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Federal Estate Taxation -- Gross Estate -- Inclusion of Trust Assets Where Settlor Retains Control of the Corporation Whose Stock is Transferred to the Trust -- Section 2036 (a)(2) -- United State v. Byrum

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Federal Estate Taxation—Gross Estate—Inclusion of Trust Assets Where Settlor Retains Control of the Corporation Whose Stock is Transferred to the Trust—Section 2036(a)(2)—*United States v. Byrum.*[1]—In 1958 Byrum created an irrevocable inter vivos trust benefiting his children or, in the event of their death before termination of the trust, their surviving children. Under the terms of the trust, a bank was appointed sole trustee. The trustee was authorized to exercise its discretion to accumulate the trust's income or to distribute it to the beneficiaries.[2] The corpus of the trust consisted almost entirely of stock in three closely held corporations.[3] Prior to the creation of the trust Byrum had owned the majority of the outstanding shares of all three corporations. Upon creation of the trust, Byrum and the trust each owned approximately the same number of shares in two of the corporations, while Byrum retained a greater percentage of ownership in the third.[4] In contrast to the trustee's extensive authority over distribution of trust income, the trustee's authority to distribute and invest the principal was severely limited. By express language in the trust agreement Byrum retained for himself (1) the right to vote the shares of stock held in trust, (2) the right to disapprove the sale or transfer of the trust assets by the trustee, (3) the right of approval over trust investment and (4) the right to remove the trustee and designate a corporate successor.[5] Thus the trustee could not distribute the transferred stock or attempt to deal with the stock in any way without the approval of Byrum, the settlor. Byrum did not retain, however, the right to direct payment or accumulation of the trust income or the right to change the beneficiaries of the trust.

In 1964 Byrum died and subsequently the Commissioner of In-

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1 408 U.S. 125, rehearing denied, 409 U.S. 898 (1972).

2 The trustee's authority to distribute income was delineated by broad guidelines:

> Article VI. Distribution Prior To Age 21.
>
> Until my youngest living child reaches the age of twenty-one (21) years, the Trustee shall exercise absolute and sole discretion in paying or applying the income and/or principal of the trust to or for the benefit of Grantor's child or children and their issue, with due regard to their individual needs for education, care, maintenance and support and not necessarily in equal shares, per stirpes. The decision of the Trustee in the dispensing of Trust funds for such purposes shall be final and binding on all interested persons.

408 U.S. at 129.

3 Id. at 157 n.1 (dissenting opinion). The dissent noted that other than the corporate stock, the only other assets of the trust were three Series E United States Savings Bonds worth $300 total at maturity. Id.

4 Id. at 130 n.2. After the creation of the trust the ownership of the stock was distributed as follows:

Percentage of Total Stock Ownership

	Decedent	Trust	Trust & Decedent Combined
Byrum Lithographing Co., Inc.	59	12	71
Graphic Realty Inc.	35	48	83
Bychrome Co.	42	46	88

5 Id. at 127 n.1.

ternal Revenue determined that the trust was includable in Byrum's gross estate under the Internal Revenue Code of 1954, section 2036,[6] which specifically requires:

> (a) The value of 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 . . . under which he had retained for his life or for any period not ascertainable without reference to his death . . . (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 the income therefrom.[7]

More specifically, the Government argued first that Byrum's retention of the powers enumerated in the trust agreement—particularly the power to vote the transferred stock—constituted enjoyment of the transferred stock under section 2036(a)(1).[8] Secondly, the Government argued that Byrum's control over corporate dividend policy involved an apparent ability to regulate the flow of income to the trust, and that by allowing Byrum to shift the beneficial enjoyment of trust income between the present beneficiaries and the remaindermen, this ability was tantamount to the retention of the power to designate income beneficiaries and therefore warranted inclusion of the trust in Byrum's gross estate under section 2036(a)(2).[9] The Government contended that this ability was derived from Byrum's retained voting control over all three corporations, which enabled him to regulate the flow of dividends into the trust.[10]

The executrix of the estate, after paying the additional tax, brought a refund action in federal district court. The district court granted the executrix' motion for summary judgment,[11] and the Sixth Circuit Court of Appeals affirmed.[12] On certiorari, the Supreme Court HELD: (1) that Byrum did not have an unconstrained de facto power to regulate the flow of dividends to the trust, much less the right to designate who was to enjoy the income from the trust,[13] and

[6] Although some of the cases discussed in this article were decided under the predecessors of § 2036(a), the present statute for all practical purposes is identical to its predecessors. Int. Rev. Code of 1939, § 811(c)(1)(B); H.R.J. Res. 529, 71st Cong., 3d Sess., 74 Cong. Rec. 7198, 46 Stat. 1516 (1931), amending Int. Rev. Code of 1926, § 302(c). For simplicity's sake, references in this article will be to § 2036(a) even where the decisions discussed applied predecessors of the present statute.

