Michigan Law Review

Volume 33 | Issue 8

1935

# FEDERAL TAXATION OF SETTLORS OF TRUSTS

Harry B. Sutter
*Of the Chicago Bar.*

Anderson A. Owen
*Of the Chicago Bar*

Follow this and additional works at: https://repository.law.umich.edu/mlr

Part of the Taxation-Federal Estate and Gift Commons

Recommended Citation
Harry B. Sutter & Anderson A. Owen, *FEDERAL TAXATION OF SETTLORS OF TRUSTS*, 33 MICH. L. REV. 1169 (1935).
Available at: https://repository.law.umich.edu/mlr/vol33/iss8/3

This Article is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

# FEDERAL TAXATION OF SETTLORS OF TRUSTS

*Harry B. Sutter** *and Anderson A. Owen*†

IN THE Revenue Act of 1924[1] there simultaneously appeared three new provisions. By Section 219(g) the income of trusts revocable by the grantor, either alone or in conjunction with *any person not a beneficiary* of the trust, was specifically required to be taxed to the grantor as his income.[2] By Section 302(d) there was required to be included in the gross estate of a deceased grantor the value at his death of any property previously given by him in trust, where the enjoyment of such property remained subject to change through the exercise by the grantor, either alone or in conjunction with *any other person,* of the power to alter, amend or revoke. Section 319 imposed a gift tax (which remained in effect through 1924 and 1925) upon the transfer by gift of any property, directly or indirectly.

The coincident appearance of these sections in the Revenue Act of 1924 created for the practitioner a very real dilemma with respect to previously created trusts in which the grantor had retained one of the powers enumerated in Section 219(g) or 302(d). Short of submitting to the tax imposed, the alternatives open were to advise (1) a contest of the tax, (2) the revocation of the trust, if a power of revocation had been retained, or (3) the surrender of the offending power. A contest of the tax imposed led to the decision of the Supreme Court in *Corliss v. Bowers*[3] and in *Porter v. Commissioner of Internal Revenue,*[4] in which the Court upheld the validity of Sections 219(g) and 302(d), respectively, as applied to the facts of those cases. An attempt of a grantor to meet the situation in 1925 by a release of a power of revocation retained by him led to the imposition of a gift tax under Section 319. This tax was upheld by the Supreme Court in *Burnet v. Guggenheim,*[5] the Court holding that the release of the power constituted a gift of the property within the meaning of the Act.

* Of the Chicago Bar. A.B., J.D., Michigan.—*Ed.*

† Of the Chicago Bar. B.S., Chicago; LL.B., Harvard.—*Ed.*

[1] 43 Stat. 253, Act of June 2, 1924, 4:01 P.M.

[2] There also appeared Sec. 219(h), taxing to the grantor income which might be distributed or accumulated for future distribution to him or used to pay premiums on policies of insurance on his life.

[3] 281 U. S. 376, 50 Sup. Ct. 336 (1929).

[4] 288 U. S. 436, 53 Sup. Ct. 451 (1932).

[5] 288 U. S. 280, 53 Sup. Ct. 369 (1932).

By reason of the revival of the gift tax in the Revenue Act of 1932, the continuation thereof at increased rates in the Revenue Act of 1934, and the ever broadening definition of the trusts for which the grantor remains responsible in taxes, the practitioner is today confronted with the same dilemma as in 1924. This has been vividly brought home to the members of the bar and the officers of trust companies throughout the country by the action of the Supreme Court in granting writs of certiorari to review the judgments of the Circuit Courts of Appeal for the Second and First Circuits and of the Court of Appeals of the District of Columbia in *Commissioner v. City Bank Farmers' Trust Company*,[6] *White v. Poor*,[7] and *Helvering v. Helmholz*.[8] In each case the court below had held that under Section 302(d) the property of a trust which the grantor could revoke only with the consent of a substantial beneficiary of the trust, adversely interested, was not taxable as part of the grantor's estate. The Supreme Court's decision in these cases can be expected this fall, as can also its decision in another case, that of *Helvering v. St. Louis Union Trust Co. (Orthwein Estate)*,[9] in which certiorari was granted on May 20, 1935, and in which the Court may reconsider its decision in *Helvering v. Duke*.[10] The problem is further given point by Regulations 80 and Regulations 86, recently promulgated by the Treasury Department relating to estate and income taxes, respectively, under the Revenue Act of 1934.

The present provisions found in the Revenue Acts which tax to the grantor or his estate the income or property of trusts are the result of a progressive, if somewhat haphazard, enlargement.[11] Because of the ever mounting need for additional revenues, no reversal of this trend can be expected. Through administrative and judicial interpretation and by reason of legislative revision, trusts once thought immune are certain to be brought within the sweep of the statute. A comprehension of the trend and its possible constitutional limits concerns as well those who are advising on the creation of new trusts as those dealing with trusts already in existence.

The subject thus presented is one which involves almost exclusively the Revenue Acts, their history and interpretation, and the few perti-

[6] (C. C. A. 2d, 1934) 74 F. (2d) 242, cert. granted by Supreme Court.

[7] (C. C. A. 1st, 1935) 75 F. (2d) 35, cert. granted by Supreme Court.

[8] (App. D. C. 1934) 75 F. (2d) 245, cert. granted by Supreme Court.

[9] Docket 879, 2 U. S. LAW WEEK, index p. 900 (1935), reported below in (C. C. A. 8th, 1935) 75 F. (2d) 416.

[10] 290 U. S. 591, 54 Sup. Ct. 95 (1933). See infra, p. 1193.

[11] See Burnet v. Wells, 289 U. S. 670 at 675, 676, 53 Sup. Ct. 761 (1932).

nent decisions bearing on their constitutionality. The local law has little application,[12] both because the mutual rights, powers and duties of the various parties to a trust are sufficiently uniform in the several jurisdictions to permit of only one tax consequence and because the courts have repeatedly assured us that since taxes are intensely practical, both from the point of view of the government and the taxpayer, they do not depend on, and may not be defeated by, refinements of title.[13]

## CONSTITUTIONAL LIMITATIONS

So far as the answers to the questions raised depend not on the provisions of the Revenue Acts and their interpretation, but on the power of Congress to lay the taxes, little enough help can be obtained from the decisions to date. There are a number of pertinent decisions, later referred to, which sustain the burden imposed on the grantor. None of those dealing with the precise subject matter condemn it.

Since the adoption of the Sixteenth Amendment authorizing Congress to impose an income tax without apportionment, thus avoiding the holding of the Supreme Court in *Pollock v. Farmers' Loan & Trust Co.*,[14] that such a tax is tantamount to a direct tax, at least in the circumstances there considered, the only constitutional limitation upon the power of Congress to impose either income tax or estate tax in the circumstances being considered is found in the Fifth Amendment, containing the oft invoked "equal protection" and "due process" clauses. No historical research will reveal the meaning of "due process" in relation to the imposition of a tax under the circumstances here considered. The farthest the Supreme Court has gone in expounding the considerations which may lead to the condemning of such a tax are its holdings that, under given circumstances, the tax may be so wholly "arbitrary" and "capricious" as to be beyond the power of Congress. This test, after having been suggested in *Brushaber v. Union Pacific R. R.*,[15] was apparently first applied in *Nichols v. Coolidge*,[16] in which the

[12] Burk-Waggoner Oil Ass'n v. Hopkins, 269 U. S. 110, 46 Sup. Ct. 48 (1925); McCauley v. Comm. of Int. Rev., (C. C. A. 5th, 1930) 44 F. (2d) 919. *Cf.* Poe v. Seaborn, 282 U. S. 101, 51 Sup. Ct. 58 (1930); United States v. Robbins, 269 U. S. 315, 46 Sup. Ct. 148 (1925).

[13] Tyler v. United States, 281 U. S. 497 at 503, 50 Sup. Ct. 356 (1929); Burnet v. Guggenheim, 288 U. S. 280 at 283, 53 Sup. Ct. 369 (1932); Corliss v. Bowers, 281 U. S. 376, 50 Sup. Ct. 336 (1929).

[14] 157 U. S. 429, 15 Sup. Ct. 673 (1894).

[15] 240 U. S. 1 at 24, 36 Sup. Ct. 456 (1915).

[16] 274 U. S. 531, 47 Sup. Ct. 710 (1926).

