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THE USE OF THE TRUST TO ESCAPE THE IMPOSITION OF FEDERAL INCOME AND ESTATE TAXES

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Throughout the history of the trust and its predecessor, the Use, an important employment of the trust device has been that of escaping burdens imposed by law.[1]

Income and estate taxes are not the least unpleasant of these. Naturally the trust, long a handy device for getting out of difficulties, has been and is being used for the purpose of avoiding these statutes. The purpose of this paper is to discuss the possibilities of the device with reference to federal income and estate taxes. Further, it is not the purpose to deal with illegal employment of the trust. If tax laws cover trusts and a secret trust is made in order to avoid the taxes, such a trust would seemingly be properly classified as illegal. This paper will deal with the open and aboveboard use of the trust in order to escape the imposition of the taxes. In other words, the grantor is seeking to avail "himself to the full of what the law permits."[2]

In connection with the subject of taxation it is frequently reiterated that "such statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the government and in favor of the taxpayer."[3] This has to an extent helped those seeking to escape tax burdens by means of the device. However, the practice of the Supreme Court of the United States is to construe the trust sections liberally and it is generally when the constitutionality of the measure is in question that the doctrine of strict construction is mentioned.[4] The attitude taken by the Vermont court in *In re Fulham's Estate*[5] seems justifiable and it is believed in reality represents the attitude of the Federal Court. It is set forth in the following language:[6]

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[1]For example see Scott, *The Trust as an Instrument of Law Reform* (1921) 31 YALE L. J. 457.

[2]Justice Holmes in Bullen v. State of Wisconsin, 240 U. S. 625, 36 Sup. Ct. 473 (1916).

[3]Gould v. Gould, 245 U. S. 151, 153, 38 Sup. Ct. 53, 54 (1917); U. S. v. Merriam, 263 U. S. 179, 188, 44 Sup. Ct. 69, 71 (1923); Reinecke v. Northern Trust Co., 278 U. S. 339, 349, 49 Sup. Ct. 123, 125 (1929).

[4]See cases *supra* note 3. Also *see* Irwin v. Gavitt, 268 U. S. 161, 166, 45 Sup. Ct. 475 (1925).

[5]96 Vermont 308, 314, 119 Atl. 433, 435 (1923).

[6]*Ibid.* For Supreme Court case see Bowers v. New York and Albany Lighterage Co., 273 U. S. 346, 47 Sup. Ct. 389 (1926).

> "It is quite generally held that taxing statutes are to be strictly construed against the taxing power, and this rule is applied to statutes providing for inheritance taxes. But the real meaning and purpose of the law giver is the thing to be sought after, and if fair and reasonable construction discloses it, it is to be given effect. Then, too, we must remember that the section under consideration is not the one that provides for taxing inheritances, direct or collateral, but the one intended to prevent evasion of such taxes. The very purpose of its enactment was to make it impossible to escape such taxes by transfers merely colorable or fictitious. The policy of such statutes—now in force in many of the states—is that the owner of property shall not evade the tax except by full and effective transfers made during his lifetime. *State Street Trust Company v. Stevens*, 209 Mass. 375, 95 N.E. 851. Surely such a statute should be carefully considered and liberally construed in favor of the taxing power (*In re Gordon*, 186 N.Y. 471, 79 N.E. 722, 10 L.R.A. (N.S.) 1089), lest its purpose be easily circumvented by designing persons. For a construction that would facilitate evasion should be avoided."

From an examination of the cases it is impossible to determine to what extent the trust has been used in order to evade taxes. They simply show that the parties are seeking to evade the tax by reason of the fact that there is a trust. It is equally impossible to determine to what extent the present popularity of the trust is due to the idea which prevails or has prevailed in the past that these two classes of taxes may be minimized or wholly escaped by means of it. The great growth of the trust to a certain extent coincident with the widespread imposition of these taxes[7] may shed a little light upon the question but even then there are many other factors that have to be taken into consideration. The fact that Congress has steadily closed the avenue of escape by means of the trust indicates, however, that the Revenue Department has been aware that incomes and estates were escaping taxes by that means. That the Treasury Department thinks that the trust is being deliberately used is shown by the statement of the changes made in the *Revenue Act of 1921 by the Treasury Draft and Reasons Therefore*,[8] in which appears the following: (1) "The creation of a revocable trust constitutes nothing but an assignment of the right to receive future income and the income of such a trust should be included in the income of the grantor;" (2) "Trusts have been used to evade taxes by means of provisions allowing the distribution of the income to the

[7]Smith, Trust Companies in the United States (1928) 373, says that trust deposits in trust companies had in the State of Pennsylvania alone increased from $496,000,000 in 1907 to $4,067,000,000 in 1927.

[8]Prepared by A. W. Gregg, subsequently Solicitor of Internal Revenue, at page 44.

grantor or its use for his benefit. The purpose of this sub-division of the draft is to stop this evasion." "The explanation of their purposes in the committee reports is substantially that quoted."[9]

No attempt will be made to show to what extent the suspicions of Congress and the Treasury are justified. The attempt will be to determine to what extent property already in trust may escape federal income and estates taxes and to what extent individuals as distinct from business trusts may escape these taxes by future creations.[10]

THE FEDERAL INCOME TAX ON PRIVATE INDIVIDUALS

There are at least three types of cases where it has been thought that the federal income tax of private individuals could be minimized or avoided by use of the trust.

1. The income could be minimized by avoiding the progressive rate of surtaxes in the following manner: A person who is spending, let us say, $50,000 a year on his family of five might declare himself a trustee of the property which is producing that income for the benefit of the five reserving to himself wide powers in the investment, management, etc. of the trust funds and the power to alter, amend, or revoke the trust. The tax payable upon the income of $10,000 each for the five beneficiaries would be less than on a lump income of $50,000, unless the whole is to be taxed to the trustee.

2. Property which has greatly appreciated in value, since it was first acquired could be put in trust for members of the family and then sold and so escape the tax on the great appreciation in value. In other words, shares of stock are acquired for $100,000, when they reach $300,000 they are put in trust by a father for his daughter. Six weeks later they are sold by the trustee for $325,000. The expectation was that the tax would fall on $25,000 appreciation and not on $225,000.