[7] Int. Rev. Code of 1954, § 2036.

[8] 408 U.S. at 131.

[9] Id. at 131-32.

[10] Id. at 132. This power to regulate the flow of dividends accrued from Byrum's ability (1) to elect the corporate directors, and (2) theoretically, to dictate the dividend policy of the corporations.

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

[12] 440 F.2d 949 (6th Cir. 1971).

[13] 408 U.S. at 143.

therefore the trust was not includable in Byrum's gross estate under section 2036(a)(2); and (2) that Byrum's retention of voting control over the transferred stock did not constitute enjoyment of that stock within the meaning of section 2036(a)(1).[14]

The Supreme Court's decision is significant in that it limits the applicability of section 2036(a)(2). The Court, in defining the limits of section 2036(a)(2), compared the retention of control over management of the closely held corporation with the retention of broad management or administrative powers over a trust by a settlor. It relied upon a line of lower court decisions, handed down after passage of section 2036(a)(2), which held that retention of the latter powers does not necessarily require imposition of the estate tax on the trust.[15] The *Byrum* majority apparently determined that the two types of management powers—management of close corporations and management of trusts—although factually distinguishable, should be treated identically for purposes of section 2036(a)(2).[16] That is, just as a settlor can exercise administrative control over the trust through retention of the decision-making function of the trust's investment policy without subjecting the trust assets to the federal estate tax,[17] so, in the case of a trust whose corpus is composed of stock in a closely held corporation,[18] a settlor can retain control of management of the

[14] Id. at 150. This note will discuss only the first holding, since the significance of the *Byrum* decision centers on the majority's interpretation of § 2036(a)(2). The parameters of § 2036(a)(1) are clearly defined, both by the specific statutory language and by subsequent judicial history, to pertain to the retention by a settlor of a life estate or life income in the transferred property or to the use of the trust income to discharge an obligation of the settlor. See, e.g., Treas. Reg. § 20.2036-1(b)(2) (1960). Since Byrum clearly did not retain either of these rights either directly or indirectly, the majority correctly refused to apply § 2036(a)(1) to the Byrum trust.

[15] 408 U.S. at 133 & n.6. The Court went on to discuss Estate of Willard V. King, 37 T.C. 973 (1962), a leading decision in this line of cases. Id. at 134. The majority also cited Reinecke v. Northern Trust Co., 278 U.S. 339 (1929), for the proposition that "a settlor's retention of broad powers of management does not necessarily subject an *inter vivos* trust to the federal estate tax." Id. at 133. The *Northern Trust* decision preceded the passage of what is now § 2036(a), but the *Byrum* court stated that the proposition articulated in *Northern Trust* is still valid and applies equally when the management powers retained are powers of management over the corporations whose stock comprises the trust assets. Id. at 134. The Court's actual language was: "Essentially the power retained by Byrum is the same managerial power retained by the settlors in *Northern* and in *King*. Although neither case controls this one . . . the existence of such precedents carries weight." Id.

[16] Id.

[17] These types of administrative controls have been defined as "what are considered to be the normal powers granted to a trustee to permit him more effectively to administer a trust." Gray & Covey, State Street—A Case Study of Sections 2036(a)(2) and 2038, 15 Tax L. Rev. 75 n.2 (1959).

[18] The control of investment policy is one of three types of retained management powers important to § 2036(a) considerations. The other important management powers, for § 2036(a) purposes, are: (1) retention of a right to allocate trust income, and (2) retention of a right to exchange of trust assets. Id. In *Byrum*, the trustee alone had the right to allocate income; the trustee's right to exchange trust assets or to invest them was subject to Byrum's approval. Thus Byrum could not legally direct the trustee to make investments or exchange assets; rather Byrum was limited to approving or vetoing

corporation[19] without necessarily incurring the adverse estate tax consequences of section 2036(a)(2). After *Byrum* there may still be justification for applying section 2036(a)(2) to a trust in which a settlor's retained powers of management provide indirect but substantial and unlimited control over income designation,[20] but his retention of power to affect indirectly the amount of income which a particular beneficiary will receive, will not per se be sufficient to warrant the imposition of federal estate tax under section 2036(a)(2).[21]

This note will examine the Supreme Court's decision in *Byrum*, focusing on its interpretation of section 2036(a)(2). The decision will be analyzed in light of that section's legislative and judicial history. In addition, an attempt will be made to estimate the future ramifications of the decision in the area of trust formation. Finally, it will be submitted that in *Byrum* the majority reached a correct result under section 2036(a)(2); nevertheless, criticism will be offered concerning some of. the reasoning which the majority employed to reach that result.

