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Federal Estate Taxation - Retained Powers under Internal Revenue Code of 1954, 2036(a) - United States v. Byrum, 408 U.S. 125 (1972)

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COMMENT

FEDERAL ESTATE TAXATION — RETAINED POWERS UNDER INTERNAL REVENUE CODE OF 1954, § 2036(a) — *United States v. Byrum*, 408 U.S. 125 (1972)

INTRODUCTION

A decedent's "gross estate" is determined by computing the value of all of his property, both real and personal, tangible and intangible, wherever situated at the time of his death.[1] The value of the gross estate includes the value of all of decedent's property "to the extent of [his] interest therein at his death."[2] If the decedent has retained an interest in any property which had been ostensibly transferred, his estate is thereafter required to pay taxes on that property to the extent of the decedent's retained interest.[3] Conversely, property over which the decedent had completely severed all dominion and control at least three years prior to his death cannot be included in his gross estate for tax purposes.

Because effective estate planning requires an understanding of the subtle distinctions between retention and divestment of control over transferred property, the Internal Revenue Code specifically defines those inter vivos transfers consummated by the decedent which could create a semblance of complete severance of control, but which would not, in fact, divest the decedent of sufficient powers over the transferred property to escape estate tax consequences.[4]

This comment deals with one such retained power — the reservation of a life interest, defined in section 2036 of the Internal Revenue Code of 1954.[5] Under this statutory provision,

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[1] INT. REV. CODE OF 1954, § 2031 [hereinafter cited as CODE].

[2] *Id.* § 2033.

[3] Included in the decedent's gross estate is property that had been the subject of a gratuitous, incomplete transfer during the decedent's lifetime.

[4] CODE §§ 2035-40.

[5] *Id.* § 2036 provides for transfers with retained life estates as follows:

(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 bona fide 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

the decedent's gross estate includes the value of all property, transferred by trust or otherwise,[6] under which the decedent has retained for life[7] either: (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 its income.[8]

I. THE SCOPE OF 26 U.S.C. § 2036(a)

A 1931 United States Supreme Court decision precipitated the passage of the predecessor to section 2036.[9] Since the enactment of section 811 of the 1932 Code, the courts have repeatedly attempted to define and delineate its scope. These judicial interpretations of section 811, and its successor, section 2036(a), have brought the statute into somewhat sharper focus. Nevertheless, the court decisions remain contradictory.[10] The modern estate planner is still faced with the task of ferreting out those interpretations of section 2036(a) which can be safely utilized as drafting guidelines.

Section 2036(a) is divided into two main subsections. The first attaches estate tax consequences to the donor's retention

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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.

(b) LIMITATION ON APPLICATION OF GENERAL RULE — This section shall not apply to a transfer made before March 4, 1931; nor to a transfer made after March 3, 1931, and before June 7, 1932, unless the property transferred would have been includible in the decedent's gross estate by reason of the amendatory language of the joint resolution of March 3, 1931 (46 Stat. 1516).

6 Where section 2036 is applicable, the amount included in the decedent's gross estate is the value of the entire property transferred, less only the value of any portion of the property which is not subject to the decedent's interest and which is actually being enjoyed by another person at the time of the decedent's death. Treas. Reg. § 20.2036-1(a) (1960).

7 The interest is taxable if retained for life or for any period not ascertainable without reference to decedent's death or for any period which does not in fact end before his death. For examples of the latter two situations, see Treas. Reg. § 20.2036-1(b)(i)-(ii) (1960).

8 This comment deals exclusively with subsections (1) and (2) of section 2036(a).

9 In May v. Heiner, 281 U.S. 238 (1930), the Supreme Court held that property is fully transferred for estate tax purposes even though the settlor retains the right to income for life. The Supreme Court affirmed *May v. Heiner* on March 2, 1931, indicating that the decision would not be confined to its facts. On the very next day, March 3, 1931, Congress responded to the Supreme Court decision by passing a Joint Resolution which taxed all transferred property that was subject to a life interest retained by the settlor. The President signed the Congressional Resolution into law that same day. Approximately one year later, on June 6, 1932, Congress reenacted the 1931 Resolution, although in somewhat broader form. INT. REV. CODE OF 1932, § 803(a), 47 Stat. 279. The language in that provision is identical to the language contained in § 2036(a) of the 1954 Code.