3. The funded insurance trust could be used to minimize the income tax and also to escape the inheritance tax in the following manner. The insured having made a policy payable to a beneficiary settles property on trust, with the provision that the income be used as far as necessary to pay the premiums on the policy and that on the settlor's death the principal of the trust fund and any accumulations be paid to the beneficiary. The insured reserves the right to change the beneficiary and also the right to alter, amend, or revoke the trust. It is clear that no income from this fund would be payable to the insured unless the trust were revoked.

[9]Magill, *The Taxation of Unrealized Income* (1925) 39 HARV. L. REV. 82, 98.

[10]The use of the trust in business enterprises to escape income as well as other corporation taxes furnishes ample material for a separate article.

The possibilities of minimizing the tax by avoiding progressive rate of surtaxes in the manner suggested in (1) appears by reason of additions to the Income Tax Act of 1913[11] and decisions thereunder to be very limited. Important additions were (g) and (h) to Section 219 of the Revenue Act of 1924[12] which read as follows:

> "(g) When 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.
>
> "(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."

Those sections have been substantially unchanged in subsequent acts.[13]

Granting that 219 (g) and (h) are constitutional, a certain minimizing is possible if the grantor is willing to reserve no beneficial interest in himself and no power to alter, amend, or revoke the trust except in conjunction with a beneficiary. By making himself trustee, of a trust for the support, education, etc. of his family with wide powers of management, as *Reinecke v. Northern Trust Company*[14] indicates is permissible, he may still continue to manage the property as of old. The income will be taxable to him now, however, as the fiduciary. In that event because of the relatively smaller income of the beneficiaries and the progressive rate of the surtaxes a minimizing will be accomplished.

Mr. Magill points out opportunities for circumventing those sections of the statute in the following extract:[15]

> "In the first place it will be noted that the effectiveness of these provisions is very much restricted by the requirement that the grantor possess the power alone or in conjunction with a person not a beneficiary of the trust. If the grantor is willing to

[11] 38 STAT. 166 *et seq.* (1913). [12] 43 STAT. 276, 277 (1924).

[13] 44 STAT. 34 (1926); 45 STAT. 840 (1928).

[14] Reinecke v. Northern Trust Co., *supra* note 3, at 346, 49 Sup. Ct. at 125.

[15] Magill, *loc. cit. supra* note 9.

exercise the power in conjunction with a beneficiary, that is if he can find any such person whom he can trust to join him in exercising the power as he may desire, he can completely circumvent the statutory provisions. Again, Treasury Regulations 65 provide in Article 347, that if the grantor relinquished the power of revocation during the taxable year, the income of the trust shall be taxable to him only for the period during which he had the power. A logical corollary of this proposition would be that if the grantor had the power for only part of the year, then the income should be taxable to him for only such part. So to hold, however, would be to fly in the face of the words of the subdivision. Finally, it would seem that the effect of subdivision (g) at least could be avoided by the creation of an irrevocable trust for a brief period, which would very possibly serve the same purpose as a trust with a power of revocation."

The same provisions appear in Treasury Regulations 74, Article 881. Professor Magill's remarks are still pertinent.

Mr. Magill points out that there is a reasonable doubt as to their constitutionality in the following:[15a]

"The final question is whether, assuming that the present provisions are not wholly effective, they are nevertheless valid. The subdivisions apparently apply to trusts created long before the passage of the act, when tax evasion could not have been considered. But even if the statute were applicable only to trusts created after its enactment, and was enacted solely to prevent escape from the tax, it is a commonplace that Congress cannot constitutionally designate some amount as income to an individual, unless it is such in the opinion of the Supreme Court. It may be granted, perhaps, that the income of a trust used to pay premiums on the grantor's life insurance policies may properly be taxed to the grantor, on the theories already discussed. In most cases, the fact would probably be that an obligation of the grantor was thereby being discharged. Again if the income of the trust is, at the grantor's orders, distributed to him or accumulated for future distribution to him there seems to be no difficulty in taxing it to him. But suppose that the grantor has a mere power to revest in himself title to a part of the *corpus* of the trust which he does not exercise; and that, accordingly, the income of that part of the trust is paid to X, pursuant to the terms of the trust deed. It is well settled that the validity of a trust is not affected by the fact that it contains a power of revocation. In the absence of an actual revocation, such a trust is enforceable by the beneficiary. Since revocable trusts were a well-recognized and perfectly legal device long before the adoption of the revenue acts, they can hardly be disregarded for tax purposes. The fact that a power is reserved by the grantor whereby he may revest in himself the income for 1926 and following years is scarcely a conclusive showing that the 1925 in-

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[15a] *Ibid.*

come, actually paid to X, pursuant to the deed, belongs to the grantor. Granted that the creator of the trust might have had the 1925 income himself had he so chosen, he did not so choose, and it is difficult to find a satisfactory theory for substituting the Congressional volition for his."

Since Mr. Magill's article was published the Supreme Court of the United States has treated the corpus of such a trust for the purpose of the Estate Tax as property of the grantors.[16] Due to the different nature of the estate tax and the income tax it does not necessarily follow that that court will treat the income actually paid over to the beneficiary as income of the trustor for income purposes. Such treatment seems justifiable, however. The District Court in the southern district of New York passed upon the question in *Corliss v. Bowers*.[17] It held that the sections were constitutional as to a tax which had been levied in the same year in which the statute was passed upon income which had been paid in that year to the beneficiary of a trust created prior to the act. The judgment was affirmed in the Circuit Court.[18] The plaintiff created the trust in 1922 making the income for life payable to his wife with remainders over for his children reserving control over investment and the power "to alter in any manner, or revoke in whole or in part." Income amounting to $124,352.97 was paid over to his wife in 1924 and plaintiff was assessed $44,687.43 in respect to it, which he paid under protest and sought to recover. The court granted the motion to dismiss the complaint. It relied upon the fact that the sections were designed to prevent evasions of the income tax laws. The pertinent section of the opinion in the lower court on this point reads as follows:[18a]

"It is abundantly clear from its legislative history that Congress passed the 1924 statute in order to prevent taxpayers from evading the surtaxes. The progressive rate is one of the vital features of the present system of income taxation. If income-producing estates could be parceled out among donees having incomes, in such a way that the donor paid no tax, although he retained full powers of control and recapture, the surtax would be deprived of efficacy, and the income tax thereby greatly limited, despite the fact that a tax at the basic rate would still be collectible."