Section 2036(a)(2) requires inclusion of a trust in the gross estate of the decedent when the decedent has retained "the right . . . to designate the person who shall possess or enjoy the property or income therefrom."[22] The Government sought to expand the parameters of the statute to reach situations in which a settlor retains voting control over a corporation and the stock of that corporation comprises the trust assets.[23] In such situations, the trust is dependent

recommendations of the trustee. The trustee, in turn, was limited in his recommendations by the fiduciary duty imposed generally on trustees.

19 Control over the investment policy of a trust which holds stock in a closely held corporation is less valuable than that over one which holds stock in a public corporation. Typically, the stock of a closely held corporation has little or no market value. See discussion in Galler v. Galler, 321 Ill. 2d 16, 27, 203 N.E.2d 577, 583-84 (1964). The ability to shift investments is more important where trust assets are highly liquid, e.g., marketable securities.

20 See text as notes 61-63 infra.

21 This conclusion follows from the express language of the *Byrum* court in rejecting control as per se grounds for imposing tax liability under § 2036(a). 408 U.S. at 138 n.13.

22 Int. Rev. Code of 1954, § 2036(a)(2). Section 2036(a) is quoted more completely in the text at note 7 supra.

23 This policy was expressly articulated in Rev. Rul. 67-54, 1967-1 Cum. Bull. 269, which states:

> The value of nonvoting corporate common stock transferred in trust is includable in the grantor's gross estate . . . where the grantor retained . . . a controlling interest in the corporate voting stock . . . and where . . . the trustee was restricted in any way in his power to dispose of the nonvoting stock . . . . Since the grantor retained the power to regulate the income from the transferred property, he retained . . . the right to designate the persons who shall possess or enjoy the property or the income therefrom.

The Ruling further concludes that if

> he also retains control over the disposition of the nonvoting stock . . . he has in fact made a transfer whereby he has retained for his life the right to designate

for income upon the dividends of the controlled corporation. Thus the settlor in his role of controlling shareholder may exercise considerable influence over the directors in formulating dividend policy and could affect indirectly the amount of income which would flow to the trust. The Government maintained that retention of corporate control was tantamount to retention of the legal right to designate income beneficiaries within the meaning of 2036(a)(2).[24] This note will submit that the majority was correct in declining to expand the scope of section 2036(a)(2), simply on the ground of Byrum's ability to affect indirectly the amount of income distributed to the beneficiaries at a particular time.

The legislative and judicial history of section 2036 provides some insight regarding the intended scope of subsection (a)(2). Section 2036 was enacted in 1931[25] in direct response to a number of Supreme Court decisions[26] that allowed settlors to create inter vivos trusts and retain for themselves life estates or a right to income without subjecting the trusts to subsequent imposition of an estate tax on the transferred property.[27] That the congressional intent underlying section 2036 was to override the effect of these decisions[28] is apparent

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> the persons who shall possess or enjoy the transferred property or the income therefrom.

Id. at 270.

24 408 U.S. at 132.

25 Act of Mar. 3, 1931, ch. 454, 46 Stat. 1516. The language of the present § 2036 is almost identical to that of the 1931 Act.

26 The first of these decisions was May v. Heiner, 281 U.S. 238 (1930), which was subsequently reaffirmed by three contemporaneous decisions: Burnet v. Northern Trust Co., 283 U.S. 782 (1931); Morsman v. Burnet, 283 U.S. 783 (1931); McCormick v. Burnet, 283 U.S. 784 (1931). Congress reacted quickly: a Joint Resolution, which contains substantially the same language as § 2036, was passed the day after the latter three cases were decided. H.R.J. Res. 529, 71st Cong., 3d Sess., 74 Cong. Rec. 7198, 46 Stat. 1516 (1931). The provisions of the Resolution were later incorporated in § 2036. See note 28 infra.