10 *See* pp. 229-30 *infra*.

of possession or enjoyment or the right to the income from the transferred property. A clear example of what would constitute a taxable interest under this section is a reservation of a life estate.[11] Similarly, a grantor who transferred property in trust, retaining a right to the income therefrom would subject his estate to taxation under section 2036(a)(1).[12] It makes no difference for estate tax purposes whether the income retained consists of rental payments,[13] stock dividends,[14] or some other type of income.[15] On the other hand, if the use of transferred property for the benefit of the grantor depends solely on the discretion of an independent trustee, the transferred property will not be subjected to estate taxation.[16] Nor would such estate tax be imposed if the grantor retained administrative powers only.[17]

The second part of section 2036(a) prohibits retention of the right to designate the persons who shall possess or enjoy the transferred property or its income.[18] The grantor who retains the power to determine whether income is to be paid to the life beneficiary or accumulated for the benefit of the remainderman clearly holds a taxable interest under this section.[19] A grantor reserving the power to terminate the trust, thereby allowing premature distribution of the principal, similarly subjects his estate to taxation under section 2036(a)(2).[20] On the other hand, if the grantor's retained power to designate is limited by an "ascertainable standard," no resulting estate tax arises.[21] Similarly, if a grantor designates himself as one of the trustees, his retained interest may escape future taxation if the court determines that the grantor's "fiduciary obligation" (as a trustee) to treat all beneficiaries with im-

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[11] Commissioner v. Church's Estate, 335 U.S. 632 (1949).

[12] Estate of Pamelia D. Holland, 47 B.T.A. 807 (1942), *modified*, 1 T.C. 564 (1943).

[13] McNichols' Estate v. Commissioner, 265 F.2d 667 (3d Cir. 1959).

[14] Varian v. Commissioner, 396 F.2d 753 (9th Cir. 1968).

[15] United States v Estate of Grace, 395 U.S. 316 (1969).

[16] Estate of Jack F. Chrysler, 44 T.C. 55 (1965), *rev'd on other grounds*, 361 F.2d 508 (2d Cir. 1966).

[17] Old Colony Trust Co. v. United States, 432 F.2d 601 (1st Cir. 1970).

[18] It makes no difference, for estate tax purposes, whether the grantor exercises this control alone or in conjunction with another person. Nor dces it matter in what capacity the power is exercisable. Treas. Reg. § 20.2036-1(b)(3) (1960).

[19] United States v. O'Malley, 383 U.S. 627 (1966); Biscoe v. United States, 148 F. Supp. 224 (D. Mass. 1957).

[20] Lober v. United States, 346 U.S. 335 (1953); Commissioner v. Holmes, 326 U.S. 480 (1946).

[21] Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947); Estate of Milton J. Budlong, 7 T.C. 756 (1946).

partiality provides a sufficient limitation on his reserved powers.[22]

These conflicting interpretative strains reach a discordant crescendo in the following hypothetical. *S*, a settlor, transfers property into an irrevocable trust. *S* retains powers which are ostensibly administrative in nature. *S* is not a trustee nor are his powers limited by an ascertainable standard, although they substantially affect the beneficial enjoyment of the transferred property. In a case where all of these factors exist, how should sections 2036(a)(1) and (2) be interpreted and applied? Such is the question that faced the United States Supreme Court in *United States v. Byrum*.[23]

II. *United States v. Byrum*

A. *The Facts*

In 1958, decedent Milliken C. Byrum created an irrevocable trust in which he placed shares of stock in three closely held corporations. The trust instrument vested the corporate trustee with broad managerial powers over the trust property, subject to certain specified controls retained by the settlor. Byrum, the settlor, reserved for himself the rights to (1) vote the shares of unlisted stock held in the trust estate; (2) veto the trustee's sale or transfer of any trust assets; (3) approve all investments; and (4) remove the trustee, appointing another corporate trustee to serve as successor.[24]

Prior to the creation of the trust, Byrum had owned at least 71 percent of the outstanding stock of each of the close corporations. After the transfer, Byrum owned 59 percent of the stock in one of the corporations and less than 50 percent in each of the other two.[25] Nevertheless, Byrum's reserved right to vote all of the unlisted stock held in trust, when combined with the voting rights he possessed over his own shareholdings, gave him continued voting control of at least

[22] Estate of Willard V. King, 37 T.C. 973 (1962).

[23] 408 U.S. 125, *petition for rehearing denied*, 409 U.S. 898 (1972).

[24] Pertinent provisions of the trust instrument are quoted in a footnote to the majority's decision. 408 U.S. at 127 n.1.

[25] The actual proportions were:

	Percentage owned by Decedent	Percentage owned by Trust	Total Percentage owned by Decedent and Trust
Byrum Lithographing Co., Inc.	59	12	71
Graphic Reality, Inc.	35	48	83
Bychrome Co.	42	46	88

71 percent of the common stock in each of the three corporations.

The Commissioner of Internal Revenue determined that the transferred stock should have been included in Byrum's gross estate under section 2036(a). The Commissioner asserted that Byrum's retained powers entitled him to "enjoyment of . . . the property"[26] and, in addition, enabled him to determine the flow of dividends so as to "designate the persons who shall . . . enjoy . . . the income."[27] The district court ruled for Byrum's executrix on the cross motions for summary judgment,[28] and the Court of Appeals affirmed its decision.[29] Certiorari was granted to review the important tax questions.