It is submitted that the court is sound in its conclusion that Congress is within the limits of its power to "prevent evasion and give practical effect to the exercise of its admitted power." The same result should

[16]Reinecke v. Northern Trust Co., *supra* note 3.

[17]30 F. (2d) 135 (S. D. N. Y. 1929).

[18]34 F. (2d) 656 (C. C. A. 2d, 1929).

[18a]*Supra* note 17, at 136.

perhaps be reached when the power of revocation is reserved in conjunction with a trustee although here the grantor's power of control is not so unlimited.

It appears probable that the grantor can safely use the device suggested in (1) only when he is willing to forego the power of revocation except that he may reserve it in conjunction with a beneficiary.

The second suggested bit of evasion has been blocked by statutory provisions. The section now appears in the Revenue Act of 1928 in Section 113 as follows:

> "*Transfer in Trust after December 31, 1920.*—If the property was acquired after December 31, 1920, by a transfer in trust (either by a transfer in trust by a bequest or devise) the basis shall be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made . . . . "

The preceding section covering gifts is as follows:

> "*Gift after December 31, 1920.*—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift. If the facts necessary to determine such basis are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis shall be the fair market value of such property as found by the Commissioner as of the date or approximate date at which according to the best information that the Commissioner is able to obtain, such proOerty was acquired by such donor or last preceding owner."

In the absence of such provisions the grantor might deprive the government of revenue whenever property had considerably increased in value by transferring on trust for the benefit of members of his family or making an outright gift to them.

The Supreme Court in two cases[19] decided February 18, 1929, has sustained the validity of these provisions as applied to outright gifts, applying the Revenue Act of 1921, Section 202a,2.[20] The Court says in substance that the donor could not by giving to his daughter property worth $3000 which he had bought for $1000 deprive the sovereign of taxing the appreciation when actually severed and convert the entire property into a capital asset of the donee as though the latter had purchased at the market price. In truth the stock represented only

[19]Taft v. Bowers: Gilbert Greenway v. Bowers, 278 U. S. 470, 49 Sup. Ct. 199 (1929). [20]42 STAT. 227, 229, 237 (1921).

a single investment of capital, that made by the donor. "She accepted the gift with knowledge of the statute and voluntarily assumed the position of the donor. When she sold she got the original amount invested plus the entire appreciation and out of the latter was called on to pay only the tax demanded. Congress did not act arbitrarily in requiring the donee to take the donor's position." It would seem that the same result must be reached in the use of the trust for the same purpose. The same reasoning applies.

The chances of minimizing the income tax by means of the funded insurance trust, the third method, are slimmer than by the first method. That portion of 219h reading as follows:[21] "[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 purpose and in the manner specified in paragraph (10) of subdivision (a) of section 214)[22] such part of the income of the trust shall be included in computing the net income of the grantor"— expressly covers the attempted evasion or minimizing of the tax. What was said in regard to *Corliss v. Bowers*[23] is applicable here. Indeed, there is, if anything, less doubt about the constitutionality of this section since the insured is with this income discharging his own debt to the insurance company.[24] In accordance with the terminology of this portion the tax will lie even though the trust is irrevocable.

Attention might be called to what appeared to be a gap in the income tax law of 1913[25] by reason of which one who left property by will on trust the income to be paid to beneficiaries for life might avoid for the beneficiaries during their lives the tax on this income. Section II B provided that the net income should include "gains or profits and income derived from any source whatever, including the income from, but not the value of, property acquired by gift, bequest, devise, or descent." The contention was made in *Irwin v. Gavit*[26] that where property was transferred to a trustee and only the income was given to a beneficiary for a period which in the case would not exceed fifteen years, that the income itself was a bequest, and therefore not subject to the tax. The Supreme Court decided against the taxpayer on what seems the fair construction of the pertinent section of

[21] *Supra* note 12.
[22] The portion in parentheses refers to certain charitable purposes.
[23] *Supra* note 17. See discussion on page 589.
[24] For a contrary opinion see SHATTUCK, THE LIVING TRUST (1928) 78.
[25] 38 STAT. 114, 166 (1913).
[26] *Supra* note 4.

the act. Succeeding acts[27] have made it clearer that Congress did not intend that these trusts should escape the income tax.[28]

The possibilities of the use of the trust for escaping the operations of the Federal income tax except as to business organizations seem then limited to the narrow field set forth under the first type of cases mentioned. If the grantor is content to transfer the beneficial interest reserving no power of revocation other than the one in conjunction with a beneficiary he may by making himself trustee with wide powers of management, be able to use the income of the fund for his family's benefit in substantially the same way that he would if he were the unencumbered owner. Whether it would be fatal if he reserved the power of revocation in himself alone or in conjunction with the trustee is not definitely settled, though it seems probable. By leaving out the power of revocation entirely he can kill two birds with one stone, minimizing the income and escaping the federal estate tax as well, as we shall see later.[29]

FEDERAL ESTATE TAXES

One can by means of a trust *inter vivos* get that which corresponds closely to a testamentary disposition of property and yet such a disposition is not testamentary.[30] Even in conservative jurisdictions by the use of the trust a person ean, by reserving a life interest and the power to revoke the trust in whole or in part, keep the enjoyment and ultimate control of property during his life and it is not until his death that the equitable remainderman will come into the enjoyment of the property in any substantial sense. Such a trust will be valid and the instrument creating the trust will not have to comply with the statute of wills.[31] If estate or succession taxes could not be levied at the death of the grantor upon such trusts, it is evident that a great opportunity would be presented for avoiding these taxes.