27 C. Lowndes & R. Kramer, Federal Estate and Gift Taxes 136 (2d ed. 1962): "[T]he obvious purpose of these sections [2036 and 2038] is to tax transfers where the transferor has not parted completely with the transferred property until his death." Thus, § 2036 taxes not the designation of beneficiaries but the *retention* of a right to designate beneficiaries.

28 Although the Joint Resolution that enacted the provisions later incorporated in § 2036 was passed one day after three of these decisions, see note 26 supra, apparently the Treasury had earlier anticipated an unfavorable ruling in the three on the basis of May v. Heiner, 281 U.S. 238 (1930). The Joint Resolution introduced by Rep. Hawley was accompanied by a memorandum from the Acting Secretary of the Treasury, Ogden Mills, in which he estimated that without corrective legislative action, the Supreme Court decisions of the previous day would "cause a loss in excess of one-third of the revenue derived from the Federal estate tax, with anticipated refunds of in excess of $25,000,000." 74 Cong. Rec. 7198 (1931). The actual legislation was initially drafted by the Treasury, reported on favorably by the House Committee on Ways and Means, and quickly ratified by the Congress. Id. at 7198-99. Congress in enacting the Resolution accepted the Treasury's view that the Supreme Court decisions of the previous day produced an undesirable result in the federal estate tax system. Thus, the Resolution—and hence § 2036—can best be viewed as a measure designed to counteract that unfavorable result.

from the words of one legislator explaining why the legislation had been introduced: "If a person . . . creates a trust of his property and provides that during his lifetime, he shall enjoy the benefits of it, . . . the Supreme Court held that it goes to his heir free of any estate tax . . . ."[29] It is readily apparent that subsection (a)(1) of section 2036 was designed to preclude a settlor from retaining a legal right to income from transferred property without incurring adverse estate tax consequences; and the courts have consistently given effect to that legislative design.[30] On the other hand, subsection (a)(2) of section 2036 was never specifically discussed in any of the relevant congressional reports, and its purpose is less evident. However, it has been surmised[31] that subsection (a)(2) was enacted in response to a particular type of trust arrangement which the Supreme Court had held not subject to estate tax in *McCormick v. Burnet*,[32] one of the decisions that, as noted above, prompted passage of section 2036. The terms of the trust in that case required the trustee to distribute income to such charities as the settlor would subsequently designate. Congress apparently determined that the settlor's retention of a right to designate without adverse tax consequences was as objectionable as retention of a right to income.[33] Also, Congress may have been fearful that failure specifically to tax retention of designation rights would result in the use of the "right to designate" to circumvent the estate taxation of retention of the right to income. What is clear, however, is that Congress was concerned only with the retention of a *legal right to designate* income and never considered the possibility of applying section 2036(a)(2) to retention of other rights and powers which only indirectly affect the amount of income a particular beneficiary would receive. It is submitted that the Government's attempt to expand the scope of section 2036(a)(2) in *Byrum* is contrary to this legislative intent. Viewed in its proper legislative context, section 2036(a)(2)

> was concerned only with taxing trusts over which a decedent retained a *specific* and *direct* right to designate who shall

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29 74 Cong. Rec. 7198 (1931) (remarks of Rep. Hawley).

30 See generally Estate of Spiegel v. Commissioner, 335 U.S. 701 (1949); Commissioner v. Estate of Church, 335 U.S. 632 (1949); Helvering v. Hallock, 309 U.S. 106 (1940). The provisions of § 2036(a)(1) are summarized in note 14 supra.

31 See, e.g., Gray & Covey, supra note 17, at 78-79.

32 283 U.S. 784 (1931). The factual description of the trust in *McCormick* is contained in the lower court opinion, Commissioner v. McCormick, 43 F.2d 277, 278 (7th Cir. 1930).

33 See text at note 34 infra. This interpretation of the intent behind § 2036(a)(2) is supported by C. Lowndes & R. Kramer, supra note 27, at 152-53:

> The obvious purpose of Section 2036(a)(2) is to equate the power to designate income or possession with the *direct* retention of income under Section 2036 (a)(1). Presumably, therefore, in order to incur a tax under Section 2036(a)(2), the decedent must have retained power to designate income or possession whose *direct* retention would have incurred the tax under Section 2036(a)(1). [Emphasis added.]

receive the "income," and no thought was given to the taxability of management powers which at best can only affect the "income" indirectly.[34]