Court held that Section 402(c), which extended the estate tax to gifts intended to take effect in possession or enjoyment at or after death, was invalid as applied to gifts in trust made long before the appearance of such a provision in the statute, even though the grantors had retained the income for life. The subsequently imposed burden upon a gift previously completed was held to be so "arbitrary" and "capricious" as to offend the Fifth Amendment. Following this decision, the gift tax imposed by the Revenue Act of 1924, which was approved June 2 of that year, but made effective from January 1, was held in *Blodgett v. Holden*[17] and *Untermyer v. Anderson*[18] to be invalid as applied to gifts made in 1924 but before the Act took effect.

Of course, a vague moral concept such as the quality of being wholly "arbitrary" and "capricious," which of necessity derives its content from the temper of the Court, permits of no satisfactory prognostication as to what burdens may be considered beyond the power of Congress to impose under any particular set of circumstances at any particular time. It is sufficient to say that the Supreme Court, after intimating in *Knowlton v. Moore*[19] that it would reach such a result if the case were presented, has held in *Hoeper v. Tax Commission of Wisconsin*,[20] and in *Heiner v. Donnan*,[21] that a tax may not be laid on one person by reason of another's income or property, which he either never owned or had given away. In the *Hoeper* case, the Court held that under the Fourteenth Amendment, the state of Wisconsin could not impose a graduated income tax on a husband measured in part by the income of his wife. In *Heiner v. Donnan* the Court followed its prior decisions in the *Hoeper* case and in *Schlesinger v. Wisconsin*[22] and held invalid the provision of Section 302(c) of the Revenue Act of 1926, making it an irrebuttable presumption that gifts within two years of death were made in contemplation of death. The Court held that it could not be said as a fact that all gifts within two years of death were in contemplation of that event, and that the presumption in question thus resulted in the inclusion in the grantor's estate of property no longer his, where the fact which would authorize the imposition might or might not exist.[23] Both the *Schlesinger* and

[17] 275 U. S. 142, 48 Sup. Ct. 105 (1927).
[18] 276 U. S. 440, 48 Sup. Ct. 353 (1927).
[19] 178 U. S. 41 at 77, 20 Sup. Ct. 747 (1899).
[20] 284 U. S. 206, 52 Sup. Ct. 120 (1931).
[21] 285 U. S. 312, 52 Sup. Ct. 358 (1931).
[22] 270 U. S. 230, 46 Sup. Ct. 260 (1925).
[23] In the course of the opinion, the Court stated that the restraint imposed on

*Donnan* cases fully sustain the proposition that the need to buttress the collection of a valid tax does not permit of an exaction beyond the power of Congress to lay.[24] However, note must be taken in passing that even a tax on one person by reason of the income or property of another may possibly not be so "arbitrary" or "capricious" as to be invalid. The relationship of the parties and incidental benefits flowing therefrom may be sufficient to sustain the tax. The dissenting opinion in the *Hoeper* case fully illustrates this possibility.[25]

GIFTS IN TRUSTS — POLICIES

The trust is at once an instrument for effecting *inter vivos* family settlements, in which capacity its history is both ancient and vigorous, and, under the Revenue Acts, a medium of tax avoidance. This latter aspect of the trust has so concerned Congress and the Treasury Department that it has overshadowed the trust's more ancient and, if you please, more honorable function, of which the courts once thought so highly as to shelter its growth into the "spendthrift" form. All gifts *inter vivos* reduce the grantor's estate and income taxes, regardless of the form they take, and may thus be considered as instruments of tax avoidance. The gift tax embodies this conception.[26] However, it is safe to assume that it would still be felt unwise and unjust to attach such tax consequences to *inter vivos* gifts generally as to tax such gifts out of existence.[27] And yet, under the Revenue Acts that is what is fast happening to the family settlement trust. Its very existence, beneficent as it may have heretofore been considered in securing the family against even its own improvidence, may be doomed. These considerations may go entirely to the question of policy, but it is suggested that they have some bearing on what burdens or classifications may be considered "arbitrary" or "capricious."

The same considerations apply to forcing the grantor, under the

legislation by the "due process" clauses of the Fourteenth and Fifth Amendments is the same, and that, hence, the Schlesinger and Hoeper cases involving state statutes held invalid under the Fourteenth Amendment were in point. See Heiner v. Donnan, 285 U. S. 312 at 326, 52 Sup. Ct. 358 (1931).

[24] *Cf.* Taft v. Bowers, 278 U. S. 470, 49 Sup. Ct. 199 (1928); Purity Extract & Tonic Co. v. Lynch, 226 U. S. 192, 33 Sup. Ct. 44 (1912).

[25] 284 U. S. 206 at 218, 52 Sup. Ct. 120 (1931).

[26] Bromley v. McCaughn, 280 U. S. 124, 50 Sup. Ct. 46 (1929). See Burnet v. Guggenheim, 288 U. S. 280 at 286, 53 Sup. Ct. 369 (1932).

[27] By Sections 504, 505 of the Revenue Act of 1932, an exemption from the gift tax of $50,000 and in addition the first $5,000 to any donee in any one year is provided, indicating an intention by Congress to encourage *inter vivos* gifts, at least to this extent. 47 Stat. 247.

impact of taxes, to put a trust so completely out of the control of all persons that, once created, its substantive provisions cannot thereafter be changed, no matter what the altered circumstances or necessities of the beneficiaries might demand. In *People v. Northern Trust Co.*[28] the Supreme Court of Illinois, speaking of the power of revocation retained by the grantor to himself alone with respect to the trust there in question, sought to be included in the grantor's estate and subjected to the state inheritance tax, said: "All well-skilled and far-seeing lawyers advising for the benefit of their clients usually suggest the insertion of such a clause of revocation. . . ." Powers of amendment or revocation appear in trust instruments drawn long before any tax consequence could have been anticipated. Their use antedates the Revenue Acts and is justified by substantial reasons quite independent of those acts.

On the other hand, it is obvious and admitted that so-called "revocable" trusts have been unjustifiably used to defeat the graduated income and estate taxes and to cause their burden to be unequally borne. They became devices through which men of substance continued their dominion over their property and yet evaded taxes which others, with no more substantial dominion over their property, had to pay. The distinction between a reduction of taxes by this misuse and the reduction of taxes which results whenever a taxpayer relinquishes his property and his dominion over it, whether through the medium of a gift in trust or otherwise, is clear when phrased in terms of a generalization. But the question remains, at what point does Congress and may Congress draw the line?

## THE REVENUE ACTS

A grantor's continued relation to a trust after its establishment by him may vary from the entire and unrestricted exercise of dominion over and power to beneficially enjoy the trust property and its income to a trust with which the grantor has so completely severed all relation that a third person might have created it.[29] Between these extremes lie numerous possibilities. Thus, the trust instrument may in terms provide that the income of the trust may be payable to the grantor presently or upon the happening of some event which, in turn, may or may not be within the grantor's control or the control of a stranger to the trust, or of a trustee, or a beneficiary who would otherwise enjoy

[28] 289 Ill. 475 at 481, 124 N. E. 662 (1919).

[29] Of course, in all trusts, there is a possibility of a reversion to the grantor of the trust estate upon the failure of the trust purposes.

the income, or in the joint control of the grantor and such other person, be he a stranger, trustee or beneficiary. This would include the income payable to the grantor in his discretion either acting alone or in conjunction with a stranger, trustee or beneficiary, or in the sole discretion of such stranger, trustee or beneficiary. Instead of the income being payable to the grantor, the trust instrument may perhaps provide, under such restrictions as above set out, that the income may be so used that its benefit redounds to the grantor.

Under the terms of the trust instrument, the grantor may be entitled to the corpus of the trust upon the happening of some event which may or may not be within the grantor's control or the control of a stranger to the trust, or a trustee or a beneficiary of the trust, or the joint control of the grantor and such stranger, trustee or beneficiary. This would include a power to revoke the trust and revest the trust property in the grantor, exercisable by the grantor alone or in conjunction with a stranger, a trustee or a beneficiary, or exercisable by such stranger, trustee or beneficiary acting alone. It would include cases where such power of revocation might be exercised only after preliminary notice or upon the happening of some future event not in the control of any person.

Again, the trust instrument may provide that the terms of the trust may be so amended or altered that the beneficial enjoyment of the trust property or its income may be changed by the grantor, either acting alone or in conjunction with a stranger, a trustee or a beneficiary, or by such stranger, trustee or beneficiary, acting alone. In such cases, the amendment or change permitted by the trust instrument may be one which may give the grantor a fettered or unfettered interest in or power over the trust estate or its income, may permit of a provision that the trust income or estate be used in a manner benefiting the grantor, or may entirely exclude any benefit to the grantor but permit him to designate from time to time who may enjoy the trust or its income.