The Supreme Court has called attention to a possible distinction in results between estate taxes and succession or inheritance taxes in *Saltonstall v. Saltonstall*,[32] indicating wider powers of taxation in the

[27]39 STAT. 756 (1916); 40 STAT. 300 (1917); 40 STAT. 1071 (1919); 42 STAT. 227 (1921); 43 STAT. 275 (1924).

[28]For two discussions of the case of Irwin v. Gavit, *supra* note 4, see (1923) 27 U. OF PA. L. REV. 413, 74 *ibid.* 182. [29]See *infra* pages 598, 599.

[30]Leaphart, *The Trust as a Substitute for a Will* (1930) 78 U. OF PA. L. REV. 626.

[31]Jones v. Old Colony Trust Co., 251 Mass. 309, 146 N. E. 716 (1925); Roche v. Brickley, 254 Mass. 584, 150 N. E. 866 (1926); Allen v. Hendrick, 104 Ore. 202, 206 Pac. 733 (1922). For the extent to which the grantor may go, see Leaphart, *op. cit. supra* note 30.

[32]276 U. S. 260, 48 Sup. Ct. 225 (1928).

case of the succession tax which was the form of the Massachusetts state tax involved in the case. The estate tax is a tax on the privilege of transmitting,[33] and the inheritance or succession tax upon the privilege of succession.[34] They are both taxes upon shifting of the legal interest at death.[35] It is doubtful whether much more can be done by means of the trust towards avoiding the estate tax than the succession tax. The possible difference will be discussed later.[36]

In considering how far estate taxes can be avoided by the use of the trust, the first question that presents itself is, if the grantor creates a trust reserving a life interest in himself, will the value of the property in trust be included in estimating the value of the gross estate of the grantor for purposes of the estate tax? In the absence of special provisions covering trusts it would seem not. The reservation of a life estate does not make the disposition testamentary.[37] Prior to 1924 the taxing authorities relied on the following provisions of the Revenue Act.[38]

> Sec. 402. "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—
>
> (c) To the extent of any interest therein of which the decedent has at any time made a transfer, or *with respect of which he has at any time created a trust, in contemplation of or intended to take effect in possession or enjoyment at or after his death* (whether such a transfer or trust is made or created before or after the passage of this Act). . . . "

From a strictly technical point of view it could be said that the estate took effect in possession and enjoyment at the time it was created.[39] In one very important respect, at least, the estate vests in enjoyment at the time of creation. The grantee can sell his interest immediately. This power is, of course, valuable, and is one of the rights of enjoyment of law as ordinarily understood.[40] The framers of the statute were, however, aiming at evasions—and "the retention

[33]Edwards v. Slocum, 264 U. S. 61, 44 Sup. Ct. 293 (1924); Y. M. C. A. v. Davis, 264 U. S. 47, 44 Sup. Ct. 291 (1924).

[34]Saltonstall v. Saltonstall, *supra* note 32.

[35]Knowlton v. Moore, 178 U. S. 41, 20 Sup. Ct. 747 (1900).

[36]*Infra* pages 602, 603.

[37]In addition to cases cited in SCOTT, CASES ON TRUSTS (1919) 215, n. 1, see McGillivray v. First Nat. Bank of Dickinson, 56 N. D. 152, 217 N. W. 150 (1928); Nat. Newark and Essex Banking Co. v. Rosahl, 97 N. J. Eq. 74, 128 Atl 586 (1925); Allen v. Hendrick, 104 Ore. 202, 206 Pac. 733 (1922).

[38]40 STAT. 1097 (1919). Italics are the writers.

[39]May v. Heiner, 25 F. (2d) 1004, 1005 (W. D. Pa. 1928).

[40](1916) 25 YALE L. J. 602.

by the grantor of a life interest in the property is so distinctly a characteristic of possession or enjoyment of an estate as to be convincing evidence of an intent that the grant or the deed of trust is not to take effect in enjoyment until the grantor's death.[41] One would expect the courts to consider these trusts within the statute. While the Supreme Court of the United States has not passed upon the question it has been the general view of the lower federal courts[42] that where the income for life is reserved for the grantor even though the grantor has not reserved the right to revoke the trust, the conveyance is one intended to take effect in possession and enjoyment at or after the death of the testator, and therefore is subject to the tax, and where part of the income is retained by the settlor for his life, the tax is imposed on a proportionate share.[43] State courts have reached the same conclusion with regard to similar provisions in state inheritance tax laws.[44]

In *Nichols v. Coolidge*[45] it appears in the statement of facts that Mr. and Mrs. Coolidge in 1907 transferred property on trust for themselves for life and on their death the property was to be distributed by their trustees among their children. In 1917 the grantors assigned their beneficial interest to their children. In 1921 Mrs. Coolidge died. The Commissioners of Internal Revenue decided that this property must be included in the gross estate of the decedent in order to determine the estate tax to be paid under the Revenue Act of 1919.[46] The executor having paid the tax on this basis was allowed to recover the excess payment. The Court was of the opinion that 402C[47] was intended to apply retroactively but that so applied it was unconstitutional. The Court's objection was that Congress was purporting in this act to levy a tax on the privilege of transmission; that measuring the tax by including the value of property gratuitously

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[41](1926) 75 U. OF PA. L. REV. 168, 170.

[42]Reed v. Howbert, 8 F. (2d) 641 (D. Colo. 1925); McCaughn v. Girard Trust Co., 11 F. (2d) 520, (C. C. A. 3rd, 1926); Bradley v. Nichols, 13 F. (2d) 857 (D. Mass. 1926); May v. Heiner, *supra* note 39.

[43]Bradley v. Nichols, *supra* note 42; Tips v. Bass, 21 F. (2d) 460 (W. D. Tex. 1927).