Despite this limited purpose on the part of Congress, the major source of litigation concerning section 2036(a)(2) has been the question of the extent to which 2036(a)(2) circumscribes the retention of management powers over trusts, particularly the retention by the settlor of the discretionary right to determine whether to accumulate income or distribute it to the beneficiary.[35] Although it has been argued that section 2036(a)(2) was never meant to apply to the retention by a settlor of those management powers over a trust which are normally granted to a trustee,[36] the courts, nevertheless, have seen fit to require that whenever a settlor retains the legal right to determine whether to accumulate or distribute income, that right must be limited by ascertainable standards for distribution expressed in the trust agreement.[37] With one exception,[38] the courts have allowed settlors wide managerial discretion to determine investment policy and distribute income as long as the limiting standard imposed on their management powers is one which a court of equity could apply to insure that these powers were not used to shift income beneficiaries.[39] In *Byrum*, of course, the Court was faced with a different type of management power, the settlor's retention of managerial control of the corporation which in turn enabled him to exercise his business expertise to protect the value of his own holdings in the corporation and also the value of the trust's holdings in the corporation.

In *Byrum*, the Government based its argument, in part, on the 1966 Supreme Court decision, *United States v. O'Malley*,[40] in which the extent of permissible control over trust income was discussed. In *O'Malley* the settlor designated himself co-trustee and retained the *legal right* to determine, with the other trustees, whether to accumulate or distribute trust income. The issue in *O'Malley* was the taxability under section 2036(a)(2) of the income which the settlor, as co-trustee, in his discretion decided to accumulate in the trust,[41] rather

[34] Gray & Covey, supra note 17, at 79. See also note 33 supra.

[35] See, e.g., Old Colony Trust Co. v. United States, 423 F.2d 601 (1st Cir. 1970); Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947); Estate of Willard V. King, 37 T.C. 973 (1962); Estate of Milton J. Budlong, 7 T.C. 756 (1946).

[36] Gray & Covey, supra note 17, at 79.

[37] See, e.g., Old Colony Trust Co. v. United States, 423 F.2d 601 (1st Cir. 1970); United States v. Powell, 307 F.2d 821 (10th Cir. 1962).

[38] State Street Trust Co. v. United States, 263 F.2d 635 (1st Cir. 1959). *State Street* was severely questioned if not expressly overruled in Old Colony Trust Co. v. United States, 423 F.2d 601, 603 (1st Cir. 1970).

[39] The *Byrum* court expressly approved the reasoning of Estate of Willard V. King, 37 T.C. 973 (1962), which is representative of this line of decisions. 408 U.S. at 134. See also note 15 supra.

[40] 383 U.S. 627 (1966). This was the last case prior to *Byrum* which interpreted § 2036(a)(2).

[41] Id. at 630.

than distribute. The *O'Malley* Court held that when trust income is added to principal it becomes includable in the settlor's gross estate; this followed because the income, when added to principal, became subject to the legal right reserved by the settlor in the trust agreement to determine whether to accumulate or distribute further income.[42] This right was held to be equivalent to the right to designate beneficiaries of the trust in the sense that the settlor, by distributing the trust income or accumulating it in the trust, could confer the trust income on the present beneficiaries or alternatively defer it to the remaindermen. Since the settlor in *O'Malley* had in this manner reserved the right to designate beneficiaries, the trust was held to be includable in his gross estate under section 2036(a)(2). In *Byrum*, the Government argued that Byrum's ability to regulate the flow of income to the trust through his control of corporate dividend policy was tantamount to the settlor's right in *O'Malley* to designate income beneficiaries by virtue of his reserved right to distribute or accumulate trust income.

It is essential to distinguish between the varying uses of the terms "power" and "right" in *O'Malley* and *Byrum* because the distinction between the two terms is extremely important to the decision in *Byrum*. Section 2036(a)(2) expressly imposes estate taxation on the transferred property when the grantor retains a "right . . . to designate." In *O'Malley*, the settlor, who was also a trustee, retained a legally enforceable right to accumulate or distribute income without any limiting standard. The *O'Malley* Court determined that the retention of such a right fell within the scope of 2036(a)(2). However, the *O'Malley* Court used the terms "right" and "power" interchangeably to describe the nature of the ability of the settlor to designate income.[43] The Government in *Byrum* argued first that the *O'Malley* Court's use of the term "power" interchangeably with the term "right" warranted the application of section 2036(a)(2) whenever a settlor retains either the right or a power to designate income beneficiaries. Secondly, the Government asserted that Byrum, although not a trustee, retained a power to designate income beneficiaries because he could indirectly stop the flow of dividends to the trust by exercising his

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42 Id. at 633.