B. *The Majority Opinion*

In a 6-3 decision, the Supreme Court held that Byrum's retained powers over the trust assets did not render the trust property includible in his gross estate. The majority opinion, written by Mr. Justice Powell, is divided into two parts. The first deals with the Government's arguments under section 2036(a)(2) and the second deals with the Government's arguments under section 2036(a)(1).

1. Section 2036(a)(2)

Initially the majority argues under section 2036(a)(2) that a settlor's retention of managerial powers over the trust assets does not subject his inter vivos trust to federal estate tax.[30] The Supreme Court cites several lower court opinions which have upheld this theory,[31] and Justice Powell contends that these decisions may have been relied on in the drafting of Byrum's and of hundreds of other inter vivos trusts.[32] As a derivative of this argument, the Court adds that interpretations of the tax code with potentially far-reaching conse-

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[26] CODE § 2036(a)(1).

[27] *Id.* § 2036(a)(2).

[28] United States v. Byrum, 311 F. Supp. 892 (S.D. Ohio 1970).

[29] United States v. Byrum, 440 F.2d 949 (6th Cir. 1971).

[30] The Court cites McCormick v. Burnet, 283 U.S. 784 (1931), to support its proposition. 408 U.S. at 133. However, *McCormick* was decided before Congress had enacted the statutory predecessor to section 2036. *McCormick's* validity under section 2036 is, therefore, not conclusive. It should be noted at the outset that Byrum's retention of managerial and administrative controls over the trust estate required him to pay income tax on income from the property he had transferred into the trust. *See* CODE §§ 675(4)(A), (B).

[31] 408 U.S. at 133 n.6.

[32] Justice Powell admonishes: "The modification of this principle now sought by the Government could have a seriously adverse impact, especially upon settlors (and their estates) who happen to have been 'controlling' stockholders of a closely held corporation." *Id.* at 134-35.

quences should be left to the legislature, not to the courts.[33]

As a second basis for defeating the Government's arguments under section 2036(a)(2), the majority enters into a type of Hohfeldian analysis concerning the distinctions between the legal terms "power" and "right." The word "right," according to the majority, connotes an "ascertainable and legally enforceable power."[34] Byrum's power to utilize his majority position to vote the stock and thereby control the payment of dividends[35] was neither "ascertainable" nor "legally enforceable."[36] According to the court's analysis, it was a power but not a right.

Third, whatever power Byrum may have exercised over the directors and thereby over the flow of income to the beneficiaries was restricted by Byrum's fiduciary duty as a majority shareholder. Justice Powell argues that, as a majority shareholder, Byrum had the obligation to promote the interests of the corporation and would be subjected to a derivative action should he fail to abide by that fiduciary standard.[37]

The majority continues its argument by asserting that even though Byrum did possess voting control, it does not necessarily follow that he actually possessed the power to control dividends. Justice Powell suggests, in his fourth argument under section 2036(a)(2), that business and economic variables provide the most potent influence over the declaration of corporate dividends, not the person or persons possessed of voting control.[38]

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[33] In Justice Powell's opinion, "Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences." *Id.* at 135.

[34] *Id.* at 136.

[35] Presumably control over the directors would be tantamount to control over the payment of dividends. Under corporate law, it is the directors who alone exercise authority over the declaration of dividends. *See* 11 FLETCHER, CYCLOPEDIA CORPORATIONS § 5320 (1971). The majority has neglected to mention in support of its argument that the controlling stockholder may, in fact, lack control over dividends in the case where a dissident director refuses to follow his directions. In that event, the controlling stockholder's only recourse is to remove the recalcitrant director at the next election.

[36] The majority considers the concept of "control" too vague and indefinable to constitute an "ascertainable" power. Generally, "control" connotes the right to vote more than 50 percent of the voting shares of a corporation. However, "control" may exist in some instances where there is a right to vote far less than 50 percent of the shares, depending on factors such as the size of the corporation and the number of shareholders. Therefore, the Court concludes, the idea of "control" is too nebulous a concept to influence the ultimate determination of the case. 408 U.S. at 137-39 nn.10 & 13.

[37] *Id.* at 137-38 n.11.

[38] The Court argues that, in deciding whether or not to declare dividends, the directors must balance the expectations of the shareholders against corporate needs for retention of earnings. Justice Powell points out that

2. Section 2036(a)(1)

In the second part of its analysis, the Court opines that the trust is not subject to taxation under the other statutory provision — section 2036(a)(1). The Court bases this decision on two essential grounds. First, Justice Powell argues that the word "enjoyment" in section 2036(a)(1) refers to a present economic benefit,[39] such as an income interest or the lifetime use of transferred property. The benefits which Byrum enjoyed (his salary as an officer of the corporations and the probability of continued employment in such capacity) were neither "present economic benefits" nor assets independent of other factors and constraints.[40]