[44](1926) 75 U. OF PA. L. REV. 168 and following cited cases: Moore v. Bugbee, 3 N. J. Misc. 435, 128 Atl. 679 (1925); People v. Taverner, 300 Ill. 373, 133 N. E. 211 (1921). In the Matter of Green, 153 N. Y. 223, 47 N. E. 292 (1897). In the Matter of Cornell, 170 N. Y. 423, 63 N. E. 445 (1902); Dubois' Appeal, 121 Pa. 368, 15 Atl. 641 (1889); *In re* Dobson's Estate, 73 Misc. 170, 132 N. Y. Supp. 472 (Surr. Ct. 1911); *In re* Todd's Estate, 237 Pa. 466, 85 Atl. 845 (1912).

[45]274 U. S. 531, 47 Sup. Ct. 710 (1927). See Frew v. Bowers, 12 F. (2d) 625 (C. C. A. 2d, 1926).

[46]*Supra* note 38. [47]40 STAT. 1057, 1096 (1919).

transferred long prior to the act, when there could be no question of an attempted evasion of the act, was arbitrary, whimsical, and capricious, and therefore violated the Fifth Amendment. The Court was especially disturbed by the fact that a tax so levied might take all the property actually transmitted at death and that the valuation of the gift was to be made not at the time of the transfer but at the time of death, when its value might have increased many fold. The fact that at the time of the creation of the trust the conveyance was intended to take effect in possession or enjoyment at or after the grantor's death was not sufficient to make the tax valid. There was no question of an attempt at evasion of estate taxes as the trust was prior to the statute. The Court leaves unsettled the question whether the tax is constitutional with respect to transfers made subsequent to the statute in case a beneficial life interest is retained by the grantor and no power of revocation is reserved. There is nothing in this case which would intimate that the provision would not be constitutional as to trusts created subsequent to the statute, and one may venture to suggest that the Supreme Court will follow the view generally taken and hold such a trust should be included in the estate of the grantor for purposes of the tax.

The next question is if the grantor reserves a power to alter, amend, or revoke the trust will the trust property be included? When the grantor reserves the power to himself alone the question has been settled. It does not matter whether he has reserved a beneficial interest in himself or not. Construing 402 C of the Act of 1921, previously noted, which is silent as to powers of revocation, the Supreme Court in a recent case[48] held that where property has been transferred during the life of the grantor and the power to alter, amend, or revoke, has been reserved to him, that property is to be included in the grantor's estate for the purpose of estimating the estate tax, although the grantor has left the power unexercised. The Court further held that under the clause "whether such transfer or trust is made or created prior to or after the passage of the act,"[49] trusts created prior to 1921 in which the grantor reserved the right of revocation were to be included in the gross estate of the grantor for taxing purposes. The Court based its decision on the ground that a "transfer made subject to a power of revocation in the transferrer terminable at his death is not complete until his death." Since the death occurred after the passage of the Act the provision was not as to such a case retroactive. This set at rest any doubts as to the constitutionality of prevailing provisions with

[48]Reinecke v. Northern Trust Co., *supra* note 3.
[49]42 STAT. 227 (1921).

respect to trusts created prior thereto in which the right of revocation is reserved to the grantor alone.

Suppose next that the grantor reserves a right to alter, amend, or revoke the trust in conjunction with a trustee or in conjunction with a beneficiary. *Saltonstall v. Saltonstall,*[50] a case having to do with a Massachusetts inheritance or succession tax is of importance in connection with this question. The trust involved was created on various dates between 1905 and 1907. It contained a power of revocation to be exercised by the grantor in conjunction with one trustee. At the time of its creation such a trust was not subject to the tax. The Massachusetts Supreme Court[51] construed the statute in effect at the grantor's death to apply to such a case and sustained the validity of the tax which had been levied. On error to the Supreme Court of Massachusetts the United States Supreme Court decided that the tax did not violate the due process clause of the Fourteenth Amendment. The court called attention to a difference between the case before it and the case of *Nichols v. Coolidge,*[52] in that in the latter the matter of a tax upon the privilege of transmitting was involved, while in the former the tax was a succession tax. In respect to the succession tax the Court says:[53]

> "So long as the privilege of succession has not been fully exercised it may be reached by the tax. . . . And in determining whether it has been so exercised technical distinctions between vested remainders and other interests are of little avail, for the shifting of the economic benefits and burdens of property which is the subject of a succession tax may even in the case of a vested remainder be restricted or suspended by other legal devices. A power of appointment reserved by the donor leaves the transfer as to him, incomplete and subject to the tax."

While it is clear from this case that state succession taxes may be levied on transfers in trust when the power of revocation is reserved to the grantor in conjunction with a trustee as to trusts created prior to as well as subsequent to the enactment of a statute which contains retroactive provisions, the same is not necessarily true as to the federal transfer or estate tax. The Court indicates a possible difference in the treatment in the following language:[54]

> "But we are here concerned, not with a tax on the privilege of transmission, not with an attempt to tax a donor's estate

[50]*Supra* note 32.

[51]Saltonstall v. Treasurer and Receiver General, 256 Mass. 519, 153 N. E. 4 (1926).

[52]*Supra* note 45.

[53]Saltonstall v. Saltonstall, *supra* note 32, at 271, 48 Sup. Ct. at 227.

[54]*Ibid.*

for an absolute gift made when no tax was thought of, and to do so at the probably appreciated value which the gift now bears, but with a tax on the privilege of succession, which also may constitutionally be subjected to a tax by the state whether occasioned by death, *Stebbins v. Riley*, *supra*, or effected by deed, *Keeney v. Comptroller*, 222 U.S. 525 [32 Sup. Ct. 105 (1912), 38 L.R.A. (N.S.) 1139]; *Chanler v. Kelsey*, *supra*; *Nickel v. Cole*, *supra*. The present tax is not laid on the donor, but on the beneficiary; the gift taxed is not one long since completed, but one which never passed to the beneficiaries beyond recall until the death of the donor; and the value of the gift at that operative moment, rather than at some later date is the basis of the tax."

In the present revenue acts, 302 takes the place of 402 of prior acts. 302d, the substance of which dates from 1924,[55] expressly covers trusts created in the past in which the power is reserved to the grantor alone or in conjunction with any one in the following language:

"(d) To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power in contemplation of his death, except in case of a bona fide sale for an adequate and full consideration in money or money's worth."

The courts have not yet passed upon the question whether this provision is constitutional.