43 Id. at 631-32. Int. Rev. Code of 1954, § 2038, provides that:

> (a) The value of gross estate shall include the value of all property—(1) . . . [t]o the extent of any interest herein of which the decedent has at any time made a transfer . . . subject . . . to any change through the exercise of a *power* (in whatever capacity exercisable) by the decedent . . . to alter, amend, revoke or terminate. [Emphasis added.]

Justice White, who wrote the majority opinion in *O'Malley* and the dissenting opinion in *Byrum*, utilized cases decided under § 2038 to support the Government's assertion that § 2036(a)(2) applies to the Byrum trust. Note, however, that the language of the two sections differs: § 2036(a)(2) talks in terms of "retention of a right," while § 2038 is concerned with "exercise of power." It would appear that the different statutory language suggests that judicial interpretation of the term "power" in a § 2038 case is not determinative of the meaning of the term "right" under § 2036(a)(2).

majority control over the corporation. Thus the trust would have little or no income if such were Byrum's wish. In each year that dividends were withheld, the present beneficiary would be deprived of any opportunity to receive income. Earnings would be retained in the corporation rather than distributed as dividends, and the corporate stock would appreciate in value, providing a substantial benefit to the ultimate beneficiary of the trust. This, the Government argued, amounted to retention of the power to designate indirectly.[44]

The majority in *Byrum* rejected the Government's interpretation of section 2036(a)(2) by distinguishing between the terms "right" and "power," stating:

> It must be conceded that Byrum reserved no such "right" in the trust instrument or otherwise. The term "right," certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and legally enforceable power, such as that involved in *O'Malley*. Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to "regulate the flow of dividends" to the trust. That "right" was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term.[45]

The majority's distinction in *Byrum* effectively points up the qualitative difference between the retention of a legally enforceable right and retention of a legally unenforceable power. For instance, in *O'Malley* the settlor, as trustee, had the absolute legal right to deal with any trust income exactly as he wished. He had the right to determine during his lifetime who, as between the present beneficiary and remainderman, should receive trust income. In *Byrum* the settlor had no such legal right, since once income was paid to the trust, he had no legal control over the trustee's decision to accumulate or distribute that income.[46] All the settlor retained was the power to regulate the flow of dividends to the trust.

It is submitted that the "right-power" distinction is consistent with the limited role Congress initially intended for section 2036(a)(2).[47] The Government's position, which is essentially the same position taken by the *Byrum* dissent, would improperly expand the limited scope of section 2036(a)(2) to include all corporate control situations and could be used as a basis for future arguments that section 2036(a)(2) applies whenever a settlor retains any power *indirectly* to affect the flow of income which a particular beneficiary might receive.[48]

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[44] 408 U.S. at 132.

[45] Id. at 136-37 (footnotes omitted).

[46] See trust agreement, 408 U.S. at 127 n.1.

[47] See text at notes 30-34 supra.

[48] The Government unsuccessfully attempted this exact approach in Estate of Arthur

It should be emphasized, however, that the majority's "right-power" distinction is not wholly determinative of the estate taxation issue in *Byrum*. According to the majority, the retention of an unlimited legal right, as in *O'Malley*, requires the application of section 2036(a)(2); retention of an alleged power to designate, as in *Byrum*, requires further inquiry into the exact nature and scope of the power.[49] Accordingly, the majority next addressed itself to determining whether, despite its right-power distinction, the trust in *Byrum* was still includable in the settlor's gross estate. It appears from the Court's rationale that it adopted the premise that a decision to apply section 2036(a)(2) to the trust would have required an affirmative answer to two distinct questions. First, does a controlling shareholder actually have the power to dictate what the corporation's dividend will be? Secondly, assuming the controlling shareholder has that power, is such power equivalent to the right to designate income beneficiaries within the meaning of section 2036(a)(2)? The Court never reached this second question since it answered the first question negatively[50] and decided the case on the ground that the settlor in *Byrum* did not have the unrestrained power to determine dividends, much less the power to designate income beneficiaries.