The variations are almost infinite, even without considering those non-beneficial or minimum relationships to the trust and trust property with respect to which it has not even been suggested that they affect the grantor's liability to tax, such as cases where the grantor acts as trustee or retains the right to direct investment of the trust estate, to remove or appoint trustees, or even to enlarge the powers of the trustees.[30]

[30] See Reinecke v. Northern Trust Co., 278 U. S. 339 at 344, 49 Sup. Ct. 123

By Section 219(g)[81] of the Revenue Act of 1924, carried forward without change into the Revenue Act of 1926, and retained as Section 166 in the Revenue Act of 1928, the income of trusts for any taxable year if the grantor has the power, either acting alone or in conjunction with any person not a beneficiary of the trust, to revest in himself title to the trust estate, is required to be treated as the income of the grantor for such taxable year. If the power relates to only a portion of the trust estate, the section applies to the income of that portion. The companion section, Section 219(h)[82] of the 1924 Act, appearing without material change as Section 219(h) in the 1926 Act and as Section 167 in the 1928 Act, consists of two parts. The first part requires the inclusion in the income of the grantor of the income of a trust which in his discretion, alone or in conjunction with any person not a beneficiary, may[83] be distributed to the grantor or held or accumulated for future distribution to him. The second part requires the inclusion in the grantor's income of any part of the income of a trust which is or may be applied to the payment of premiums upon policies of insurance upon the life of the grantor. It may be noted that the second part of the section does not specify in whom the discretion to apply the income to insurance premiums must be vested. This omission was cured in the 1932 Act.

The only other substantial changes made in the provisions of these

(1928); Dort v. Helvering, (App. D. C. 1934) 69 F. (2d) 836 at 840, 841; G. C. M. 4208, Cumulative Bulletin VII-2, p. 142 (1928).

[81] Revenue Act of 1924, Section 219(g) [43 Stat. 277], is as follows:

"(g) 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."

[82] Revenue Act of 1924, Section 219(h) [43 Stat. 277], is as follows:

"(h) Where any part of the income of a trust may, in the discretion of the grantor of the trust, either alone or in conjunction with any person not a beneficiary of the trust, be distributed to the grantor or be held or accumulated for future distribution to him, or 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 of insurance irrevocably payable for the purposes and in the manner specified in paragraph (10) of subdivision (a) of section 214), such part of the income of the trust shall be included in computing the net income of the grantor."

[83] See Kaplan v. Comm. of Int. Rev., (C. C. A. 1st, 1933) 66 F. (2d) 401.

two sections by Sections 166[34] and 167[35] of the Revenue Act of 1932 were to extend them to apply if the power of revocation or to distribute or accumulate income, or to apply it to insurance premiums, can be exercised either (1) by the grantor alone, (2) by the grantor in conjunction with any person not having a substantial adverse interest in the disposition of the trust property or its income, as the case might be, or (3) by any person, other than one so adversely interested, acting alone.

Thus the two important changes brought about by the 1932 Act are: first, that for "beneficiary" there has been substituted one who has "a substantial adverse interest" in the trust income or property, as the person whose required consent will exclude the trusts from the operation of the sections; and, second, that the fatal powers need no longer

[34] Revenue Act of 1932, Section 166 [47 Stat. 221], is as follows:
"SEC. 166. REVOCABLE TRUSTS.

"Where at any time during the taxable year the power to revest in the grantor title to any part of the corpus of the trust is vested—

(1) in the grantor either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or

(2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom,

then the income of such part of the trust for such taxable year shall be included in computing the net income of the grantor."

[35] Revenue Act of 1932, Section 167 [47 Stat. 221], is as follows:
"SEC. 167. INCOME FOR BENEFIT OF GRANTOR.

"(a) Where any part of the income of a trust—

(1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor; or

(2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor; or

(3) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, applied to the payment of premiums upon policies of insurance on the life of the grantor (except policies of the insurance irrevocably payable for the purposes and in the manner specified in Section 23(n), relating to the so-called 'charitable contribution' deduction);

then such part of the income of the trust shall be included in computing the net income of the grantor.

"(b) As used in this section, the term 'in the discretion of the grantor' means 'in the discretion of the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of the part of the income in question.'"

reside in the grantor alone or in others in conjunction with him, but the sections apply if the powers may be exercised solely by others than the grantor if they do not have a substantial adverse interest. The effect of this latter change on powers of appointment in *inter vivos* trusts which may be exercised in the grantor's favor is apparent.

Cases involving a decision as to what constitutes a substantial adverse interest in the trust property or income, which obviously is not a rule of thumb, have yet to arise. Undoubtedly, a direct beneficial or property interest will be required. In other words, as revealed by the reports of the Congressional Committees on the 1932 Act, the purpose of the change was to narrow, not enlarge, the previous provision which excepted trusts requiring a beneficiary's consent for their revocation, etc., and in this manner to make the sections applicable even where a beneficiary's consent is required if such beneficiary has "a very minor interest."[36] The effect of the new provisions on trusts revocable with the consent of beneficiaries having remote, contingent interests, to which the prior sections were held inapplicable,[37] thus becomes subject to debate.

The provisions of Section 302(d)[38] of the Revenue Act of 1924 relating to estate taxes were carried forward without substantial change into the Revenue Act of 1926 and, as amended to meet two specific situations later discussed, are still in force.[39] The section is at once broader than the income tax provisions [Section 219(g) and 219(h)]

[36] Report of Committee on Ways and Means to accompany H. R. 10236, House Report No. 708, 72nd Cong., 1st Sess., p. 25. Report of Committee on Finance to accompany H. R. 10236, Senate Report No. 665, 72nd Cong., 1st Sess., p. 34. See the discussion in Comm. of Int. Rev. v. McCormick, (C. C. A. 7th, 1930) 43 F. (2d) 277 at 279, reversed 283 U. S. 784, 51 Sup. Ct. 343 (1930).

[37] Smith v. Comm. of Int. Rev., (C. C. A. 1st, 1932) 59 F. (2d) 56; Jones v. Comm. of Int. Rev., 27 B. T. A. 171 (1932).

[38] Revenue Act of 1924, Section 302(d), provides as follows:

"SEC. 302. The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated. . . .

"(d) To the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has at any time created a trust, 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 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 a fair consideration in money or money's worth. . . ."

[39] Title III of the Revenue Act of 1926 still remains in force and effect. The provision relating to estate taxes in the later Revenue Acts merely amended the Revenue Act of 1926.

and more succinct. It requires the inclusion in the grantor's gross estate of property transferred by him in trust during his lifetime if at his death the enjoyment [40] of such property was subject to change through the exercise by the grantor, either alone or in conjunction with *any person*, of a power to revoke, alter or amend. The section also requires the inclusion of such property if one of the enumerated powers was relinquished by the grantor in contemplation of death.

The outstanding distinctions between Section 302(d) and the income tax sections are: (1) that as now written the income tax sections apply whether or not the exercise of the prescribed power requires the joinder therein of the grantor, while Section 302(d), as a condition to its application, still requires the power to be one in which the grantor joins;[41] (2) that Section 302(d) applies, regardless of whether the trust income or property can be returned to or applied for the benefit of the grantor, which is not true of the income tax sections; and (3) that Section 302(d), by its bare language, applies even where the described powers can be exercised only with the consent of a beneficiary. "Either alone or in conjunction with *any person*" is the phrase used in Section 302(d).

In passing, it may be noted that both the income and estate tax sections apply only to the grantor's contribution to the trust or the income therefrom.[42] The correlative is likewise true that the sections reach the actual donor and may not be insulated by the interposition of some third person.[43] And, of course, they may not be defeated because their references are couched in the singular rather than the plural.[44]

Prior to the appearance in the Revenue Acts of the provisions of

[40] See Dort v. Helvering, (App. D. C. 1934) 69 F. (2d) 836 at 841, cert. denied, 288 U. S. 436, 55 Sup. Ct. 80 (1934). *Cf.* Porter v. Comm. of Int. Rev., 288 U. S. 436 at 443, 53 Sup. Ct. 451 (1932).

[41] Under the income tax sections prior to those in the 1932 Act and under Section 302(d), a power residing exclusively in one other than grantor is not sufficient to bring the trust within the sections. Comm. of Int. Rev. v. Yeiser, (C. C. A. 6th, 1935) 75 F. (2d) 956. Similarly, under Sec. 302(d), decided without discussion, see St. Louis Union Trust Co. (Orthwein Est.) v. Comm. of Int. Rev., 28 B. T. A. 107 (1933), aff'd (C. C. A. 8th, 1935) 75 F. (2d) 416, cert. granted, May 20, 1935, 2 U. S. LAW WEEK 900 (1935).