In *Farmers Loan and Trust Co. v. Bowers*,[56] the court refused to apply 402C of the Act of 1919[57] to a trust created in 1916 and modified in 1919 to the extent of rearranging the shares of beneficiaries. In this trust the grantor had reserved the right to alter, amend, and revoke with the consent of the trustee and had further reserved the right, as the court below[58] points out, to remove the trustee. The court below stressed this point and stated that there was no probability of the trustee withholding his consent and if he did the grantor could remove him and get one who would consent.[59] Such being the case, that court felt that the case should be treated as though the grantor had reserved the right in himself to revoke the trust and held that the value of trust property should be included in estimating the estate tax of the grantor's estate. The Circuit Court decided other-

[55]43 STAT. 304 (1925).
[56]29 F. (2d) 14 (C. C. A. 2d, 1928).
[57]40 STAT. 1097 (1919).
[58]15 F. (2d) 706 (S. D. N. Y. 1926).
[59]*Ibid.* 710.

wise, laying much stress on *Nichols v. Coolidge.*[60] In the light of the decisions in *Reinecke v. Northern Trust Company*[61] and *Chase National Bank v. United States*[62] which were decided subsequent to this case, one is inclined to conjecture that the District Court's rather than the Circuit Court's position will be sustained. There was a real power of control here up until the death of the grantor. The following language of the court in the *Chase National Bank* case seems applicable: "Termination of the power of control at the time of death inures to the benefit of him who owns the property subject to the power and thus brings about, at death, the completion of that shifting of the economic benefits of property which is the real subject of the tax." Carrying those cases to their logical conclusion the tax should be sustained.

In four of the trusts involved in *Reinecke v. Northern Trust Company*[63] life estates were given terminable five years after the death of the grantor, or on the death of respective life tenants, whichever should happen first—remainder over to others. The testator reserved the right "to alter, change or modify the trust," acting jointly with the beneficiaries. The grantor also reserved the right to supervise investments and others powers of management. The Court held in this case that the economic interest had shifted and that the reserved powers did not serve to distinguish these trusts from any other gift *inter vivos* not subject to the tax. Stating that there was no explicit language compelling the tax, the Court applied the principle that doubt should be resolved in favor of the tax payer. It remains to be seen whether the Court will treat the estate tax with its present express provisions as it did the Massachusett's succession tax in *Saltonstall v. Saltonstall.*[64]

There may be a difference in result between the case where the grantor reserves the right to revoke in conjunction with a trustee and where in conjunction with the beneficiary. In the latter case there is nothing if the beneficiary so desires which will keep the property from coming to him, and the language of *Reinecke v. Northern Trust Company* would seem to apply:[65]

> "Since the power to revoke or alter was dependent on the consent of the one entitled to the beneficial and consequently adverse, interest, the trust, for all practical purposes, had passed as completely from any control by decedent which might inure to his own benefit as if the gift had been absolute.

[60]*Supra* note 45. [61]*Supra* note 3.
[62]278 U. S. 327, 49 Sup. Ct. 126 (1929).
[63]*Supra* note 3. [64]*Supra* note 32.
[65]*Supra* note 3, at 346, 49 Sup. Ct. at 125.

> "Nor did the reserved powers of management of the trust save the decedent of any control over the economic benefits or the enjoyment of the property. He would equally have reserved all these powers and others had he made himself the trustee, but the transfer would not for that reason have been incomplete. The shifting of the economic interest in the trust property which was the subject of the tax was thus complete as soon as the trust was made. His power to recall the property and of control over it for his own benefit then ceased and as the trusts were not made in contemplation of death, the reserved powers do not serve to distinguish them from any other gift *inter vivos* not subject to the tax."

With respect to a gift *inter vivos* the Supreme Court has recently decided in *Untermeyer v. Anderson*[66] that a tax paid under protest which was levied upon a gift made before the passage of the act, but made after it was certain that the act would pass, could be recovered. The majority reasoned that although the act of Congress so provided, yet applied retroactively, it violated the due process clause of the Fifth Amendment. The minority were of the opinion that the act did not apply. Brandeis strongly dissented. Justices Stone and Holmes concurring to the view that if the act applied it would be constitutional, pointed out that the view of the majority is a departure from the view of the Supreme Court, settled for half a century, that a tax is not bad simply because it is retroactive. From the previously quoted language of the *Reinecke* case and the views of the majority in the *Untermeyer* case one might justifiably expect that as to trusts created prior to the act of 1924 in which the right to revoke, etc. rests in the grantor in conjunction with the beneficiaries, the tax would be held invalid.

Where the power of revocation is reserved to the grantor in conjunction with a trustee the adverse interest is not necessarily present and the economic interest has not so completely passed. We have previously noted[67] that in *Saltonstall v. Saltonstall*[68] the United States Supreme Court upheld the constitutionality of a Massachusetts succession tax applied to a trust created before the passage of legislation upon the subject in which the grantor reserved the power to revoke in conjunction with the trustee.

There is a difference between a succession tax and an estate tax. The succession tax is levied on the privilege of succession.[69] From the point of the successor whether he shall enjoy depends on the joint will

[66]276 U. S. 440, 48 Sup. Ct. 353 (1928). See also Blodgett v. Holden, 275 U. S. 142, 48 Sup. Ct. 105 (1927).

[67]*Supra* page 601.

[68]*Supra* note 32.

[69]*Supra* note 34.

of grantor and trustee. The death of the grantor not having joined with the trustee in a revocation will serve to fix his rights. The estate tax is levied on the privilege of transmission.[70] Looking at the matter, however, from the point of view of taxing the grantor's estate for the privilege of transmitting, where the grantor has reserved no right to remove the trustee, if his trustee is unwilling to join in a revocation, he may have lost control of the property at the time of the creation of the trust. It is possible for the Court to hold that *Saltonstall v. Saltonstall*[71] does not apply and reach the result that has just been suggested might be reached in the case where the power is reserved in conjunction with the beneficiary. The distinction, however, seems without substantial merit and it is believed that the *Saltonstall* case should be followed. Certainly where the power to remove the trustee is reserved the grantor's power is now in its essence as great as if it were reserved to himself alone and the property should be subject to the tax.

