "... Since in substance a power to terminate is the equivalent of a power to revoke, this question should be set at rest. Express provision to that effect has been made and it is believed that it is declaratory of existing law. . . ." H.R. REP. NO. 2818, 74th Cong., 2d Sess. 10 (1936).

¹⁴ 326 U.S. 480, 487 *et seq.* (1945).

inclusion of the trust property in decedent's gross estate under § 811(d)(2). The Court said:

It seems obvious that one who has the power to terminate contingencies upon which the right of enjoyment is staked, so as to make certain that a beneficiary will have it who may never come into it if the power is not exercised, has power which affects not only the time of enjoyment but also the person or persons who may enjoy the donation. More therefore is involved than mere acceleration of the time of enjoyment. The very right of enjoyment is affected, the difference dependent upon the grantor's power being between present substantial benefit and the mere prospect or possibility, even the probability, that one may have it at some uncertain future time or perhaps not at all. A donor who keeps so strong a hold over the actual and immediate enjoyment of what he puts beyond his own power to retake has not divested himself of that degree of control which § 811(d)(2) requires in order to avoid the tax.¹⁵

By emphasizing the fact that the power to terminate in this case could have been exercised so as to determine *who* should enjoy the property, Mr. Justice Rutledge inferentially left open the question whether a power to terminate which could affect only the time or manner of enjoyment is taxable under § 811(d)(2). This question was squarely presented in *Hays' Estate v. Commissioner*.¹⁶ The decedent had conveyed property to herself in trust, reserving the power to accumulate income and to terminate the trusts at her discretion and pay over the principal and accumulated income. Unlike the *Holmes* case, however, in the event of the death of a beneficiary prior to termination, the beneficial interest was to vest in the heirs of that beneficiary, so that, regardless of when the trusts should be terminated, the property would pass to the beneficiaries or their estates, respectively. The Court of Appeals for the Fifth Circuit, reversing the decision of the Tax Court,¹⁷ held that the power to reserve by decedent was not taxable, inasmuch as the exercise of the power could not have created or terminated any right of enjoyment of trust property or changed the persons who should enjoy it.

Since life itself is uncertain and every power affecting the *time* of enjoyment may affect as well the *persons* who enjoy, it would seem that a gossamer distinction was spun by the court in the *Hays* case in an effort to give effect to the statement of Mr. Justice Rutledge that

¹⁵ *Id.* at 487.

¹⁶ 181 F.2d 169 (5th Cir. 1950).

¹⁷ 12 T.C. 210 (1949).

"More therefore is involved than mere acceleration of the time of enjoyment." In the *Lober* case the Court, choosing to ignore rather than to interpret this statement, repudiated the *Hays* decision and "followed" the *Holmes* decision in taxing to the estate of the deceased settlor a power essentially identical with that reserved in the *Hays* case. Although the *Lober* case is somewhat inconsistent with the language of Mr. Justice Rutledge's opinion in the *Holmes* case, it seems to be a sound interpretation of the phrase, "possession or enjoyment."¹⁸

An interesting facet which might have been here considered, but, rather surprisingly, was not raised in the *Lober* case was the fact—that did not appear in the record—that one of the beneficiaries had reached the age of twenty-one before decedent's death.¹⁹ Arguably, the Court might have distinguished the trust for his benefit from the other two trusts and held it not taxable to the decedent's estate upon the ground that, since this beneficiary had a present right to the income from the trust, the power to terminate in this situation was not a power to affect the enjoyment of the trust property.²⁰ Since the Court did not mention that fact, however, it must be assumed that the power to terminate is taxable even where the beneficiary has the present right to income as well as a vested remainder in the principal.