The Court concluded that a majority shareholder in seeking to exercise control over dividend policy for the purposes of designating income beneficiaries would be subject to substantial legal and economic restraints.[51] The legal restraints emphasized by the majority were the fiduciary duties of the corporate directors which could be enforced either through a suit by the trustee on behalf of the trust or by the minority shareholders of all three corporations who were unrelated to Byrum. It is submitted, however, that an analysis of these restraints indicates that they may not be nearly so limiting as the majority suggested. In particular, the threat of a derivative suit by minority shareholders to compel the declaration of dividends may not be a realistic threat.[52] As one commentator has noted:

> The cases in which courts have refused to require declaration of dividends or larger dividends despite the existence of current earnings or a substantial surplus or both are nu-

C. Chalmers, 31 T.C.M. 792 (1972). In that case the settlor retained the right to change the securities in which the trust invested. The Government's assertion that such a right enabled the settlor to shift trust income and thus designate income beneficiary was rejected by the Tax Court, which cited *Byrum* as controlling. Id. at 794.

[49] 408 U.S. at 137.

[50] Id. at 143. The Court clearly indicated an assumption that had the answer been positive, it would have had to consider the second question. Id. at 144. The Court's actual language was: "We do not hold that a settlor 'may keep the power of income allocation' . . . we hold . . . that this settlor did not retain the power to allocate income within the meaning of the statute." Id. at 145 n.27.

[51] Id. at 139-42.

[52] See Gottfried v. Gottfried, 73 N.Y.S.2d 692 (Spec. T. 1947); contra, Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919).

> merous; plaintiffs have won only a small minority of these cases. . . . The courts have accepted the general defense of discretion, supplemented by one or more of a number of grounds put forward as reasons for not paying dividends, or larger dividends . . . .[53]

Thus the existence of a fiduciary duty to the corporation on the part of a director or a majority shareholder does not place strong limitations on the dividend decision. Similarly, the importance that the Court attached to the existence of unrelated minority shareholders with legal standing to enforce the directors' fiduciary duty[54] seems overstated in view of the fact that suits to compel dividends are rarely successful.

Nor does another factor on which the *Byrum* Court relied realistically provide the claimed restraint. Although the trustee is under a legal duty, as fiduciary,[55] to prosecute claims on behalf of the trust, it does not appear realistic to expect him to bring suit against an individual who has the power to remove him as trustee. It may not be unreasonable to speculate that the trustee in *Byrum* may also have had considerable business dealings with the corporations apart from his role as trustee,[56] and that a suit might seriously prejudice his position vis-à-vis the corporations. According to this speculation it would seem that the trustee's perception of his fiduciary duties might well be colored by his business relationship with Byrum's three corporations.

Similarly, general business vicissitudes which the majority regarded as providing economic restraints on the declaration of dividends would be important only in a case where the controlling shareholder was attempting to flood the trust with income.[57] It is true that if the goal of a settlor were to flood the trust with income through declaration of large dividends, business reversal arising from factors beyond his control could decrease income and would certainly limit his ability to flood the trust. However, this point seems relatively unimportant to the central issue, since in reality such a situation does not appear likely to provide a ground for application of section 2036(a)(2): that is, even if Byrum could have flooded the trust with income, he could not legally have compelled the trustee to distribute it since Byrum had unequivocably relinquished that right in the trust agreement.[58] In con-

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[53] W. Cary, Cases and Materials on Corporations 1587 (4th ed. 1969).

[54] 408 U.S. at 142. There were minority shareholders unrelated to Byrum in all three corporations. Id. at n.20.

[55] The Trust Agreement explicitly granted the trustee power "[t]o enforce . . . any claim or demand whatsoever arising out of or which may exist against the Trust Estate." Id. at n.22.

[56] For a discussion of the interrelationship of various departments within banks, see generally Herman & Safanda, The Commercial Bank Trust Department and the "Wall," 14 B.C. Ind. & Com. L. Rev. 21 (1972).

[57] This follows because Byrum's power to deny income through denial of dividends would be meaningless in a situation in which the corporations had no money to distribute.

[58] See Article IV of the Trust Agreement, 408 U.S. at 127 n.1.

trast, the Government's argument and the dissenting opinion in *Byrum* correctly emphasized that the power to designate income with which they were concerned was the power to *withhold* income. That is, the Government predicated the application of section 2036(a)(2) entirely on Byrum's alleged retained power to deprive the *present* beneficiary of income by pursuing a low-or-no dividend policy. It may be surmised that the Government necessarily recognized that Byrum could never designate in the other direction—that is, in favor of the present beneficiary—since he had relinquished the right to distribute income. Therefore the portion of the majority opinion focusing on the economic restraints which would limit large dividend declarations appears irrelevant to the issue of income designation in *Byrum*.