As to trusts created subsequent to 302d, there is still some question as to the constitutionality of the purported tax when the right of revocation is reserved in conjunction with a beneficiary. While the Court in *Reinecke v. Northern Trust Company* [72] did say in regard to such a situation:

> "The shifting of the economic interest which was the subject of the tax was then complete as soon as the trust was made.... the reserved powers do not serve to distinguish them from *any other gift inter vivos not* subject to the tax."

Yet Congress may if it chooses tax other sorts of gifts *inter vivos*. The District Court for the Southern District of New York in *McNair v. Anderson*[73] held such a tax a direct tax and invalid under Article 1, paragraph 2, clause 3, for want of apportionment. The District Court of the Western District of Michigan in *Blodgett v. Holden*[74] took the opposite view of a tax levied under the same act[75] which was repealed in 1926.[76] *Blodgett v. Holden* went up to the Supreme Court of the United States on certificate by the United States Circuit Court of Appeals for the Sixth Circuit. The Supreme Court[77] held that the plaintiff was entitled to recover the tax on the ground that the gift had been made prior to the passage of the statute. Four of the eight judges sitting considered that the act was not intended to be re-

[70]*Supra* note 33. [71]*Supra* note 32.

[72]*Supra* note 3, at 346, 49 Sup. Ct. at 125. Italics are the writers.

[73]10 F. (2d) 813 (S. D. N. Y. 1926).

[74]11 F. (2d) 180 (W. D. Mich. 1926).

[75]43 STAT. 313 (1924). [76]44 STAT. 125 (1926).

[77]Blodgett v. Holden, *supra* note 66.

'troactive. The other four thought that it was but that so applied it was unconstitutional. We have already noted the views taken in *Untermeyer v. Anderson.*[78] The intimation was that the tax was not a direct tax and therefore not invalid for that reason. In *Bromley v. McCaughn*[79] the question was squarely presented and the court decided that a gift made subsequent to the act was not invalid as a direct tax not apportioned.[80] Subsequently created trusts of this type would seem then to be taxable provided the tax were properly assessed.

The question remains could Congress measure the tax by the value of the property at the time of the death of the grantor? In *Nichols v. Coolidge*[81] we have seen that the Court held that 402C of the Act of 1919 was unconstitutional as to an irrevocable trust created prior to the passage of the act as being arbitrary and capricious and thus depriving persons of property without due process of law. The Court laid much stress on the fact that a small gift made years before with no intent to evade the statutes might have so increased in value that including the value of that property in that of the grantor for purposes of determining the tax, might leave nothing in the estate for distribution. The same thing might, of course, be true in regard to such trusts as we are considering created subsequent to the Act. However, in such a case the donor has warning of what may happen to his estate. Will that make it less arbitrary? If the transaction was an absolute completed gift holding up the time of assessing the tax until the donor's death and estimating the tax which the estate would have to pay on the value of that property at that time might still seem to be arbitrary, capricious, and unreasonable. Since Congress has seen fit to repeal the tax on gifts *inter vivos* it seems that the reason for the provisions in question is largely, if not entirely, the prevention of evasion of the estate tax. The time for measuring it would naturally be at the death of the grantor. Further, since the power to revoke, alter, or amend might be surrendered by the grantor at any time, it is not until death that we can determine whether the tax will be due. For these reasons and in view of the Court's reluctance to declare a tax even when retroactive [82] unconstitutional, it seems altogether probable that as to all trusts created subsequent to the passage of 302d in which any power of revocation is reserved, the tax will be upheld.

The grantor, however, may make some reservations. He may re-

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[78]*Supra* note 66. [79]280 U. S. 124, 50 Sup. Ct. 46 (1929).

[80]The arguments for and against are set forth in (1926) 74 U. OF PA. L. REV. 836. See also (1926) 39 HARV. L. REV. 888. [81]*Supra* note 45.

[82]See the opinion of Justice Brandeis in Untermeyer v. Anderson, *supra* note 66.

serve powers of management or may make himself the trustee in which event he will have such powers. To that effect is the previously quoted language from *Reinecke v. Northern Trust Company:*[83]

> "Nor did the reserved powers of management of the trusts save the decedent any control over the economic benefits of the enjoyment of the property. He would equally have reserved all these powers and others had he made himself the trustee, but the transfer would not for that reason have been incomplete. The shifting of the economic interest in the trust proper which was the subject of the tax was thus complete as soon as the trust was made."

Suppose a trust is made in which the grantor reserves to himself no life estate and no power to alter or amend, but in which an estate is vested in the beneficiary or beneficiaries which they will not or may not enjoy in the lay sense of the term until the death of the grantor. Will such a trust be included in the estate of the grantor for the purpose of the estate tax?

In *Shukert v. Allen*[84] the Court held that trusts in which there was an accumulation for thirty years, the grantor reserving no interest in himself and no power of revocation, were not subject to the tax although the beneficiary did come into enjoyment in the lay sense of the term after the grantor's death. The government was unsuccessful in its contention "that the trust is in substance and effect testamentary, because it postpones the ordinary incidents of ownership until the donor's death."[85] In this case, however, the period was not fixed with reference to the donor's death, although it probably would not take place until after the death of the donor. In *Reinecke v. Northern Trust Company*[86] in some of the trusts under consideration beneficial interests were given to certain life tenants which were terminable five years after the death of the grantor or on the death of the life tenants, whichever happened first, remainder over. The Court then had to pass squarely upon the question whether the tax was collectible when the passage of the possession or enjoyment of the trust fund was fixed at a time at or after the death of the grantor. The Court held that in the absence of plain and compelling language a trust *inter vivos* in which the power to revoke was reserved in conjunction with the beneficiary and in which the grantor retained no interest would not be subject to the estate tax because the gift takes the form of a life estate in one with remainder over at or after the donor's death.[87]

[83] *Supra* note 3, at 346, 49 Sup. Ct. at 125.
[84] 273 U. S. 545, 47 Sup. Ct. 461 (1927).
[85] *Ibid.* 546, 47 Sup. Ct. at 461.
[86] *Supra* note 3.
[87] *Supra* note 3, at 346, 49 Sup. Ct. at 125.