[42] In Comm. of Int. Rev. v. Strauss, decided by the Circuit Court of Appeals for the Seventh Circuit on March 30, 1935, it appeared that only a portion of the trust corpus was contributed by the decedent and there was taxed as part of decedent's gross estate only the portion of the corpus contributed by him. See, also, Fidelity & Columbia Trust Co. v. Comm. of Int. Rev., 20 B. T. A. 203 (1930).

[43] Jackson v. Comm. of Int. Rev., (C. C. A. 4th, 1933) 64 F. (2d) 359.

[44] Bromley v. Comm. of Int. Rev., (C. C. A. 3rd, 1933) 66 F. (2d) 552.

Section 219(g) and 219(h), (Sections 166 and 167 of the 1928 and later Acts) and of Section 302(d), provision was made in each Act, starting with the Revenue Act of 1916, for the taxing of trust income to the trustee, or, if distributed or currently distributable, to the beneficiary; and with respect to the estate tax, Section 402(c), later 302(c), required the property of trusts to be included in the grantor's estate if they constituted gifts in contemplation of or intended to take effect in possession and enjoyment at or after death.[45] These prior provisions still appear in the Acts and govern in all but the special situations to which the new provisions apply.

THE DECISIONS

Even under the earlier Acts, the Board of Tax Appeals and the courts had little trouble with respect to the trust which was little more than an agency for the grantor's benefit and which left him with absolute dominion over the trustee and the trust estate and with the right to beneficially enjoy the same and the income therefrom. They held that such trusts could be ignored and the trust property and income treated as remaining the grantor's in every sense.[46] These decisions are, of course, still law today.

But there being no express provision to the contrary in the earlier acts, the Bureau of Internal Revenue finally reversed its former position,[47] and ruled that the income of trusts subject to being revoked by the grantor alone, but otherwise fully operative, could not be taxed as the income of the grantor.[48] It was at this juncture that Sections 219(g), 219(h) and 302(d) appeared in the 1924 Act. Not until some time after the effective date of that Act did the courts finally settle upon their present opinion, namely, that with respect to trusts revocable by

[45] Revenue Act of 1916, approved Sept. 8, 1916, Secs. 2(b), 202(b), 39 Stat. 757, 777; Revenue Act of 1918, approved Feb. 24, 1919, Secs. 219, 402(c), 40 Stat. 1071, 1097; Revenue Act of 1921, approved Nov. 23, 1921, Secs. 219, 402(c), 42 Stat. 246, 278; Revenue Act of 1924, approved June 2, 1924, Secs. 219, 302(c), 43 Stat. 277, 304; Revenue Act of 1926, approved Feb. 26, 1926, Secs. 219, 302(c). 44 Stat, 32; Revenue Act of 1928, approved May 29, 1928, Sec. 161, 45 Stat. 838; Revenue Act of 1932, approved June 6, 1932, Sec. 161, 47 Stat. 219; Revenue Act of 1934, approved May 10, 1934, Sec. 161, 48 Stat. 727.

[46] Stoddard v. Eaton, (D. C. Conn. 1927) 22 F. (2d) 184; Boynton v. Comm. of Int. Rev., 11 B. T. A. 1352 (1928); Cleveland Trust Co. v. Comm. of Int. Rev., 24 B. T. A. 132 (1931).

[47] O. D. 621 and O. D. 676, Cumulative Bulletin 3, p. 202 (1920).

[48] L. O. 1102, Cumulative Bulletin I-2, p. 50 (1922); I. T. 1589, Cumulative Bulletin II-1, p. 51 (1923). See Warden v. Lederer, (D. C. E. D. Pa. 1927) 24 F. (2d) 233.

the grantor alone, Section 219(g) of the 1924 Act was merely declaratory of the pre-existing law.[49] And it was not until almost five years after the adoption of the 1924 Act that the Supreme Court decided *Reinecke v. Northern Trust Co.*,[50] which involved the interpretation of the Revenue Act of 1921.

In the *Reinecke* case, following its decision in *Chase National Bank v. United States*,[51] the Court held that two trusts revocable by the grantor, alone, were subject to the estate tax as constituting gifts intended to take effect in possession and enjoyment at or after death within the meaning of Section 402(c), but that five other trusts, which were revocable only with the consent of the beneficiary or a majority of the beneficiaries, were as complete dispositions of the trust property at the time of their creation as if the gifts had been absolute, because the grantor had no power except with the consent of persons adversely interested. The Court held that the five trusts did not come within the purview of Section 402(c) because to construe that section otherwise would raise grave doubts as to its constitutionality. It thus appears that the courts might ultimately have held that the income or property of a trust revocable by the grantor alone was to be treated as his, quite apart from the express provisions of Sections 219(g) and 302(d). Those sections can in no sense be considered as having been adopted either to embody or attempt to obviate the decision in *Reinecke v. Northern Trust Co.* and similar cases.

With its decisions in *Reinecke v. Northern Trust Co.*, and *Chase National Bank v. The United States*[52] before it, it is small wonder that the Supreme Court was able tersely to dispose of the attack made upon the constitutionality of Section 219(g) of the Revenue Act of 1924 in *Corliss v. Bowers*,[53] which involved a trust revocable by the grantor alone. To paraphrase the opinion in the *Corliss* case, the income which

[49] O'Donnell v. Comm. of Int. Rev., (C. C. A. 9th, 1933) 64 F. (2d) 634, cert. denied, 290 U. S. 699, 54 Sup. Ct. 208 (1933); McCauley v. Comm. of Int. Rev., (C. C. A. 5th, 1930) 44 F. (2d) 919.

[50] 278 U. S. 339, 49 Sup. Ct. 123 (1928). The judgment of the Circuit Court of Appeals for the Seventh Circuit was entered Dec. 12, 1927. 24 F. (2d) 91.

[51] 278 U. S. 327, 49 Sup. Ct. 126 (1928). The question involved was the validity of Section 402(f) of the Revenue Act of 1921, which required the proceeds of life insurance on the decedent's life to be included in his estate so as to be subject to the estate tax, as applied to the proceeds of policies taken out before such a provision appeared in the Acts but which remained subject to the decedent's control. Because of the continued, unfettered control, the tax was sustained.

[52] See also, Bullen v. Wisconsin, 240 U. S. 625, 36 Sup. Ct. 473 (1916).

[53] 281 U. S. 376, 50 Sup. Ct. 336 (1930).

is subject to a man's unfettered command, and which he is free to enjoy at his own option, may be taxed to him as his income whether he sees fit to enjoy it or not. Candor precludes any heated argument that the tax burden upheld in the *Corliss* case was either "arbitrary" or "capricious." The decision in the *Corliss* case is, of course, conclusive likewise of the validity of Section 302(d) as applied to a trust revocable by the grantor alone, a question already inferentially settled by the decision in *Reinecke v. Northern Trust Co.*

At least before it was taken, the next step did not appear as free from doubt. In *Reinecke v. Smith*,[54] the Supreme Court sustained the validity of Section 219(g) of the 1924 Act as applied to five trusts created in 1922, which the grantor could alter or revoke with the consent of either one of two trustees, one of whom was a public trust company and the other a beneficiary of the trusts. The case had several facets. It was first suggested that the section by its terms did not apply, a trustee being, for the purpose of the statute, indistinguishable from a beneficiary. Reliance was placed upon *White v. Erskine*,[55] in which the Court had held Section 302(d) of the 1924 Act inapplicable to a trust which the grantor could alter with the consent of a trustee; upon *Farmers' Loan & Trust Co. v. Bowers*,[56] which arose under the Act of 1919, and in which a trust created by Mr. Astor was held not to be within Section 402(c) although revocable with the consent of a trustee, who, the Court said, had a duty to the beneficiaries with respect to joining in the power; and upon the avowed purpose of Congress to tax only "revocable" trusts as appears from the Committee reports [57] on the 1924 Act. It was further urged that, in any event, the trust being subject to change only with the consent of an adverse interest, the gifts were complete in 1922 when the trusts were established, under the decision in *Reinecke v. Northern Trust Co.*, and to tax the trust income to the grantor to which he was not entitled under the terms of the trust indentures was to tax him on the income of another, a result condemned by the Fifth Amendment as had been held in *Hoeper v. Tax Commission* [58] and *Heiner v. Donnan*.[59] It was also urged that

[54] 289 U. S. 172, 53 Sup. Ct. 570 (1933).