Second, the majority argues that the benefits which Byrum derived from his position as controlling stockholder were not the result of any "retained" powers.[41] Section 2036(a)(1) requires the decedent to have "made a transfer" under which he has "retained" for life the "possession or enjoyment" of "the property" transferred. Justice Powell contends that Byrum's "enjoyment" was the result of his "control." However, Byrum never transferred his "control," since the trust never owned as much as 50 percent of the stock of any of the three corporations. Therefore, according to the majority opinion, Byrum did not divest himself of the property ("control"), subject to his retention of an attribute of that property. Rather, he never lost possession of control. In the strained technical interpretation of the majority opinion, Byrum may have *maintained* control, but he did not divest himself of it and sub-

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excessive retained earnings may result in the imposition of a penalty tax. CODE §§ 531-37. Moreover, accumulated earnings which are unreasonable may subject the directors to a derivative action. 408 U.S. at 141.

Justice White's dissenting opinion explains that both of these alleged deterrents to the accumulation of income are spurious. No penalty tax is imposed until accumulated income exceeds $100,000. CODE § 535(c). In practical terms, derivative suits for nonpayment of dividends are rarely brought and almost never won, since the court may label the decision to declare dividends one of "business judgment," not subject to review. 408 U.S. at 158-59.

39 408 U.S. at 145, *citing* Commissioner v. Holmes, 326 U.S. 480 (1946). The *Holmes* decision defined "enjoyment" in the sense of the "present right to immediate enjoyment" of the beneficiaries, not in reference to the retained "enjoyment" of the settlor. Although Justice Powell cites *Holmes* as authority for his position, it is important to note that the *Holmes* case was decided in favor of the Commissioner.

40 Justice Powell contends that, because of his position as majority shareholder, Byrum's actions were restricted by (1) a fiduciary duty to the minority shareholders, and (2) the potential threat of derivative actions against him.

41 With all due respect to the majority opinion, this argument is referred to in the decision rather obliquely and presented by Justice Powell in a somewhat cryptic manner. 408 U.S. at 148-49.

sequently *retain* it.[42]

C. *A Critique of the Court's Analysis*

Although the majority's opinion articulates several compelling arguments against the Government's position,[43] it fails to grapple with the reality and the substance of Byrum's estate planning scheme. Byrum did not "absolutely, unequivocally, and irrevocably"[44] divest himself of all interest in the trust. Not only did he retain the right to vote the stock in trust, but he also retained the right to veto any sale or transfer of the trust assets. These two powers, when combined, gave Byrum control over his own salary, stock dividends, corporate decisions, and other matters vitally affecting the value of the stock in the hands of the beneficiaries. By constricting the sale or transfer of the stock out of trust, Byrum was free to chart the course of each corporation's development and to control

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42 Transfers are not taxed under section 2036 unless the decedent acquired his life interest by *retaining* it in connection with his inter vivos transfer of the the property. For example, suppose *S* transferred property to *T* in trust, instructing *T* either to pay the income to *B* or to accumulate it during *S*'s life. If *T* resigned as trustee and *S* were appointed in his place, the trust property would not be taxable to *S*'s estate under section 2036 (a) (2) because, although *S possessed* the power to designate income from the trust property, he did not *retain* this power in connection with the transfer to the trust. Rather, he acquired it later by virtue of his subsequent appointment as trustee.

43 In explaining his decision, Justice Powell warned that a holding in favor of the Government would cause imminent problems in drawing the line between *Byrum* and other cases. For example, if the dissenters were victorious in this case, how would they rule in a case where the settlor transferred stock into a trust and did not retain control via the right to vote, but, by virtue of his own position as a majority shareholder in the company, he, in fact, controlled the payment of dividends to the shares in trust?

To Justice Powell, this hypothetical trust should not be taxable. To the dissenters, however, such a trust might be subject to estate taxation.

Justice Powell is appalled by the inevitable result of the latter view. Under that theory, a majority shareholder in a close corporation could never transfer any of his shares into a trust (regardless of whether or not he reserved fatal powers) without subjecting the trust to estate tax consequences. As long as the settlor remained the majority shareholder, the trust would be subject to estate taxation.

For a similar result, see Rev. Rul. 67-54, 1967-1 CUM. BULL. 269, cited by the dissent. 408 U.S. at 157 n.8.

> Where a decedent transfers nonvoting stock in trust and holds for the remainder of his life voting stock giving him control over the dividend policy of the corporation, he has retained for a period which did not in fact end before his death, the right to determine the income from the nonvoting stock. . . . Since under § 20.2036-1(b)(3) of the Estate Tax Regulations it is immaterial in what capacity a power was exercisable by the decedent, it is sufficient that the power was exercisable in the capacity of controlling stockholder. Under the facts of this case, therefore, the decedent has made a transfer with a reserved power within the meaning of § 2036(a) of the Code.