There remains at least one other important question. If the grantor arranges the trust so that the property shall be the grantor's in case the beneficiaries predecease him, shall the property be included in the gross estate of the grantor for the purpose of the estate tax, though the beneficiaries do not predecease the grantor? In *Nichols v. Bradley*[88] the grantor created a trust, one-half the income of which was to be paid to the grantor's daughters and their issue, and if the grantor predeceased them, the trust was to continue twenty years after the death of the last surviving daughter when the corpus was to be distributed among the issue, but if all the daughters died without issue during the grantor's life, then the income to the grantor for life, remainder over. The daughter survived the grantor. The court held that this trust should not be included in computing the tax. A similar result was reached in *In re Schweinert's Estate*[89] in connection with the New York Transfer tax. The grantor of the trust provided that the income should be paid to A for life and on the death of the grantor the principal to A, but if A predeceased the grantor then to the grantor absolutely. A survived the grantor. It remains to be seen what view the United States Supreme Court will take of such trusts. Will *Shukert v. Allen* and *Reinecke v. Northern Trust Company* be extended to cover them? In the *Shukert* and *Reinecke* cases the estate vested at the time of the creation of the trust and there was no question of a reversion. In *Nichols v. Bradley* and in *In re Schweinert's Estate* whether the beneficiaries got anything more than a life income depended on whether they survived the grantor. Since whether the beneficiaries in such trusts shall get anything more than the income for life is contingent on whether they outlive the grantor, it is certainly questionable whether as far as the corpus is concerned the trusts are not intended to take effect in possession and enjoyment at or after the death of the grantor. In *In re Dunlap's Estate*[90] the court took the view that it was so intended where the grantor having made no express provisions for the emergency there was a possibility of a reversion on the contingency of the death of all the grantor's daughters without issue during his life. A result contrary to *Nichols v. Bradley* seems quite possible. The creator of a

[88] 27 F. (2d) 47 (C. C. A. 5th, 1928).

[89] 133 Misc. 762, 234 N. Y. Supp. 307 (Surr. Ct. 1929). See also *In re* Kirby, 133 Misc. 152, 231 N. Y. Supp. 408 (Surr. Ct. 1928), and *In re* Bowers, 195 App. Div. 548, 186 N. Y. Supp. 912 (1st Dept. 1921), *aff'd*, 231 N. Y. 613, 132 N. E. 910 (1921).

[90] 205 App. Div. 128, 199 N. Y. Supp. 147 (1st Dept. 1923). See a note in (1929) 43 HARV. L. REV. 143, approving the decision in the Matter of Schweinert.

trust who retains even that slight hold upon the property takes a chance that the trust will not escape the estate tax.

There has also been a question as to whether one might not by means of the funded insurance trust escape federal estate taxes. Can the grantor set up a trust providing that the income shall be used to pay the premiums on a policy of insurance in favor of a named beneficiary and reserving the right to change the beneficiary and to alter, amend, or revoke the trust? There seems no more possibilities in the device than in the case of ordinary trusts. *Chase National Bank v. United States,*[91] a companion case to *Reinecke v. Northern Trust Company,* upheld the government's contention that, where the insured reserved the right to change the beneficiary, the proceeds of the policies in excess of $40,000 were subject to the estate tax, in the following pertinent language:[91a]

> "Such outstanding power residing exclusively in a donor to recall a gift after it is made is a limitation on the gift which makes it incomplete as to the donor as well as to the donee, and we think the termination of such a power at death may also be the appropriate subject of a tax upon transfers. . . . Termination of the power of control at the time of death inures to the benefit of him who owns the property subject to the power and thus brings about at death, the *completion* of that shifting of the economic benefits of property which is the real subject of the tax."

In summary, when the grantor reserves a life estate, it seems probable that the property in trust will be included in the gross estate of the grantor for the purpose of the Federal Estate Tax. When the grantor reserves a power of revocation in himself alone, it undoubtedly will be included. And this is true as to all past trust creations, including funded insurance trusts. Where the power has been reserved to the grantor and the trustee or beneficiary in a trust created prior to 1924, the matter is still in doubt, especially in the latter case. As to future creations in such a case there is also a doubt with less reason however, to hope for successful escape from the tax. When the grantor has reserved no present beneficial interest in the property and no powers of revocation, the fact that the beneficiary is to come into possession in the lay sense at or after his death will not render the trust property subject to the provisions of the statute. The Supreme Court in *May v. Heiner*[91b] held that the value of property

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[91]*Supra* note 62.

[91a]*Supra* note 62, at 336, 49 Sup. Ct. at 128. Italics are the writers.

[91b]50 Sup. Ct. 286 (1930), reversing May v. Heiner, 32 F. (2d) 1017 (C. C. A. 3rd, 1929).

in trust to A for life, then to the grantor for life, remainder over, was improperly included, citing *Reinecke v. Northern Trust* Co.[91c], without adverting to the fact that in that case the grantor had parted with all the beneficial interest in the property. It therefore appears possible to create a trust in the property in which the grantor may enjoy the income for life, remainder over, and escape the imposition of the tax.

There is left a limited field for evasion when the grantor retains no beneficial interest in himself and no powers of revocation. Whether his retention of a reversionary interest, in case the beneficiary of the trust dies during his lifetime, will make the trust taxable is unsettled. If the grantor is willing to give up all beneficial interest as well as the right to revoke, alter, or amend, by making himself the trustee with wide powers of management of the trust, which we have noted *Reinecke v. Northern Trust Company*[92] indicates is possible, he may manage his property as before, and on his death the property, free of the trust, will be in the hands of his beneficiaries, and will not be included in the valuation of his estate for the purpose of the tax. In addition as has been pointed out he may in this way minimize his income taxes as well.[93]

[91c]*Supra* note 14.
[92]*Supra* note 3.
[93]*Supra* page 589.