[55] (C. C. A. 1st, 1931) 47 F. (2d) 1014. See below, Erskine v. White, (D. C. Mass. 1930) 43 F. (2d) 765.

[56] (C. C. A. 2d, 1928) 29 F. (2d) 14. See also, Hill v. Nichols, (D. C. Mass. 1927) 18 F. (2d) 139.

[57] Report of Ways and Means Committee, House Report 179, 68th Cong., 1st Sess.; Report of Finance Committee, Senate Report, 398, 68th Cong., 1st Sess.

[58] Supra, p. 1172.

[59] Supra, p. 1172.

as the gifts were complete in 1922, long before such trusts were taxable to the grantor, to impose a tax on him in 1924 by reason of the gifts was likewise "arbitrary" and "capricious" and invalid under the decisions in *Nichols v. Coolidge* [60] and *Blodgett v. Holden.*[61]

This last suggestion was adopted by the Circuit Court of Appeals for the Seventh Circuit, which held the tax offended the Fifth Amendment.[62] The Supreme Court, however, denied that the trustee owed any duty to the beneficiaries with respect to joining in the exercise of the power and treated the case as like one where the power could be exercised with the consent of a stranger to the trust, a person who had been selected by the grantor. The Court held that under such circumstances Congress could presume a continued control by the grantor and tax the trust income to him, thus preventing facile tax evasions. It also held that the tax had no retrospective operation. It seems clear, however, that by its decision in *Smith v. Reinecke,* the Court left open the question of the validity of the tax where it affirmatively appears that the grantor's control is gone because he is unable, for substantial reasons, to obtain the trustee's or third person's consent.[63]

The decision in *Reinecke v. Smith* must be taken to have overruled the decision of the First Circuit in *White v. Erskine,* and it may now be considered, apart from special circumstances, that both under Sections 219(g) and 219(h),[64] now Sections 166 and 167, and under Section 302(d),[65] the grantor is taxable upon the property and income of a trust which is subject to revocation or substantial change either by the grantor alone or with the consent of a trustee or, in fact, of anyone who is not a beneficiary.

As has heretofore been noted, Section 302(d) by its terms does not require for its application that the trust property be returnable to the grantor. It is enough if a change in the enjoyment of the trust property or the income therefrom may be effected. In *Porter v. Commissioner of Internal Revenue,*[66] the validity of this phase of Section

[60] Supra, p. 1171.

[61] Supra, p. 1172.

[62] Reinecke v. Smith, (C. C. A. 7th, 1932) 61 F. (2d) 324.

[63] " 'A statute may be invalid as applied to one state of facts and yet valid as applied to another.' " Quoted in Du Pont v. Comm. of Int. Rev., 289 U. S. 685 at 688, 53 Sup. Ct. 766 (1933).

[64] Bromley v. Comm. of Int. Rev., (C. C. A. 3rd, 1933) 66 F. (2d) 552.

[65] Witherbee v. Comm. of Int. Rev., (C. C. A. 2d, 1934) 70 F. (2d) 696, cert. denied 293 U. S. 582, 631, 55 Sup. Ct. 96, 138 (1934).

[66] 288 U. S. 436, 53 Sup. Ct. 451 (1933).

302(d) was upheld as applied to trusts which the grantor, acting alone, could alter or modify in any manner except that he could make no change in favor of himself or his estate. The Court repudiated the suggestion advanced in *Erskine v. White*,[67] that Section 302(a) was a limitation upon paragraph (d) of the section and required the grantor to have an "interest" in the trust property. The Court had already pointed out in *Tyler v. United States*,[68] in upholding a tax imposed under Section 402(c) of the 1921 Act upon the entire value of property held by the decedent and his spouse as tenants by the entirety, that while the various subdivisions under Section 402 (now Section 302) clearly passed beyond the bounds of a mere estate tax, they were none the less valid. The Court consequently had no trouble in upholding the tax in the *Porter* case because although the grantor could not take the property to himself, he retained substantial dominion over it until his death. In that case the grantor's death was considered as the generating source of new rights to the beneficiaries to whom the property was released by the falling in of the grantor's power at death.

It may be noted that the decision in *Reinecke v. Northern Trust Co.*, holding not taxable the five trusts revocable with the beneficiaries' consent, was referred to and distinguished in both *Reinecke v. Smith* and *Porter v. Commissioner* in terms in no way detracting from the force of that holding.

Easily the most significant decision to date with respect to the taxability, present and future, of family settlement trusts is *Burnet v. Wells*,[69] not so much for the precise question it settles as for the reasoning on which the Court proceeded to its conclusion. In that case the Court reversed the Circuit Court of Appeals for the Eighth Circuit and sustained the validity of Section 219(h) of the Revenue Acts of 1924 and 1926. The case involved the taxation to the settlor of the income of an entirely irrevocable and unalterable funded insurance trust.[70] Under the terms of the trust indenture, the income was applied to pay premiums on policies of insurance on the life of the grantor, which policies were, in turn, made irrevocably[71] payable to the trust

[67] Supra, p. 1182.

[68] 281 U. S. 497, 50 Sup. Ct. 356 (1930).

[69] 289 U. S. 670, 53 Sup. Ct. 761 (1933).

[70] There were several trusts, the income of some of which was used to pay premiums on policies which were payable to the insured. The income so applied was held taxable to the grantor by the Circuit Court of Appeals. Wells v. Comm. of Int. Rev., (C. C. A. 8th, 1933) 63 F. (2d) 425.

[71] See Wells v. Comm. of Int. Rev., (C. C. A. 8th, 1933) 63 F. (2d) 425 at 428.

and in which the grantor retained no interest. The ultimate trust estate resulting was to be held for the settlor's family. Asserting that the settlor in a practical sense continued to enjoy and reap the benefit of the income as it was from time to time applied to protect and build up an estate for his family, thereby relieving him of the necessity of discharging this natural obligation, the Court, five to four, found nothing "arbitrary" or "capricious" in the application of the tax. Carried to the full extent of its implication, this decision would sustain the power of Congress to tax to the grantor the income and property of any trust for the benefit of the grantor's family.

To date, the courts have held that neither the section taxing trust income to the beneficiary nor Section 219(h), taxing to the grantor income which may be distributable to him, requires the grantor to pay taxes on the income distributable to the members of his family, more particularly to his minor children to whom he may owe a duty of support.[72] But the statute could be reframed so as clearly to apply, and it is entirely possible that this will be done to meet those very decisions and the question of the validity of such an imposition specifically raised. *Hoeper v. Tax Commission*, which held a husband could not be taxed on the income of his wife, would seem sufficient authority for its invalidity. The element of a duty to support would exist, if significant,[73] only in the case of minor children and wives, and could perhaps be eliminated if the grantor's continued independent discharge of the duty were shown. This would, of course, require the elimination from trusts of the standard "care, education and support" clause governing the distribution of income during a beneficiary's minority.

[72] Schweitzer v. Comm. of Int. Rev., (C. C. A. 7th, 1935) 75 F. (2d) 702; Grosvenor v. Comm. of Int. Rev., 31 B. T. A. No. 117 (1934); *cf.* Savage v. Comm. of Int. Rev., 31 B. T. A. No. 129 (1934). The courts distinguished the cases of trusts to pay alimony or to discharge similar direct obligations in which a contrary result is reached. Willcuts v. Douglas, (C. C. A. 8th, 1934) 73 F. (2d) 130, cert. granted, Douglas v. Willcuts, 55 Sup. Ct. 642 (1935). See, also, as cases upholding the "constructive receipt" of income upon another's discharging the taxpayer's obligation, Old Colony Trust Co. v. Comm. of Int. Rev., 279 U. S. 716 at 729, 49 Sup. Ct. 499 (1929); United States v. Boston & Maine R. R., 279 U. S. 732 at 734, 49 Sup. Ct. 505 (1929). But see Blumenthal v. Comm. of Int. Rev., (C. C. A. 2d, 1935) 76 F. (2d) 507, in which income from previously pledged stock placed in trust, applied in satisfaction of the grantor's debt, was held not taxable to her under the circumstances.

[73] In Burnet v. Wells, 289 U. S. 670 at 682, 53 Sup. Ct. 761 (1933), the Court distinguished the Hoeper case on two grounds. The first was that in the Hoeper case the income was not derived from property formerly owned by the grantor. The second and more important was that in the Hoeper case the income was not confined in its use to discharging obligations which the taxpayer might otherwise have been called upon to meet.