44 United States v. Byrum, 408 U.S. 125, 151 (1972) (dissenting opinion), *citing* Commissioner v. Church, 335 U.S. 632, 645 (1949).

investment decisions.[45]

The facts of the case establish that Byrum refused to relinquish any of his retained powers prior to his death. Had he done so, the trust would clearly have escaped estate tax consequences.[46] Nevertheless, Byrum remained obdurate in his retention of potentially fatal controls over the trust property.

1. Byrum's "enjoyment" of the property

A statutory analysis of section 2036(a)(1) uncovers several flaws in the majority opinion. The Estate Tax Regulations clearly state that "enjoyment" includes any "pecuniary benefit" derived from the retained rights of the settlor.[47] In the instant case, Byrum's ability to vote his own salary was a pecuniary advantage inuring to his benefit. Despite the transfer of the stock into the trust estate, Byrum did retain a present economic benefit (*e.g.*, his salary), and, as a consequence, his interest should have been subjected to estate taxation under section 2036(a)(1).[48]

In understanding why Byrum retained the "enjoyment" of the transferred stock, it is helpful to examine his powers in combination, rather than in isolation.[49] Section 2036(a) applies to all powers retained by a decedent, whether expressly reserved in the trust instrument or retained incident to the transfer.[50] The aggregation of Byrum's powers, both those expressly retained and those flowing from the shares not placed in trust, assured him control of the close corporations for his lifetime.

In several critical respects, Byrum was in essentially the same position after the transfer as he had been before it occurred.[51] He retained the right to an executive position without fear of discharge. He retained the right to fix his com-

45 Byrum's retained powers thus gave him the right to prevent any public sale of the corporate stock.

46 *See* Code § 2033 and Estate of I.H. Burney, 4 T.C. 449 (1944). *See also* Judge Aldrich's statement in Old Colony Trust Co. v. United States, 423 F.2d 601, 605 (1st Cir. 1970): "With the present settlor-trustee free to determine the standard himself, a finding of ownership control was warranted. To put it another way, the cost of holding onto the strings [until death] may prove to be a rope burn."

47 Treas. Reg. § 20.2036-1(b)(2)(1960).

48 Under Code section 2033, the decedent's gross estate includes the value of *all* his property to the extent of his *interest* in it.

49 As long as thirty years ago, the Board of Tax Appeals and the Tax Court determined that a similar trust should be subject to estate taxation "on an inclusive view of the whole arrangement." Estate of Pamelia D. Holland, 47 B.T.A. 807, 814 (1942), *modified*, 1 T.C. 564, 565 (1943).

50 McNichols' Estate v. Commissioner, 265 F.2d 667 (3d Cir. 1959).

51 The Government makes this argument in its brief to the Supreme Court. Brief for Appellant at 23.

pensation and receive liberal retirement and fringe benefits. He retained the power to determine if and when the corporation would be merged. And he retained the power to enjoy these benefits as long as he so desired. These powers, which are among the most important benefits associated with control of a closely held corporation,[52] certainly constituted "present economic benefits" and hence "enjoyment" of the trust property.[53]

2. Byrum's power to "designate"

Byrum's estate may have been taxable as well under section 2036(a)(2).[54] Byrum did not make himself a trustee. As a result, he was not bound by the fiduciary duties of a trustee to treat the life tenants and remaindermen with impartiality.[55] The fiduciary duty which Justice Powell would have imposed upon Byrum as a majority stockholder is a duty directed only to minority stockholders. The facts of the *Byrum* case reveal that, aside from the trust itself, the other minority stockholders in the three close corporations were persons unrelated to Byrum. Arguably, Byrum could have fulfilled his fiduciary obligations to these minority shareholders by withholding all dividend payments, although nonpayment of dividends clearly would have penalized the life tenants of the trust. Nevertheless, Byrum's fulfillment of his fiduciary duty to the minority

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52 *See* 1 F. O'NEAL, CLOSE CORPORATIONS § 107 (1971), describing the benefits of a controlling stock interest in a close corporation as follows:

> Unlike the typical shareholder in a publicly held corporation, who may be simply an investor or a speculator and cares nothing for the responsibilities of management, the shareholder in a close corporation is a co-owner of the business and wants the privileges and powers that go with ownership . . . . In his capacity as an officer or employee of the corporation, he looks to his salary for the principal return on his capital investment, because earnings of a close corporation, as is well known, are distributed in major part in salaries, bonuses and retirement benefits.
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> Since a shareholder's principal income may depend on retention of a position in the company and since his business and social prestige may depend in part on the retention of a major officership, naturally he is anxious to assure himself permanent employment by the corporation (preferably as one of the major officers), free from the possibility of discharge by the directors or other shareholders.

53 In order for section 2036(a)(1) to apply, it is not necessary for decedent to retain *all* rights to enjoyment of the property. A partial retention of enjoyment is sufficient to bring the trust within the statutory provision. *See* Brief for Appellant at 25.