In fact, the only sanction which may compel the declaration of dividends is the possibility of the imposition of the excess profits tax.[59] However, the excess profits tax does not compel declaration of dividends, but, in effect, taxes the failure to do so. Thus the inducement to declare dividends is uncertain and indirect at best, especially in light of the fact that this tax does not apply if the corporation has legitimate business needs which require the retention of earnings.[60] Thus it is submitted that the limiting effect of these legal and economic restraints are more imagined than real.

Up to this point it has been suggested that the "right-power" distinction adopted by the *Byrum* court was the correct one since it properly limits the scope of section 2036(a)(2). Now it is further suggested that the majority relied on a fallacious premise when it sought to rest its decision on the existence of restraints on the settlor's power to maintain a low dividend policy, since such restraints may well be illusory. The *Byrum* court should have admitted the unlikelihood of these restraints functioning effectively and focused on the critical issue of this case: whether retention of an unlimited power to restrict dividends payable to the trust is equivalent to the right to designate income beneficiaries. However, by sidestepping that issue[61] and by expressly limiting the result to the situation in *Byrum*,[62] the majority has left the state of the law under section 2036(a)(2) somewhat confused. The possibility now exists that in a future case, supported by a record complete with detailed financial data, the result may be different.[63] An

59 Int. Rev. Code of 1954, §§ 531-37.

60 Int. Rev. Code of 1954, §§ 533, 534, 537 provide that the corporation can furnish evidence that the accumulation of surplus was necessary to meet a reasonable business need.

61 The majority may have relied on the rationale involving legal restraints on corporations in order to avoid criticism that the decision was one of form over substance, but the dissent raised exactly this criticism. 408 U.S. at 153. It is submitted that a decision relying on a literal, albeit narrow, interpretation of § 2036(a)(2) would be a more tenable one and would not represent a form over substance rationale.

62 408 U.S. at 144 n.25.

63 See id. at n.26, in which the majority discussed the lack of information in the record in the following manner:

[T]he fallacy in the dissenting opinion's position here is that the record simply opposite result might also occur if there are no minority shareholders or the corporation involved is wholly family-owned.

Although the Court overemphasized the importance of economic restraints on Byrum vis-à-vis the corporations, it is submitted that the result reached is a correct one. The intent of section 2036(a)(2) was to tax only those transfers in which the grantor retained a legally enforceable right to designate income beneficiaries. Neither specific statutory language nor the legislative context in which it was formulated provides authority in section 2036(a)(2) to tax a trust in which a settlor, seeking to retain control of a closely held corporation, also indirectly retained some power to effect the amount of income which a particular beneficiary might receive through his control over declarations of corporate dividends. Admittedly this restrictive interpretation of the statute would allow a settlor to retain control of a closely held corporation while transferring most of his stock to an inter vivos trust and thus avoid a substantial estate tax burden. Assuming this is so, the resolution of the problem, as the majority opinion indicated,[64] lies with Congress. In enacting any new legislation, Congress should consider the substantial liquidity problem which faces an estate whose wealth consists largely of individual shares of stock with little or no market value, as is usually the case in a closely held, family-owned corporation.[65] A trust similar to the one in *Byrum* provides a useful estate planning tool for easing a potentially crushing liquidity problem in such an estate.[66] A congressional limitation on the extent to which this tool could be utilized would serve to relieve the burdens of such an estate while simultaneously insuring that inheritances that Congressional policy intends to be taxed will not pass to a settlor's heirs tax free.

JOHN F. HURLEY, JR.

does not support it. This case was decided on a motion for summary judgment. The record does not disclose anything with respect to the earnings or financial conditions of these corporations. We simply do not know whether there were any earnings for the years in question, whether there was an earned surplus in any of the corporations, or whether—if some earnings be assumed—they were adequate in light of other corporate needs to justify dividend payments.

64 Id. at 135.

65 Id. at 149 n.34.

66 The Court appeared to have this factor in mind when it referred to the plight of the small closely held corporation at the time of the death of the principal shareholder. Id. The Court pointed out:

> The typical closely held corporation is small, has a checkered earning record, and has no market for its shares. Yet its shares often have substantial asset value. To prevent the crippling liquidity problem that would result from the imposition of estate taxes on such shares, the controlling shareholder's estate planning often includes an irrevocable trust. The Government and the dissenting opinion would deny to controlling shareholders the privilege of using this generally acceptable method of estate planning without adverse tax consequences. Yet a settlor whose wealth consisted of listed securities of corporations he did not control would be permitted the tax advantage of the irrevocable trust even though his more marketable assets present a far less serious liquidity problem.

Id.