*Burnet v. Wells* did not purport to overrule *Hoeper v. Tax Commission*.[74] To date, they both stand, and the *Wells* case can be considered as decisive only upon its facts. It seems destined, however, for further elucidation by the decision which the Supreme Court will render on the taxability of trusts revocable only with the consent of a beneficiary under Section 302(d) in the cases of *Commissioner v. City Bank Farmers Trust Co., White v. Poor*, and *Commissioner v. Helmholz*[75] now pending before it on certiorari, in the petitions for which the *Wells* case was urged upon the Court. Those cases involve the distinction heretofore noted between the income tax sections and the estate tax section. The latter, Section 302(d), goes beyond the former; it purports to tax to the grantor even trusts revocable only with the consent of substantial[76] beneficiaries.

The Congressional committee reports,[77] in setting out the purpose of the inclusion of Section 302(d) in the Revenue Act of 1924, state that it was intended to reach trusts in which the grantor retained a substantial control and interest, in accordance with the principle of Section 219(g) taxing to the grantor the income of revocable trusts. It may be recalled that Section 219(g) by its terms does not apply to trusts revocable with the consent of a *beneficiary*. To avoid a grave doubt as to the constitutionality of the section were it otherwise construed, the Board of Tax Appeals has since 1931[78] and the Courts[79] have consistently, with one recent exception,[80] held that the section did not

[74] See note 73, supra.

[75] Supra, p. 1170.

[76] As noted above at pp. 1177-1178, Sections 166 and 167 tax to the grantor the income of trusts in which the enumerated powers may be exercised with the consent of a beneficiary who has no *substantial* adverse interest.

[77] Report of Committee on Ways and Means, House Report No. 179, 68th Cong., 1st Sess.; Report of Finance Committee, Senate Report No. 398, 68th Cong., 1st Sess.

[78] Old Nat. Bank in Evansville v. Comm. of Int. Rev., 31 B. T. A., No. 79 (Docket No. 67681) (Oct. 23, 1934); Louis C. Raegner, Jr., v. Comm. of Int. Rev., 29 B. T. A. 1243 (1934); City Bank Farmers Trust Co., Trustee v. Comm. of Int. Rev., 29 B. T. A. 1141 (1934); Edna T. Stevens v. Comm. of Int. Rev., 29 B. T. A. 641 (1933); Lit v. Comm. of Int. Rev., 28 B. T. A. 853 (1933); Estate of Irving Lee Stone v. Comm. of Int. Rev., 26 B. T. A. 1 (1932); Colonial Trust Co. v. Comm. of Int. Rev., 22 B. T. A. 1377 (1931).

[79] Comm. of Int. Rev. v. City Bank Farmers' Trust Co., (C. C. A. 2d, 1934) 74 F. (2d) 242; Helvering v. Helmholz, (App. D. C. 1934) 75 F. (2d) 245; White v. Poor, (C. C. A. 1st, 1935) 75 F. (2d) 35; Lit v. Comm. of Int. Rev., (C. C. A. 3rd, 1934) 72 F. (2d) 551.

[80] Comm. of Int. Rev. v. Strauss, decided March 30, 1935 (C. C. A. 7th) reported at Par. 9266, Vol. III, 1935 C. C. H. Tax Service.

apply where the consent required to the exercise of the power was that of a beneficiary, the phrase "any person" notwithstanding.

In each of the cases of *Commissioner v. City Bank Farmers' Trust Co., White v. Poor,* and *Commissioner v. Helmholz,* the beneficiaries whose consent was required had a substantial interest in the trust property or income. In the first case the beneficiary was entitled to the income after the death of the grantor and in certain events to the principal of the trust; in the second he was entitled to share the income with the grantor and after her death with her other children; and in the last case he was entitled to a portion of the income for life with a power of appointment of the same portion of the trust income in the event of death. In this connection, it is to be remembered that the income tax sections require the person who must consent to be adversely interested in the specific income or the part of the trust estate which produces it, in order that the income be not taxable to the grantor. While seemingly disregarding this aspect in its later decisions, the Board of Tax Appeals in *Lit v. Commissioner of Internal Revenue,*[81] applied the same principles to a case arising under Section 302(d), holding subject to tax any portion of the trust property in which the beneficiary whose consent was required did not have an interest adverse to the exercise of the power. This case was affirmed by the Circuit Court of Appeals for the Third Circuit.[82] In the *Lit* case the beneficiary whose consent was required was the life tenant, and it was held that the value of the life estate was not, but that the value of the remainder interest was, to be included in the grantor's estate. It is to be noted, however, that in the *Lit* case a power of modification existed, giving the grantor and the life tenant the right to change the enjoyment of the remainder interests without revoking the trust. But where the sole power is that of revocation, the life tenant has a substantial interest in the trust adverse to the exercise of the power.[83] Its exercise would deprive him of his income.

Although applicable on the facts, the doctrine of the *Lit* case was not applied in the decisions under Section 302(d) which are now pending before the Supreme Court. Were that doctrine applied in those cases to make taxable the value of all interests in each trust which could

[81] 28 B. T. A. 853 (1933). See also, Strauss v. Comm. of Int. Rev., promulgated August 24, 1933 (B. T. A., not reported).

[82] (C. C. A. 3rd, 1934) 72 F. (2d) 551.

[83] Only a power of revocation existed in Strauss v. Comm. of Int. Rev. (see footnotes 80, 81, supra), but the Board of Tax Appeals held the remainder interest taxable without adverting to this fact.

be affected by the exercise of the power without injury to the interest of the beneficiary whose consent was required, the cases would squarely present the facts involved with respect to the five trusts in *Reinecke v. Northern Trust Co.*[84] In each case the question would then be, whether Congress can validly tax as part of the grantor's estate an interest of a beneficiary in a trust which the grantor could not reacquire or otherwise affect without the consent of that beneficiary, and the somewhat broader, but seemingly indistinguishable, question of whether such an interest can be taxed if it cannot be affected by the grantor without the consent of a beneficiary who has substantial rights in that interest, although not the complete rights represented thereby.

To include such an interest in the grantor's estate and to tax it at his death would seem to be clearly invalid under the decisions in *Heiner v. Donnan, Hoeper v. Tax Commission* and *Reinecke v. Northern Trust Co.*; it would require an entirely unwarranted extension of *Burnet v. Wells* which would permit a disregard of all inter-family gifts.[85] All gifts are subject to being returned to the donor by the donees, even gifts in trust.

In addition to *Burnet v. Wells*, the Government will undoubtedly rely on *Tyler v. United States* and the earlier decision in *Saltonstall v. Saltonstall*[86] as supporting the tax. In *Saltonstall v. Saltonstall* a state inheritance tax imposed on the trust property at the death of the grantor was upheld under the Fourteenth Amendment where the trust was revocable by the grantor with the consent of a trustee. Under *Reinecke v. Smith*[87] this result today would be arrived at as a matter of course, but the *Saltonstall* case long antedated the *Smith* decision. The reasoning of the former case was that by the falling in of the power at the grantor's death additional rights accrued to the beneficiaries upon which the tax could be hung, the same ground on which the *Tyler* decision was placed. But where the trust cannot be beneficially altered without the consent of the beneficiary, he derives nothing more by the falling in of the power than he had before. While this is not literally true except as to the precise interest of the particular

[84] Supra, p. 1181.

[85] The contention might properly be made that the tax, if sustained as to trusts alterable only with the consent of a beneficiary, would effect an entirely capricious distinction between such gifts and all other *inter vivos* family gifts which were not subject to tax and are now taxable at much lower rates. See Heiner v. Donnan, 285 U. S. 312, 52 Sup. Ct. 358 (1931); Schlesinger v. Wisconsin, 270 U. S. 230, 46 Sup. Ct. 260 (1925).

[86] 276 U. S. 260, 48 Sup. Ct. 225 (1928).