54 A trust is taxed under section 2036(a) if it falls within the objectives of *either* section 2036(a)(1) or section 2036(a)(2). It does not need to be taxable under both statutory provisions in order to be subject to estate taxation.

55 Estate of Willard V. King, 37 T.C. 973 (1962). For the general rule of fiduciary duty imposed upon a trustee, see 3 A. SCOTT, LAW OF TRUSTS § 236.11 (3d ed. 1967).

shareholders would not have necessitated an awareness of the particular needs of the life tenants of the trust.[56] Therefore, the fiduciary duty to which the court found Byrum bound was not adequate to meet the requisite standard of impartiality. Because court enforcement of Byrum's alleged fiduciary duty to minority shareholders did not have a bearing on his relationship to the beneficiaries of the trust, Byrum's powers were not within sufficient court control to escape taxation under section 2036(a)(2).[57]

Byrum's broad retention of powers left him with "something more than a memory."[58] In fact, the trustee's basic determination of whether or not to distribute dividend income was completely dependent upon Byrum's prior decision — whether or not to award the payment of dividends. Even though the declaration of dividends is theoretically the function of all the directors,[59] in practice, Byrum had the power to control the directors' decision.[60]

Once the directorate had determined if, when, and how many dividend payments to make, its determination was insulated from judicial review by the court's allowance of discretionary "business judgments."[61] With regard to dividend policy, a director's fiduciary obligation requires only that he act honestly and reasonably.[62] Therefore, the directors in the three closely held corporations controlled by Byrum were free to exercise their powers in favor of nonpayment of dividends. This course of action would have been fully consistent with the fiduciary obligation imposed upon them as directors. Yet, its inevitable consequence would have been to postpone beneficial enjoyment of the trust shares until after Byrum's death.[63] To

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[56] Indeed, in the proper exercise of his discretion . . . , decedent may well have determined not to declare dividends even if the current beneficiaries were in need of additional income. And, with his absolute power to veto sales of trust assets, he could have prevented the trustee from selling the stock and reinvesting the proceeds in securities that would produce a greater return.

Brief for Appellant at 20.

[57] United States v. O'Malley, 383 U.S. 627 (1966).

[58] Commissioner v. Sunnen, 333 U.S. 591, 608 (1948).

[59] 11 FLETCHER, *supra* note 35, § 5320.

[60] If a majority of the directors were not amenable to Byrum's wishes, he had the power to remove them at the very next annual election. A controlling shareholder in a close corporation can thus change the composition of his corporation's board virtually at will. In so doing, he is essentially assured that the directors will vote in accordance with his wishes. Commissioner v. Sunnen, 333 U.S. 591, 608 (1948).

[61] W. CARY, CASES AND MATERIALS ON CORPORATIONS 1587 (4th ed. 1969).

[62] G. BOGERT, TRUSTS AND TRUSTEES § 841 (2d ed. 1962).

[63] Commissioner v. Holmes, 326 U.S. 480 (1946).

that extent, Byrum's control over the directors' decision provided him with the power to "designate" within the meaning of section 2036(a)(2).[64]

Byrum's aggregation of retained rights clearly gave him the power to substantially affect the pecuniary enjoyment of the beneficiaries. Still, the trust instrument specified no ascertainable standard to guide Byrum in the exercise of his power.[65] The broad discretion vested in Byrum, both as a director and as a majority shareholder, would have inhibited a court of equity from intervening against him, except upon a showing of unreasonableness or bad faith.[66] As a result, any fiduciary obligation which might have been imposed upon Byrum would, in fact, have provided neither an ascertainable standard nor a meaningful limitation upon his reserved rights and powers.[67]

Absent an external standard, the trust should have been subject to estate taxation under section 2036(a)(2) in order to comply with the mandate of the Supreme Court's earlier decision in *United States v. O'Malley*.[68] *O'Malley* had held that the grantor's power to accumulate trust income could be deemed the power to "designate" under section 2036(a)(2), so that all of the trust principal (including portions representing accumulated income) was includible in the grantor's gross estate. Regardless of whether the *O'Malley* holding should control the outcome in *Byrum*,[69] the Court is still bound to favor substance over form by looking to the practical effects of Byrum's aggregation of powers. Because of Byrum's actual control over almost every important facet of the trust estate, his "irrevocable" transfer was, in reality, no transfer at all.

It is no solace to those who advocate the triumph of sub-

[64] It is no defense to the application of section 2036(a)(2) that Byrum's control over dividend policy was exercisable through the boards of directors of the three corporations, rather than by him individually. The statutory provision applies regardless of whether the power is exercisable "alone or in conjunction with any person." *See* Brief for Appellant at 14.

[65] The estate tax requirement of an "ascertainable standard" to limit a fiduciary's discretionary powers was clearly articulated in Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947).

[66] *See* notes 61-63 *supra*.