A final question remains as to the possible or probable effect of the *Lober* decision on the gift tax. In *Estate of Sanford v. Commissioner*,

¹⁸ It is interesting to contrast the present construction of the Supreme Court of "possession and enjoyment" with the strained construction of some of the earlier cases. In *May v. Heiner*, 281 U.S. 238 (1930), this phrase was interpreted as meaning "title." Cf. *Shukart v. Allen*, 273 U.S. 545 (1927); *Reinecke v. Northern Trust Co.*, 278 U.S. 339 (1929); *Klein v. United States*, 283 U.S. 231 (1931). In *Helvering v. St. Louis Union Trust Co.*, 296 U.S. 39 (1935), the dissent by Mr. Justice Stone heralded the abandonment of this "title" construction, and the abandonment was finally effected in *Helvering v. Hallock*, 309 U.S. 106 (1940). The *Lober* case reaffirms the latter view of the Court, which now seems to be well established, that present economic benefit is a more appropriate standard than the vesting of title.

¹⁹ Letter of December 8, 1953, from Mr. David Stock, counsel for petitioner.

²⁰ Where the entire beneficial interest is vested in one beneficiary, it is held in England and in a few American jurisdictions that a beneficiary, *sui juris*, may terminate the trust. *Saunders v. Vautier*, 4 Beav. 115, 49 Eng. Rep. 282 (1841). The majority view in the United States is contrary, holding that the beneficiary in whom the entire beneficial interest is vested may not enforce a termination. *E.g.*, *Clafin v. Clafin*, 149 Mass. 19, 20 N.E. 454, 3 L.R.A. 370, 14 Am. St. Rep. 393 (1889). Although the beneficiary may not terminate, he may, however, transfer his interest in income and principal. *E.g.*, *De Ladson v. Crawford*, 93 Conn. 402, 106 Atl. 326 (1919). See generally, 3 SCOTT ON TRUSTS § 337.3 (1st ed. 1939).

If it is assumed that the eldest beneficiary in the *Lober* case had a present right to income, *supra* note 3, and could have alienated his right to principal and income, it would seem that the decedent had retained no power to affect the enjoyment of the trust property.

the Supreme Court held that the reservation of a power to alter beneficiaries of a trust renders the transfer incomplete for purposes of the gift tax.²¹ Mr. Justice Stone indicated in the majority opinion that the decision was influenced, in part at least, by the fact that this sort of transfer is also incomplete for purposes of the estate tax.²² The Treasury Regulations state that "[a] gift shall not be considered incomplete, however, merely because the donor reserves the power to change the manner or time of enjoyment thereof."²³ It seems reasonable to assume that this position of the Treasury was predicated on the nebulous statement of Mr. Justice Rutledge in the *Holmes* case,²⁴ that a transfer with such a power reserved was complete for purposes of the estate tax. In view of the decision in the *Lober* case that a power to accelerate the time or manner of enjoyment is taxable under the estate tax, it would seem that the Treasury, in the interest of logical consistency, should reverse its stand as to the taxability of that type of power under the gift tax.

S. PERRY KEZIAH

²¹ 308 U.S. 39 (1939). Cf. *Burnet v. Guggenheim*, 288 U.S. 280 (1933), where the Court had held earlier that the reservation of a power to revoke prevented a gift from being complete for purposes of the gift tax.

²² *Estate of Sanford v. Commissioner*, 308 U.S. 39, 45 (1939). But in *Smith v. Shaughnessy*, 318 U.S. 176 (1943), decided after the *Sanford* case, the Court held that a transfer retaining a reversionary interest was complete and taxable for purposes of the gift tax even though it had been held incomplete for purposes of the estate tax in *Helvering v. Hallock*, 309 U.S. 106 (1940). The distinction between the *Sanford* and *Shaughnessy* cases seems to be that, if the completion of the transfer is within the grantor's control, the transfer will not be taxable as a gift if it is incomplete for estate tax purposes. If, however, the completion of the transfer is not within the grantor's control, such as a reversionary interest, it may be taxable as a gift regardless of its treatment for estate tax purposes. In a *Lober* type case, since the power to terminate is within the grantor's control, it would seem that this type transfer should escape taxation as a gift under the holding of the *Sanford* case.

²³ U.S. Treas. Reg. 108, § 86.3 (1943).

²⁴ See note 15 *supra*.