[87] Supra, p. 1182.

beneficiary whose consent is required, it is substantially true if the beneficiary must give up substantial rights to join in a change affecting other beneficiaries. Those other beneficiaries in a technical sense are freed of the outstanding power on the grantor's death and their rights are increased. But the intervening defect in their rights is not one of substance from the point of view of the grantor and his relation to the property. It is a termination of a right residing, in substance, in the beneficiary whose consent is required for the power's exercise. The falling in of rights in one beneficiary and the resulting increase in the rights of another, even though brought about by the death of the grantor, is not the subject of tax. An illustration is found in the case where the grantor gives an estate to another for the term of the grantor's life with gifts over to third persons on the grantor's death.[88]

Should the Supreme Court hold that the property of even a trust revocable only with the consent of the sole beneficiary or of all the beneficiaries may be taxed as part of the grantor's estate (which would follow if it held the interest of the beneficiary whose consent is called for subject to tax), then, of course, the family trust settlement is dead. The Court has repeatedly asserted that the same considerations which would sustain either the imposition of an estate tax or an income tax would sustain the imposition of the other.[89] This assertion cannot, of course, be accepted unqualifiedly; but if the Court once took the step under Section 302(d), no distinction would seem possible calling for a different conclusion under the income tax sections provided they were also enlarged to cover the case.

## CONTINGENT POWERS AS A POSSIBLE SOLUTION

There is one possible solution which may not yet be blocked. Draftsmen, influenced by the older forms, have drawn the powers retained to the grantor more broadly in most cases than the purposes of the grantor require. Instead of retaining to the grantor continuous powers and trying to meet the problem of taxation by drawing into them the consent of this or that person, the problem might be met by providing that the powers shall arise on such defined occasions as may cause the need for their exercise. It is recognized that such a solution is not satisfactory. But the same may be said of any solution now open. Thus, a power may be given in the event of a beneficiary dying or

[88] In Reinecke v. Northern Trust Co., 278 U. S. 339, 49 Sup. Ct. 123 (1929), such a situation was held not to warrant the imposition of a tax.

[89] Reinecke v. Smith, 289 U. S. 172 at 176, 53 Sup. Ct. 570 (1933); Burnet v. Guggenheim, 288 U. S. 280, 53 Sup. Ct. 369 (1933).

becoming disabled prior to the death of the grantor, or upon comparable contingencies.[90] The event must, of course, not be one within the grantor's willful control.

The results of the adoption of the suggested course of dealing with the problems are, of course, not as yet assured. The suggestion is made with the decision in *Du Pont v. Commissioner of Internal Revenue* [91] in mind. That case involved the taxability to the grantor of the income of trusts which was applicable to pay premiums on insurance on the grantor's life. The trusts were created for the term of three years with options of renewal. The Court held the income taxable under its decision in *Burnet v. Wells*,[92] and also stated that irrespective of the decision in the *Wells* case, the income in question was taxable because by reason of the short term of the trusts with the options of renewal, the grantor had not relinquished the attributes of ownership. The above suggestion is also made with a full realization that Section 166, formerly 219(g), was altered by the 1934 Act to exclude the statutory requirement that the grantor have the offending power within the taxable year. In the Congressional committee reports on the 1934 Act,[93] it was stated that the change was made to obviate those cases in

[90] It appears in Comm. of Int. Rev. v. McCormick, (C. C. A. 7th, 1930) 43 F. (2d) 277, that the trust instrument provided that if the grantor's income fell below $250,000 a year, so much trust income should be paid over to her as would bring her income up to that figure. The Supreme Court reversed the Circuit Court of Appeals and held the trust property not taxable as part of the grantor's estate under Section 402(c) of the 1921 Act. McCormick v. Comm. of Int. Rev., 283 U. S. 784, 51 Sup. Ct. 343 (1931). See also Comm. of Int. Rev. v. Yeiser, (C. C. A. 6th, 1935) 75 F. (2d) 956. But it would seem that a contingency based on the need of the grantor might be considered to give him such continuing protection as to render the income subject to tax should the statute reach it. *Cf.* Du Pont v. Comm. of Int. Rev., 289 U. S. 685 at 688, 53 Sup. Ct. 766 (1933).

[91] 289 U. S. 685, 53 Sup. Ct. 766 (1933). It may be noted that the income being applicable to premiums on insurance on the grantor's life, the statute specifically applied. Revenue Act of 1926, c. 27, sec. 219(h), 44 Stat. 34; Revenue Act of 1928, c. 852, sec. 166, 45 Stat. 840.

[92] Supra, p. 1184.

[93] Report of Committee of Conference to accompany H. R. 7835, House Report No. 1385, 73rd Cong., 2nd Sess., p. 24. See also Report of Ways and Means Committee to accompany H. R. 7835, House Report No. 704, 73rd Cong., 2nd Sess., p. 35.

In the statement of the Acting Secretary of the Treasury regarding the report of a Subcommittee of the Committee on Ways and Means relative to methods of preventing the avoidance and evasion of Internal Revenue Laws, etc. (printed for use of the Committee on Ways and Means, United States Government Printing Office, 1933, p. 18, the sixth additional recommendation of the Acting Secretary is as follows: "(6) The income from *short-term* trusts and trusts which are revocable by the creator

which the section had been held inapplicable to a trust revocable in one year only if notice of an intention to revoke were given in the preceding year, no such notice having been given.[94] As applied to the situation in the "notice" cases where the existence of the power remains always within the grantor's control, the change is, of course, valid and effective.

It has heretofore been consistently held that the intervening income was not taxable to the grantor, even though the trust property would or might upon a contingency revert to him, whether by reason of his having retained a remainder or reversionary interest in the property,[95] or by reason of a power exercisable in the future.[96] Except for intervening periods so short that the grantor does not in substance dispose of his enjoyment of the property,[97] it would seem beyond the power of Congress to tax the grantor on income during a period prior to the return of the trust property or the coming into existence of a power to revoke or modify the trust. During such intervening period the grantor has no control or enjoyment of the income or, for the time being, of the property producing it. The full weight of the history of the law of property would be against holding such an imposition valid. Life estates, terms for years and other intervening rights in property and its income are thoroughly defined as to their consequences.

The Bureau of Internal Revenue, however, in its recently promulgated Regulations 86 relating to income taxes under the 1934 Act, has gone far beyond the intent of the change in Section 166, not only in treating estates as falling within the provisions of the section which deals only with powers,[98] but in providing that if the property of the trust may at any time or in any manner find its way back to the grantor,

at the expiration of a short period after notice by him should be made taxable to the creator of the trust."

[94] Langley v. Comm. of Int. Rev., (C. C. A. 2d, 1932) 61 F. (2d) 796; Lewis v. White, (D. C. Mass. 1932) 56 F. (2d) 390, appeal dismissed, White v. Lewis, (C. C. A. 1st, 1932) 61 F. (2d) 1046. *Cf.* Clapp v. Heiner, (C. C. A. 3rd, 1931) 51 F. (2d) 224.

[95] Remainder in grantor after a term of years: United States v. First Nat. Bank, (C. C. A. 5th, 1934) 74 F. (2d) 360; Canfield v. Comm. of Int. Rev., 31 B. T. A. 724 (No. 142) (1934). Reversion after happening of a contingency: Kaplan v. Comm. of Int. Rev., (C. C. A. 1st, 1933) 66 F. (2d) 401.

[96] Power arising after a term of years: Grosvenor v. Comm. of Int. Rev., 31 B. T. A. 574 (No. 117) (1934); Handly v. Comm. of Int. Rev., 30 B. T. A. 1271 (1934). Power arising upon a contingency such as death of beneficiary: Stokes v. Comm. of Int. Rev., 28 B. T. A. 1243 (1933).

[97] Du Pont v. Comm. of Int. Rev., 289 U. S. 685 at 688, 53 Sup. Ct. 766 (1933). *Cf.* United States v. First Nat. Bank, (C. C. A. 5th, 1934) 74 F. (2d) 360.

[98] In United States v. Field, 255 U. S. 257, 41 Sup. Ct. 256 (1921), a power was held not to be an estate or interest in property within the meaning of the statute.

whether by way of a remainder or reversion or by the exercise of a future power, no matter how contingent the possibility, the intervening income is taxable to the grantor.[99] The statute itself is still open to a construction which accords with the purpose of its alteration and which removes from its scope cases in which Congress would seem not to have power to impose the tax. Section 166, as now written, provides that where at any time the power *is vested* in the grantor, etc., *then* the income is taxable to him. Until the power arises, the statute would seem not to apply, whereas it would apply if the grantor may be said to continue to have the power, although its exercise may be postponed or relinquished from year to year. Certainly the trust instrument could make it clear that the power did not arise until the required event. The provisions of the Regulations seem clearly invalid.