[67] Ithaca Trust Co. v. United States, 279 U.S. 151 (1929); Old Colony Trust Co. v. United States, 423 F.2d 601, 604 (1st Cir. 1970).

[68] 383 U.S. 627 (1966).

[69] The Government argued in its brief to the Supreme Court that Byrum's retained power to vote and thereby to increase or decrease corporate dividends enabled him to shift or defer beneficial enjoyment in a manner much like the power to "accumulate" income. The power to accumulate was held clearly taxable under section 2036 in United States v. O'Malley, 383 U.S. 627, 631 (1966). Therefore, the Government argued that *O'Malley* was determinative of *Byrum*. Brief for Appellant at 5.

stance over form[70] that Justice Powell would prefer decisions with "far-reaching" tax consequences to be handled by the legislature rather than the courts.[71] This separation of powers concept, although valid in theory, should not permit the Supreme Court to escape its duty to interpret the existing statute in harmony with its express provisions and implied purposes.[72] A restrictive reading of section 2036(a), grounded on the fear of expanding its tax consequences, may indeed precipitate a further and more "far-reaching" effect by creating an unintended tax loophole.[73]

C. *The Dissenting Opinion*

The dissenting opinion presents a persuasive argument in rebuttal to the majority's "reliance" theory.[74] Mr. Justice White examines the state of the case law at the time that Byrum's trust was created and concludes that Byrum could not have rationally relied on legal precedent when he created his trust, nor could he have reasonably assumed that his retained powers over the trust property would have enabled it to escape future estate taxation.[75]

The dissent's flaw is the overextension of its logic. It need not have gone as far as it did in deeming *O'Malley* controlling.[76] The case before the *Byrum* Court presented a situation in which the settlor maintained actual control over property ostensibly divested. It was the *aggregation of powers* over stock in a closely held corporation which should have subjected Byrum's trust to estate taxation.[77] If Byrum had retained only one of the enumerated powers,[78] the case might have been correctly decided in his favor. Similarly, in a case where the settlor remained a majority shareholder in a closely held corporation, even after he had transferred some of his shares into an

[70] United States v. Estate of Grace, 395 U.S. 316, 321 (1969); Commissioner v. Church, 335 U.S. 632, 643-46 (1949); Helvering v. Hallock, 309 U.S. 106, 114, 116-18 (1940).

[71] 408 U.S. at 135.

[72] The legislative history of section 2036 reveals that the clear intent of Congress was to tax those trusts which had formerly avoided estate taxation despite the settlor's retention of a life interest. *See* 74 CONG. REC. 7198 (1931) (remarks of Congressman Hawley).

[73] 408 U.S. at 153 (dissenting opinion).

[74] 408 U.S. at 162-68.

[75] The dissenters might have added that the Court was confronted only with the facts of Byrum's trust. In deciding the *Byrum* case, it was not incumbent upon the Court to speculate upon the possible reliance of other settlors.

[76] 408 U.S. at 156.

[77] *Compare* State Street Trust Co. v. United States, 263 F.2d 635 (1st Cir. 1959). Had the *State Street* case concerned retention of powers over stock in a *closely held* corporation, perhaps it would still be good law.

[78] *See* p. 230 *supra* for a list of Byrum's retained powers.

irrevocable trust without retaining the right to vote the transferred shares, the settlor's control over dividends should not subject the trust to estate tax consequences, as long as he retained no other vital controls over the trust property.[79] As distinguished from the above hypothetical situations, Byrum's trust *should* have been subject to estate taxation because of his broad retention of powers, which were tantamount to virtual control of the trust.

III. FORECAST FOR THE FUTURE

Despite the valid arguments which can be made in opposition to the majority opinion, the decision in *United States v. Byrum* has set some definable standards for drafting future trust instruments. What the holding in *Byrum* has settled is that a settlor may possess the following retained powers with estate tax impunity: (1) The right to vote transferred shares; (2) the right to veto sale or transfer of trust assets by the trustee; and, (3) the right to remove the trustee as successor. *Byrum* seems to extend the decision in *Old Colony Trust*,[80] which had held that purely administrative powers are immune from estate taxation. As a consequence of *Byrum*, even the retention of administrative powers which have a substantial effect on beneficial enjoyment will not render a trust taxable under section 2036(a).

There are, however, important tax questions remaining after the *Byrum* decision. To begin with, one may query whether powers similar, but not identical, to those held in Milliken Byrum's trust are still subject to taxation. For example, what result if the settlor transferred stock in a closely held corporation and retained the power to control *all* investment decisions? A recent Tax Court Memorandum Decision[81] has held that this type of retained power, although different from the powers retained in *Byrum*, would still not subject the trust to estate taxation. The Tax Court based its decision on the Supreme Court's holding in *Byrum*.[82] One can infer from this extension of *Byrum* that the courts may be moving toward a narrower reading of section 2036(a) and the restrictions which it imposes upon the settlor. Notably, the retained power to control trust investments is not taxable even when the settlor can direct the trustee to invest in all wasting assets, to the

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[79] The question of how this type of case should be treated is raised in note 44 *supra*.