With respect to the effect on the tax on the grantor's estate of a future power over the trust property, it may be noted that Section 302(d) requires the power to be in existence at the date of the grantor's death.[100] In making the corresponding change in Section 302(d) as that made in Section 166, the 1934 Act specifically provided that it should apply only to the "notice" cases.[101]

But the question remains as to how far Congress could validly go in taxing to the grantor's estate the property of trusts over which the grantor might have had some future power on an event which in fact did not happen prior to the grantor's death. The question would seem a close one. Section 302(c) of the Revenue Act of 1921, applicable to gifts to take effect in possession and enjoyment at death, was held to be inapplicable to trusts where the grantor had reserved to himself the income of the trust for life, in *May v. Heiner*[102] and *Burnet v. Northern Trust Co.*[103] A special Act[104] was passed in 1931 amending Section

[99] Regulations 86, Art. 166-1 (b).

[100] Reference is made to a tax resulting from treating the *entire* value of the trust property at the grantor's death as a part of his gross estate. Under Section 302(a), the value of any vested remainder retained by the grantor in the trust property, which value will be something less than the whole value of the trust property, is taxable as part of the grantor's estate. Contingent remainders or other contingent interests, being without ascertainable value, are not included. See Regulations 80, relating to estate taxes under the Revenue Act of 1934, Art. 11. A power in the grantor coming into existence after a term of years or a life estate is, of course, contingent on the grantor's surviving. Under the principles enunciated in the Regulations, no value would be attributed to such a power, in and of itself, which would have to be included in the grantor's estate.

[101] See pp. 1190-1191, supra.

[102] 281 U. S. 238, 50 Sup. Ct. 286 (1930).

[103] 283 U. S. 782, 51 Sup. Ct. 342 (1931).

[104] Act of March 3, 1931, c. 454, 46 Stat. 1516.

302(c) to make it specifically applicable in such cases, and its validity as applied prospectively [105] cannot be doubted.[106]

The question of the application of Section 302(c) of the Act to a trust involving the reservation by the grantor of a possibility of reverter in the event the sole beneficiary, his daughter, should predecease him, she having in fact survived him, was involved in *Commissioner v. Duke*; an equally divided court affirmed without opinion the decision below that the tax did not lie.[107] Further illumination of the question can be expected by the Court's decision in *Commissioner of Internal Revenue v. St. Louis Union Trust Co. (Orthwein Est.)*,[108] involving the same question, in which, as stated above, certiorari was recently granted.

GIFT TAXES ON THE RELEASE OF POWERS

If the practitioner is concerned with the problem of altering existing trusts to avoid the effect of the decisions already rendered and the several provisions of the statute which may be considered valid, he is at once confronted by the question whether the grantor may thereby be incurring a gift tax under the Revenue Act of 1932. By Section 501(c)[109] of that Act it was specifically provided that the tax should not apply to a transfer of property in trust, where the power to *revest* in the donor *title* to such property remained in the donor, either alone or in conjunction with *any person not having a substantially adverse interest* in the disposition of such property or the income therefrom, but that the relinquishment or termination of such a power, other than by the grantor's death, should be considered to be a transfer by gift of the property subject to the same. Article 3 of Regulations 79, applicable to gift taxes, contains the substance of the statutory provisions. It may be noted that the provisions of the statute do not

[105] To avoid the question of the validity of the enactment under Nichols v. Coolidge, 274 U. S. 531, 47 Sup. Ct. 710 (1927), if applied to trusts created prior to its taking effect, the Bureau has ruled that it only applies to trusts created after 10:30 P.M., Eastern Standard time, March 3, 1931. Regulations 80, Art's. 18, 19.

[106] See Tyler v. United States, 281 U. S. 497, 50 Sup. Ct. 356 (1930); Guaranty Trust Co. v. Blodgett, 287 U. S. 509, 53 Sup. Ct. 244 (1933).

[107] In McCormick v. Burnet, 283 U. S. 784, 51 Sup. Ct. 343 (1931), reversing Comm. of Int. Rev. v. McCormick, (C. C. A. 7th, 1930) 43 F. (2d) 277, the same question was presented with the same result. But see Klein v. United States, 283 U. S. 231, 51 Sup. Ct. 398 (1930).

[108] Reported below, (C. C. A. 8th, 1935) 75 F. (2d) 416. It is to be remembered that the case also involves a power in the trustee acting alone to return the property to the grantor.

[109] Revenue Act of 1932, c. 209, sec. 501(c), 47 Stat. 245.

exclude from the operations of the tax, at the time of creation, gifts in trust which may be revoked by third persons acting alone. In contrast to this, the Regulations state that where the trust can only be revoked with the consent of one having an adverse interest acting alone, the gift in trust is taxable when made.

By Section 511 of the Revenue Act of 1934, Section 501(c) of the Revenue Act of 1932 was repealed. The Congressional Committee reports [110] state that the reason for the repeal was that the principles which were expressed in Section 501(c) are now a fundamental part of the law by virtue of the Supreme Court's decision in the *Guggenheim* case. In *Burnet v. Guggenheim*,[111] which reversed the Circuit Court of Appeals for the Second Circuit, the grantor in 1917 had created trusts reserving a power to himself, alone, to revoke the same. In 1925, after Section 319 of Title III of the Revenue Act of 1924 had become effective, the grantor released his power of revocation. By Article I of Regulations 67, promulgated November 8, 1924, relating to the gift tax under the 1924 Act, it was provided that where the grantor retained the power to revoke, the creation of the trust did not constitute a gift within the meaning of the Act, but that a taxable transfer took place in the year in which the power was terminated. The Court held that by the release of the power, a gift of the property in the trust was effected within the meaning of the Act and that the proposed tax was properly laid, notwithstanding that by its terms Section 319 imposed a tax upon the transfer of *property* by way of gift, directly or indirectly made, which the Circuit Court of Appeals for the Second Circuit thought did not embrace the relinquishment of a power.[112] As Section 501 of the Revenue Act of 1932 employs the same language, it cannot be now doubted that it applies to transfers effected by the release of powers.

There is no doubt but that the power of Congress to tax transfers by way of gifts is as broad as the power to tax testamentary dispositions,[113] but the Act of 1932, as it now stands, contains no explicit pro-

[110] Report of Finance Committee to accompany H. R. 7835, Senate Report No. 558, 73rd Cong., 2d Sess., p. 50; Report of Ways and Means Committee to accompany H. R. 7835, House Report No. 704, 73rd Cong., 2d Sess., p. 40.

[111] 288 U. S. 280, 53 Sup. Ct. 369 (1933).

[112] See United States v. Field, 255 U. S. 257, 41 Sup. Ct. 256 (1921).

[113] Bromley v. McCaughn, 280 U. S. 124, 50 Sup. Ct. 46 (1929). It may be noted, however, that while a power or a reversion arising upon the happening within the grantor's lifetime of a designated contingency may have no value at his death (see supra, n. 100), a possibility of a future reversion or power may have value during the grantor's lifetime before the possibility is terminated by his death. A different question

visions describing the character of the powers, the release of which occasions the imposition of the tax. However, the provisions of Regulations 79 still stand and are being applied by the Department. In other words, the release of any power residing in the grantor, alone, or in conjunction with any person not having a substantial adverse interest in the corpus or income of the trust property, to revest title to such trust property in the grantor, subjects the grantor to the gift tax measured by the value of the property of the trust *at the date* of the relinquishment of the power. But where the grantor, alone or in conjunction with a person not adversely interested, cannot revest title to the corpus of the trust in himself, as where he has a mere power of modification under which he may not benefit, the release of such a power has been recently ruled by the Bureau of Internal Revenue not to incur the gift tax; the Bureau holds that in such a situation, the tax is incurred at the time of the creation of the trust.[114] Of course, the release of any power requiring for its exercise the consent of one having a substantial adverse interest as defined in the Regulations does not lead to the imposition of the tax.

Guided by these principles, meager as they are, the practitioner may at this time find himself in a position where he can avoid some of the effects of the recently decided cases and those pending without incurring a gift tax penalty, if his client so desires.

is presented with respect to a gift tax upon the relinquishment of such a power or reversion during the grantor's life than upon his death. The release of a possibility of a reversion of the trust estate to the grantor in the event the life tenant predeceased him was recently ruled by the Bureau of Internal Revenue to be subject to a gift tax upon the then value of that possibility, which was held, in the particular case, to be approximately one-third of the value of the trust estate, and this notwithstanding the life tenant's expectancy was greater than that of the grantor.

[114] This ruling has not been officially promulgated, at least to date. It was obtained as an answer to a specific question put. In accordance with the present position of the Bureau of Internal Revenue as expressed in this ruling, the offending power retained by the grantor in Porter v. Comm. of Int. Rev., 288 U. S. 436, 53 Sup. Ct. 451 (1933), could be released without the grantor incurring a gift tax.