[80] 423 F.2d 601 (1st Cir. 1970). *Old Colony* overruled State Street Trust Co. v. United States, 263 F.2d 635 (1st Cir. 1959).

[81] Estate of Arthur Chalmers, 31 CCH Tax Ct. Mem. 158 (1972).

[82] The Tax Court held that, "While the facts in the *Byrum* case may be dissimilar to the facts before this court, it is controlling here." *Id.*

distinct pecuniary detriment of the remaindermen.[83]

It is still questionable whether the Supreme Court would have decided *Byrum* differently had the settlor transferred *all* of his controlling stock into the trust estate, reserving the right to vote the shares in trust. Does this situation fall within the statutory language of section 2306(a) as interpreted by Justice Powell? Clearly the settlor would have retained the control subsequent to its transfer. He would have parted with the property (the controlling stock), and then retained a portion of it (voting control). Reading the statutory language narrowly, the situation posed here is distinguishable from that in *Byrum*, where the settlor possessed the control, in part, by virtue of his own shareholdings which were never transferred into the trust estate.[84]

It is not entirely clear from Justice Powell's opinion whether the majority of the Supreme Court in *Byrum* would have ruled against the Government in the hypothetical situation presented above. One may indeed query whether future estate tax decisions will focus on the technicalities of the statutory language, ignoring both the substantive effect of the trust instrument and the equities of the particular situation.

The salient question left unanswered is whether *Byrum* will be limited to its facts. The Court may have focused on the existence of unrelated minority shareholders in the *Byrum* case. If that particular fact were crucial to the majority's decision, then perhaps *Byrum* would, indeed, be limited to its particular fact pattern. In most closely held corporations, there are no unrelated minority shareholders. Therefore, in these situations, the fiduciary duties imposed upon Byrum as a majority shareholder would have no real significance since the possibility of a derivative action would constitute even less of a threat where all the minority shareholders were related to the settlor.

If the *Byrum* decision is confined to its unique fact pattern, the effect of the decision on future estate planning will be marginal. If, to the contrary, *Byrum* is not so limited, the net effect of the decision may invite future settlors to "divest" themselves of property without divesting themselves of concomitant power.

United States v. Byrum would appear to condone the set-

[83] *Id.*; Estate of Willard V. King, 37 T.C. 973 (1962). It is important to note, however, that in the *King* case, the securities in question "were at no time significant from the point of view of control of the particular companies involved." *Id.* at 974.

[84] 408 U.S. at 148-49.

tlor's retention of broad administrative powers, regardless of their ultimate effect upon the beneficial enjoyment of the trust property. If taken literally, *Byrum* seems to encourage the estate planning lawyer to advise his client how to part with property for estate tax purposes and still retain the vital powers over it for practical purposes. The negative fiscal consequences to the federal government resulting from a large number of such estate planning schemes could precipitate the Congressional enactment of more stringent tax legislation.[85]

CONCLUSION

Section 2036(a) of the Internal Revenue Code of 1954 was designed to tax those inter vivos transfers of property under which the transferor retained substantial powers and controls until his death. Examples of such retained controls under section 2036 are: (1) a life estate; (2) a right to income; and (3) a right to designate who shall possess or enjoy the transferred property or its income.

In *United States v. Byrum* the Supreme Court decided that a settlor's reservation of the rights to vote shares of stock in a closely held corporation and to veto the transference of such shares out of the trust estate failed to constitute a retained "interest" in property under section 2036(a). The majority decision allowed the trust to escape estate taxation, despite Byrum's broad retention of control. The Court's opinion focused on the nature of the powers retained, rather than on their substantive effect.

Under a more critical approach to the case, highlighting the substance rather than the form, Byrum's aggregation of powers should have rendered his estate liable for taxation of the trust. Nevertheless, given the holding in *Byrum,* it is now incumbent upon future estate planners to contemplate and upon future courts to articulate the extent to which controlling interests of settlors will be taxed under section 2036. If a further judicial clarification of the applicability of *Byrum* is not soon forthcoming, estate planners may be wisest to view *Byrum* as limited to its facts.

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[85] A study of legislative tax history indicates that Congress has frequently reacted to tax loopholes by enacting stricter statutory taxing provisions. As noted in note 9 *supra*, the predecessor to section 2036 was passed into law as a response to the Supreme Court decision in May v. Heiner, 281 U.S. 238 (1930).

Justice Cardozo once astutely stated that continually revised tax legislation is essential "to keep pace with the fertility of invention whereby taxpayers [contrive] to keep the larger benefits of ownership and be relieved of the attendant burdens." Burnet v. Wells, 289 U.S. 670, 676 (1933).